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New role of Russian enterprises in international business

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New role of Russian enterprises in international business[1]

Edited by Valtteri Kaartemo

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Foreword

Russia's economy and her external economic relations have rapidly increased since the disintegration of the USSR. The Russian exports have expanded by 4–5 times since the mid-1990s. The investment expansion has been even faster than the export growth, i.e. the Russian outward foreign direct investment stock has multiplied by some 30-fold during the past 12 years.

The rapid internationalisation of the Russian enterprises has started a new era in international business, i.e. the capital expansion from emerging economies. It is obvious that the Chinese business expansion abroad will also gain momentum in a dragon scale sooner or later. The early signs are already visible.

In order to better predict the consequences of this new epoch, the main objective of this research project was to analyse, what kind of role the Russian enterprises obtain through their internationalisation. This report also reveals the other side of the coin, i.e. the impact of the FDI inflows on Russia's industrial restructuring, regional development and the competitiveness of the Russian firms.

This publication is a tip of an intellectual iceberg, which has gained weight since the year 2004, when the project was begun. In other words, this report contains a selected contribution of each individual involved in the project. As it would have been impossible to include all the studies carried out, a list of publications conducted during this project has been attached in the end of the book.

Unlike the real icebergs, this intellectual iceberg is not melting despite the fact that this project is finished by the end of this year. The research team aims at continuing research on the internationalisation from the emerging economies via other research projects of the Pan-European Institute (PEI). In order to guarantee the continuity of this project, the internationalisation from emerging economies has been selected as one of the core research areas of the PEI.

Conducting academic research is a rather expensive exercise, and the results obtained in the framework of this project could not have been reached without the generous funding from the Academy of Finland. Therefore, I want to express my sincere gratitude on the behalf of the whole research team to the Academy. This is an appropriate moment to thank also the researchers involved in this four-year-exercise. Without their personal dedication to research we would not have witnessed the dawn of two new doctoral dissertations, the drafts of two doctoral theses, which will see light of day next year, and a great number of intellectually stimulating research papers.

Turku, December 6, 2007

Kari Liuhto
A responsible person of the project

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Executive summary

by Valtteri Kaartemo

This publication combines articles on the impact of outward and inward internationalisation on macro- and microeconomic transformation in Russia. Moreover, the articles focus on the consequences of transformation in shaping the new role of Russian enterprises in international business. Thus, the publication aims at providing a thorough analysis for decision-makers and the representatives of business and academia how the current economic (and political) development in Russia shapes the international business arena.

The Russian economy has expanded with exceptional speed during the past eight years. The average annual GDP growth during these years has been around six percent, and private consumption has reached double-digit figures annually, which in addition to other factors has started a boom in foreign investments. The FDI inflow in 2006 ($29 billion) alone was more than the total inward FDI during the period 1990–2000 ($26 billion), according to the UNCTAD data. The UNCTAD data shows also in outward activity greater figures ($18 billion) for the year 2006 alone than the figure ($17 billion) for the whole period of 1990–2000. According to the latest Russian (preliminary) balance-of-payment data the first nine months of 2007 have showed more than 40 % growth y-o-y.

When the project, financed by the Academy of Finland, was started in 2004, Russia's FDI stocks were far from today's figures. Since then, the topic has become increasingly important, and analysing the impact of outward and inward internationalisation of Russia's enterprise sector is an utmost acute theme with continuously record-breaking FDI flows to and from Russia. Furthermore, Russia's possible WTO membership, forth-coming elections in 2008 and other major changes in the economy stress the need of the business, decision-makers and the academia to have better understanding on the development in Russia's enterprise sector and its impact on the international business.

In order to participate in this vast information collection process, a group of scholars have contributed articles on internationalisation, spillover effects, and sectoral and regional transition. The report is organised so that the first three articles deal with an overall view on the new role of Russian enterprises. The second three articles go deeper into the subject by analysing the development from sectoral and regional perspective. The final three papers give more specific, operational-level view on the development in Russia and its effects on enterprises in Russia and in the international business arena. In part 4, conclusions are given reflecting the views given in the independent studies.

The article by **Ilari Karppi** starts the series of the papers by focusing on the challenges faced with economic spaces, which aim at enterprise level co-operation on the two sides of the EU-Russian boundary. In the article it is imagined that corporate Russia would have a genuine interest of being attached to transnational actors' evolutionary networks on an egalitarian basis, or equitably. In this instance the prerequisites for development of a knowledge-based economy will be particularly reflected as a mechanism to redesign and rejuvenate the Russian economy. Karppi argues that mutual sense of otherness between Russia and the West stems from a much deeper historical root than that of the 20th century, and the key transnational challenge for further European East-West integration lies in the macro-institutional developments.

Kari Liuhto continues the discussion on the macro-level development in Russia by positioning its key industries in a strategic governance matrix in order to analyse the growing risks created by the expanding political economy in Russia from a perspective of a foreign investor. In his typology, the Russian economy is divided into four sectors, namely: militarily sensitive, economically sensitive, top sensitive, and non-sensitive sector. He argues that sensitive sectors contain an extremely high political risk for foreign firms, as the state control has been increasing within these key industries, such as oil and gas, strategic metals and logistical infrastructure.

In the third article, **Peter Zashev**, **Peeter Vahtra** and **Kari Liuhto** change the scope of international role of Russian enterprises by focusing on Russia's outward foreign direct investments (OFDI). Their article demonstrates the growth of the Russian OFDI, highlights the industries that are characteristically more active in the Russian OFDI, and analyses the presence of geographic patterns in the direction of the Russian OFDI. In addition they provide with a typological model of the international operations of Russian enterprises by dividing internationalising companies according to the level of conformity of their actions to Russian foreign policy and transparency of their operations.

The Part 2 takes more detailed view on the topic by focusing on two specific industries and by analysing the recent development in the Federation also from regional perspective. **Anna Korppoo** presents her findings on the development of energy efficiency and technology as well as the drivers and barriers to modernisation in the Russian paper and pulp industry. She claims that the main driver and barrier to modernisation are market signals and the lack of capital, which are dependent of solving the macro-barrier, the lack of a structural reform of the economy, including an administrative reform, which still prevails in the country. After the economic and administrative reform, also promotion of corporate ownership and introduction of a well-planned and coordinated package of energy saving policies could lead to modernisation. Even before the macro-barrier is solved it is shown that higher energy price could also spur action towards modernisation.

Veikko Kärnä analyses the institutional changes in the Russian mining industry and mining enterprises during 1990–2006. He argues that the Russian mining industry has gone through an extraordinary transitional development from the collapse of Soviet Union, which results in two contrary directions of structural transition. The individual mines, which had an autonomy in the beginning of 1990's, have now lost it, and are parts of larger holding companies returning the power back to Moscow. Similarly to the Soviet Union, the local mining companies take care of the social welfare of their own regions. In addition, vertical integration has returned to Russian Mining Industry meaning that mining companies tend to own both raw materials and the following production chain. Many companies want to produce the processed product, not the raw material.

In her article, **Elina Rantalahti** continues the analysis on the impact of recentralisation and renationalisation on Russian regions. She introduces new possible type of regionality within the Russian Federation and examines these operational principles and possibilities to operate in the Russian Federation. She claims that the necessities for (international) co-operation on regional level are foremost given by the Russian Federal government and to some extent through different EU financing instruments. In her opinion, special economic zones within these two spheres of combinations are considered to be the “extreme regions” of Russian Federation with perhaps the best prerequisites for international co-operation and integration within Russian Federation.

In Part 3, authors go even deeper into the topic and analyse the operational impact of the recent development in the Russian Federation from the perspective of international business. **Peter Zashev** presents his ideas on the business cultural impact of Russian investors on the Baltic States underlining the fact that business culture and its possible impact on the host country could be very important criteria when trying to attract FDI and select among different investors. By analysing Russian business culture and based on evidence from the Baltic States, he argues that it is reasonable to expect some negative spillover of Russian business culture in the countries hosting extensive Russian investments.

Elina Pelto continues from the spillover theme by analysing how foreign direct investment influences a local business network in a transition economy. The article presents a framework for analysing the impact of FDI on the local business on a network level, describes the changes following a foreign direct investment in the local business network in a transition economy, and identifies the mechanisms through which the changes are transmitted to the local companies. Pelto’s framework suggests that the external effects of FDI depend on the embeddedness of the foreign investor to the local business network in the host country.

In his article, **Harri Lorentz** analyses supply chain management related challenges and implications for internationalising firms in the emerging market setting, with a case study of Finnish food companies in the Russian market. He continues the discussion on spillovers by arguing that some of the facility location decision factors convey the firms’ perceived abilities to make an impact with the investment or create external effects in the local economy and business networks, while some factors are considered as prerequisites for entry into the market (i.e. the location decision). He suggests that in Finnish export supply chains to Russia, for example supply chain design is an area where companies should collaborate more closely, in order to improve supply chain performance. In general, he states that achieving supply chain integration in an emerging market context seems to be particularly challenging due to constraints in terms of infrastructure, networks and institutions, and that supply chain strategies need to be innovative, proactive, well-timed and localised.

In Part 4, conclusions are given by **Valtteri Kaartemo** based on the articles above.

This report among many other articles[2] written by the authors since 2004 would not have been possible without generous funding from the Academy of Finland, whose support for the research and the accumulation of knowledge on the new role of Russian enterprises in the international business arena is gratefully acknowledged.

The report is freely downloadable at the website of the Pan-European Institute (www.tse.fi/pei).

[2] A list of selected articles, published during the project "New role of Russian enterprises as actors in the international business arena", are presented in the appendix of this publication. The list also provides a reference for more detailed information about the subjects covered.

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PART 1 – OVERALL VIEW ON THE NEW ROLE OF RUSSIAN ENTERPRISES

A transnational challenge – integration and economic spaces: the Russian connection[3]

by Ilari Karppi

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[3] Parts of the article are based on revised paper prepared for a World Public Forum Dialogue of Civilizations Meeting held in Tampere, Finland, June 4-5 2007. The arguments presented in that paper and, later on, in this text evolved during my Master's courses on *Regional Changes and Transitions in Europe (RCTE)* and *European Peripheries MA/PhD Summer Schools* from 2005 on, for which I wish to thank my ambitious students. The RCTE course has been heavily influenced by this Academy of Finland funded project, which to my understanding pinpoints nicely at least two aspects of university ethos. The first of them is the intimacy of first-hand research and teaching built on it. The second is the process nature of academic work, texts breeding new texts, ideas being in a continuous state of transformation, built on preceding generations' insights, cross-fertilised with an inexhaustible flow of events that sum up into a stunning sense of contemporariness.

I went out drinking with Thomas Paine
He said that all revolutions are not the same
They are as different as cultures
That give them birth
For no one idea
Can solve every problem on Earth

Billy Bragg
North Sea Bubble
1991

1. Foreword: Roads to a Post-National Economy

A civilisation-based world is emerging. Thousand voices from the academia the world around echoed the tag line in the Cold War aftermath as the bipolar world faltered. The world was changing and new ways to reconstruct it as a field of action were needed. The cultural or civilisation-centred explanation was certainly a good candidate for the job, but not without competitors.

With national boundaries made more and more permeable to finance, trade, information and, increasingly, also individuals, new ideas of transnationalism were inevitable to emerge. While there is a great deal of Pan-European charm associated with processes that challenge national boundaries, it is good to keep in mind that strictly controlled national boundaries used to be a relatively recent innovation. Also it is good to stay aware of the fact that the end of the Cold War was certainly not the first earth-shattering event of the twentieth century with a more or less "European" origin. Rather it was one of the last. The world had changed for quite a few times during the past hundred years, which has called in new societal and international or trans-boundary tensions – as well as ways to explain how the world has been changing.

As we only have this one Earth and as this Earth constitutes a closed system for the various beings that find themselves on its surface, we the earthlings are intrinsically captured by both spatiality and temporality[4]. Things that happen in different environments can have unpredictable impacts on us, and things that have taken place during the course of history affect our existence. Further, awareness of our activities may have surprising impacts on our contemporaries, individuals and communities that we may not have even

[4] "*Geography matters*", as the now badly worn-out slogan dating back to the heydays of the localities research school within structuralist geography's went (e.g. Massey & Allen 1984).

heard of, and through our choices we may dramatically take away respective degrees of freedom from those that come after us.

This paper starts with a brief look at the evolution of change, stability and their cultural and institutional (or: civilisational) context. A team of eminent scholars will be taken as guides to this journey. Their groundbreaking intellectual effort is indispensable as support to some arguments that will follow on the role and importance of urban economies for the creation of larger entities of transboundary co-operation. They may at their best constitute important bridges over lingual, institutional and cultural fault-lines. After the first discussions the main focus will be changed to challenges faced with the creation of particular economic spaces that are thought of facilitating actual enterprise level co-operation processes on the two sides of the EU-Russian boundary.

While doing so this paper needs, to a great extent, to go against the tide. Verging on a contrafactual interpretation of the reality the approach endeavours to see beyond the prevailing reality with the key Russian enterprises active in the international business arena operating in oil, gas and metallurgy, prospectively followed by forest industries[5]. This paper, in turn, discusses the conditions and constraints under which the Russian businesses could take the most of the emergent transnational practices. While doing so it forgets for a while about the political expediency and usefulness of the energy sector in spearheading the internationalisation of Russian businesses. Instead, it imagines that corporate Russia would have a genuine interest of being attached to transnational actors' evolutionary networks on an egalitarian basis, or equitably. In this instance the prerequisites for development of a knowledge-based economy will be particularly reflected as a mechanism to redesign and rejuvenate the Russian economy.

The key emphasis is on conceptual discussion, as this paper deals with general principles rather than definite cases. However, more or less veiled references will be made to existing actors, economic agents and recognisable development processes as deemed appropriate.

Finally, as the Billy Bragg lyrics cited in the intro of this paper suggest, even in the face or large-scale systemic transformations the transnational world is increasingly

[5] All of them are discussed to more or less extensive depth in several articles of this volume.

multidimensional and pluralist. Moreover, with major social trends, actors and institutional forces promoting it, from the very logic of "living in the transnational" (e.g. Amin & Thrift 2000) follows that it is hard to cocoon any nation and any polity from this multidimensionality and pluralism. Thus, even the New Russian Vertical of Power may not be "the one idea" to render to a panacea.

2. Clash of civilisations as an argument

In his much-acclaimed volume on the clash of civilisations Samuel Huntington (2002) emphasised in the late 1990s that in the post-Cold War world the global conflict is over, not only the European one. While doing so Huntington cited Francis Fukuyama (1992) and his argument of the end of a dialectical process of ideas and thoughts known to us as unfolding of history. By taking that idea by its face value the societies thought of being built on and around the "western" sphere of ideas may run into problems.

"The West" seems to be time and again over-eager to believe that it comprises some sort of a universal benchmark for a "society". True, to numerous nations of the world the global transformation is revealed in the form of liberal democratic politico-economic order served by many transnational macroeconomic actors such as the IMF, or national agencies for international development co-operation. In the midst of this triumphant new public and financial management bandwagon it pays to the West to keep in mind that not all parts of the world are within its cultural affinity. I return to this after a brief while.

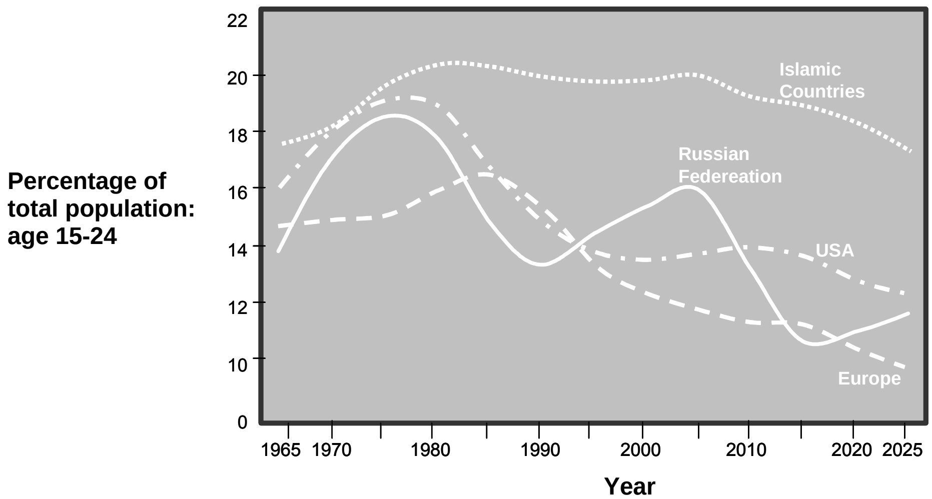
However, to begin with, it would be even difficult to define a single East/West cultural spectrum with clear divisive lines. As Huntington mentions, state and cultural fault-lines do not necessarily converge even in present day Europe. This phenomenon is illustrated even with some large European countries. A key case in point in this instance is the Ukraine with the population's political sympathies divided geographically in the east-west dimension. John Man's (2005, 211–214; e.g. Weatherford 2004, 146) account on the Kiev Russia's and its neighbouring tribes' and/or nations' attempt to create a concerted action against Mongols' first European offensive in the early 13th century adds a good deal of depth in the origins of "European" identity in this cultural region.

The opening sentence of this paper, "*a civilisation-based world is emerging*", resorts to Huntington's most central argument on the forms that the global community is taking. The argument was gradually undermined by evolving transnational endeavours and a great deal of globalisation hype – until it all changed suddenly. The aftermath of 9/11 in 2001 manifested the resurrection of the clash of civilisations argument. More than burying the globalisation discourse it added the dimensions by which the debate on the pros and cons, winners and losers, and causes and consequences of globalisation now took new courses. To give only one example, Amy Chua (2004) composed a model of arrogant affluent minorities with ethnic or cultural characteristics that cause tensions among the less well-of majority. Absence of basic civic liberties keeps the society segmented and experiences of deprivation confined. After institutions such as majority vote were introduced, deprivation-based conflict potentials emerge. Thus, global democratisation and increased interaction, an imprint of transnationalism, could thus have contributed to the 9/11, while portraying the "arrogant Americans" as a global affluent minority sharing a common political space with the Muslim community – among many other population groups.

In addition to this dramatic turning-point it the post-Cold War history, a sudden realisation of the dismal demographic state of the ageing industrialised societies drew attention to one particular graph in Huntington's volume. Indeed, there are expanding and contracting cultural spheres in the world, based on something as fundamental as demographic development. Demographic trends help one not only to assess where do the young cohorts come from today, but also to identify the future homebases of the global youth. The following graph is redesigned from the one presented by Huntington.

It is obvious that societies with young rather than old population stand for totally different potential for economic expansion, innovations, and radicalism. Grossly simplifying the demographic complexities one could maintain that stagnant ageing societies have the clearest vested interest in keeping the international status quo, the setting forged during the days when these societies used to be the demographic powerhouses. Conversely, the dynamically evolving societies have the clearest interest in restructuring the global institutional setting to better match their vibrant development and vitality.

Figure 1 Demographic trends in various cultural spheres



Source: Huntington 2002 (original sources: UN, Population Division 1994–95)

In this instance it is good to bear in mind that virtually all nations of Europe fall to the group of stagnant, ageing societies. Even the relative youthfulness of the Russian Federation, as depicted in Figure 1, is to some extent a trick of statistical figures. The graphs show relative phenomena, shares of young people, and the rise during the first decade of the 21st century can be explained with low life expectancies in the post-Soviet societal environment with harder economic and social pressures aimed at adult breadwinner cohorts. However wishfully one reads the figures, the numbers of people with “Western” or “European” origins constitute a downward trend.

Thus, Europe needs fresh workforce from the outside. The extremely alarming World Bank projections from 2007 reminds that the Russian Federation with an estimated loss of population during the first 25 years of the 21st century by ca. 10 percent, or over 17 million, is certainly no exception (Chawla et al. 2007). This fact needs to be combined with a truly transnational finding in the research on international migration that migrants remain members of at least two communities, the sending and the receiving one. Moreover, their lives across national boundaries bring two societies, “host” and “home” into one social field (Wilson & Peters 2005, 396). This challenges all political ideas that wish to keep ageing European societies “national”, or avert multiculturalism.

For Russia and the entire European sphere of the former Soviet Union there is still a particular demographically weighted civilisational feature to focus on. As indicators taken in Table 1 show, the Europe/Asia boundary is generally distinguished by different demographic profiles. Europe is “turning grey” while Asia remains vibrant. However, this feature is particularly pronounced at the interface, between the European and Asian cultural spheres. Part of the region used to be included in the former Soviet Union. The 2004 figures showing the share of the elderly in the region defined by the UN as “Eastern Europe”[6] do not look particularly bleak compared with Europe in general, but peculiarly small youthful cohorts are to follow the huge majority now at the best working age.

Table 1 Estimates of population and its percentage distribution by age in selected regions, 2004.

REGION	Pop. tot. 1 000	% -15	% 15-64	% 65+
Europe	**729**	16.1	68.2	15.7
of which				
Eastern Europe	**299**	15.8	70.1	14.0
Asia	**3 860**	28.3	65.4	6.3
of which				
Middle East & Central Asia	**210**	34.2	61.3	4.5

Source: Demographic Yearbook 2004; UN Statistics Division 2007.

The figures for Asia give food for thought as well. Middle East and Central Asia[7] – classified by the UN as “Western Asia” – as the most immediate geographical neighbour to the entire transitional and post-transitional Europe constitutes the particularly youthful part of Asian geographical entirety. Thus, the extremely old of the future are bound to face the

[6] Belarus, Bulgaria, Czech Republic, Hungary, Poland, Republic of Moldova, Romania, Russian Federation, Slovakia, Ukraine. Of these countries Ukraine, Bulgaria and Belarus are presumed by the Word Bank (Chawla et al. 2007) to face by 2025 more severe population losses than the Russian Federation.

[7] Armenia, Azerbaijan, Bahrain, Cyprus, Georgia, Iraq, Israel, Jordan, Kuwait, Lebanon, Occupied Palestinian Territory, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Turkey, United Arab Emirates, Yemen. Of these countries Georgia is presumed by the Word Bank (Chawla et al. 2007) to face by 2025 more severe and Armenia slighter population losses than the Russian Federation.

extremely young, being in the need of their workforce, and hopefully receptive to their visible and all the more central roles among the “national” populations.

The overture to this sort of development is less than promising. Not only are the ethnic relations extremely explosive, in European terms, in several transitional and post-transitional countries, the historical and geopolitical rivalries and tensions in Central Asia have make the region complicated as an arena for civilisational interaction (e.g. Meyer & Blair Byscak 2001, 568-569). The Soviet imperialist policies in the region (e.f. Kapuscinski 2003) was an integral part of this history, buoyed more recently by Western politicians’ willingness to accept Moscow’s agendas to a degree verging on acquiescence, as the late Anna Politkovskaya (2003, 7-188) angrily notes. In sum, an obvious civilisational boundary exists on the transitional fringes of Europe. Time will tell the extent of which it will challenge societal development of societies, communities and networks on its two sides, with the Russian Federation particularly at stake.

3. Transnational in the web of integration, transition, cosmopolitanism – and meaningful spaces

The world is developing towards the transnational. Networks that individual migrants construct are only one imprint of the transformation. Networks link the migrants’ host societies with their received cultural features to home societies with culture they have received at birth. Fibres of continuous interaction, made possible by the compression of space due to revolutionary developments in communication channels, vitalise these networks. However they reveal only one aspect of the transnational.

If “geography matters”, so do – consequently –the boundaries that separate geographical spaces territorially from each other. Both of these concepts are loaded with meanings that stem from the very heart of political geography (e.g. Agnew & Corbridge 1995; Paasi 1996). Yet, the mechanisms that run global economy seek to make these concepts as void as they ever can. From a transnational angle, however, the clash of civilisation argument easily ends up in reproducing or re-scaling old elements and separation lines that have made international interactions and exchange suboptimal.

While this happens, the transnational processes such as free mobility of individuals are confined within territories defined on the basis of civilisations and cultures, and reinforced with international agreements among national governments. The EU with all the debating on Fortress Europe is a case in point here. Through it we can see how transnationalism as sets of practices that help various actors to make formal boundaries more permeable to their activities turns into a club phenomenon available to those granted with an entry. Beyond its outer boundaries lies a "non-club area". The example of the Turkish eligibility for EU *Membership*[8] shows illustratively how we end up discussing about the civilisational features that define these boundaries – which also challenges the policies and practices associated with these boundaries. The last point is extremely important also when we think about the "civilisational" features of the rim that separates "The Club" from Russia.

To speak about transnationalism as an idea that implies any form of emergent cosmopolitanism – supposedly driven by avant-garde tribes eager to jump the widening sphere of free mobility and international interaction – involves a contradiction. Referring to European frameworks for spatial planning as a "transnational practice", Böhme (2006, 155) reminds that in fact the EU member states have been the key players to design them. Moreover, he continues, the national attachments of those having participated in the designing process are there to be recognised in the final product. Indeed, as the international (i.e. *inter + national*) system comprises a legal order with states as its constituent actors, any move away from the standard pattern and towards any emergent one assumes active and purposeful measures taken by the bearers of the prevailing order.

These brief examples show how development of a transnational Europe rests heavily on two large-scale developments having taken place on the continent: integration and transition. Both of these issues constitute major arenas of multidisciplinary research with particular challenges reserved to those who attempt to build sound theoretical frameworks capable of explaining what actually has happened and what is there to be expected. Almost ten years ago, while reviewing an important effort of John Pickles and Adrian Smith (1998), a collection of scholarly papers called "*Theorising Transition*", I suggested that the

[8] A constructivist interpretation would obviously point at the phrasing "becoming a member" as a fundamental feature of a nation's entry in the EU as becoming part of an exclusive club. Consequently, the *acquis communautaire* process would be revealed as an initiation rite de rigueur.

work that has already contributed importantly to our understanding of transition should be understood, in the words borrowed from Robert Merton, as *a theory of middle range* (Karppi 1998). Chasing a grand theory seems futile as we know from the start that the target of our theorising is – and cannot in the transitionary setting be anything else than – metamorphosis in its all complexity (e.g. Ball 2004).

In the field of integration theory a similar development is also apparent. The classical explanations of functionalism and federalism have been challenged by a concept of Europeanisation (e.g. Green Cowles et al. 2001). It encompasses the multi-layered character of changes and transformations in Europe that take place in a multitude of policy areas, intersected by varying geographical scopes and influenced more by practical needs and interests than a Pan-European drive for unity. Thus, it can be assumed that the practical fields and issues that constitute particular "transnational practices" are identified and defined in a kind of situational web where selfish interests, security concerns, opportunism, historical antipathies, protectionism, hegemonic campaigns and myriad other issues mingle with the overarching rhetoric of globalisation as something that opens up the world for our capitalisation and enjoyment.

Irrespective of our inclination to emphasise either the extreme peculiarities in the process of how transition has de facto unfolded in virtually dozens of former socialist economies worldwide, or how we seek to settle the decades-old debate on the appropriate interpretation of how integration builds up, one common transnational denominator cannot be missed. As Lindh de Montoya (2002, 242) appropriately remarks, the world of finance is increasingly taking over the lives of individual households and states alike, while various noncapitalist alternatives to free market disappear. It can be asked, how different approaches to transparency, ownership, mergers and acquisitions, or due diligence are compatible in an environment that assumes the standardised free market-derived practices but feature a wide variety of cronyism, oligarchism or, simply, vested interests appraised differently in different societal and cultural contexts.

What is particularly intriguing to note is still another micro-level perspective to transnationalism, attached to civilisational components in interaction. The development of global communications systems and a multi-layered character of cultural phenomena with short-lived and swiftly replaced life-spans seem to define our being's degree of cosmopolitanism. Individuals are easily seen to float in a postmodern skein of subsequent events. However, anthropologists have shown the immense complexity of our flowing time (e.g. Rabinow 2005). Even if innovations such as the Internet or budget airlines liberate individuals more than ever before from the constraints of time and space, while the postmodern culture does the same for our capability to construct identities at need or will, their only impact is not to root us out from our civilisational home-bases. Quite the contrary, these amenities help us construct and fondle multiple identities. While on the other side of the globe, we have now better possibilities than ever to remain attached to our communities of origin, their people, conventions, life.

These multiple identities in global interaction may well be scaled to the level of organised actors such as enterprises. Thus, in its transnational affairs an enterprise may be simultaneously a global player, an oil company, a Russian entity, a defender of national interests, an instrument in domestic politics or a hub for a cluster of domestic and international partners. The question is: which of these roles comes first. In our rational attempts to emphasise globalisation as an all-amalgamating force that rounds all corners and cements the breaches not appreciated by the imagined rules of a shared marketplace we deliberately forget that civilisational features are present in ways how organisations that stem from these mental backgrounds set their rules and priorities and make the way they operate generally legitimate to their stakeholders. Clegg (1990) has shown how for instance the Scandinavian welfare ethos of Confucian culture reflects into organisational practices. The transnational as an organisational practise may well get tangled into all complexities that the clash of civilisations potentially implies.

Important questions are thus bound to arise. How do the prerequisites for our capabilities to transcend either imagined or effective boundaries that stem from deep-lying cultural differences among societies look like? Moreover, what do we know of situations with that sort of civilisational differences in nations' mutual dealings being managed? Can modes of interplay be learned irrespective of culturally rooted disputes of what should be done, when and how?

4. Societies and civilisations: learning the (economic) interplay

Historian Fernand Braudel (1997) claims that society and civilisation are inseparable, that they are two ideas that refer to same reality. Braudel continues by maintaining that every civilisation adopts a view of the world that is coloured – or possibly even determined – by social tensions. Where do these arguments lead us?

The post 9/11 world started to unfold with a strike to "the arrogant Americans'" great world city of finance. In this instance Braudel would not only acknowledge but underline the importance of the urban. Towns, he says, are signs of civilisation, arenas of managed imbalance for the production of much greater order. Devoted to the *longue durée*, Braudel puts forward the time-scales: civilisations embrace much longer periods than any given social phenomena. Civilisations (like societies) depend on technological, biological and demographic circumstances, all of them today very much urban phenomena. On the other hand, rises and falls in population, illness, health, economic growth or decline, affect cultural and social structures of a given nation. Cities constitute an arena where all this is squeezed in strict spatial (and often also temporal) limits.

It is thus here that we can witness also the most impressive European success story. The ultimate, most extreme ups and downs in these fundamental elements of human fates have been taken into "industrial" control and management. A particular western urban innovation can be said of constituting certain limits to biologically based forces that might put the development of entire communities into an unmanaged oscillation irrespective of the *modus operandi*, markets that regulate the supply and demand of various "cultural goods", or administratively managed large-scale policy mechanisms (such as the "Scandinavian welfare model") to run the production and distribution processes.

In the global context the challenge faced by the West has been its ability to create a mass civilisation of high quality to constitute the expansion of management over population growth, illness, and so forth. Unfortunately to the West, in these developmental processes it has inevitably faced the practical repercussions of the global inequalities.

Stabilising societal development and keeping it in appropriate limits within "our" sphere of interest but within "their" formal sovereignty has been a traditional imperial(ist) practice. Karl Polanyi, in his seminal work from 1944, The Great Transformation (1957), discusses the origins of modern (20th century) capitalism. He locates it to a period that he chooses to call ”Hundred Years’ Peace” from 1815 to 1914. This decade witnessed only some months’ warfare in Europe, while haute finance or “High Finance” emerged as a stabilising force.

Interlinkages of public and private economic interests emerged to produce the political and economic organisation of *international life*. During this period the middle classes, drivers of the French 1798 Revolution, became finally tamed from a revolutionary force (lastly in 1830) to a bearer of wide international peace interest. Within this process it can be argued that “Europe” emerged as a functional entity. Moreover, it learned to regulate even its civilisation-based boundaries.

In this context it can be asked if Turkey was a subject or an object in the 19th century territorial-financial diplomacy power game (Polanyi 1957, 8). In 1865: “The Concert of Europe”, the top European political decision-makers influenced by financial actors, declares integrity of the Ottoman Empire as essential to European equilibrium. A dozen of years passes and in 1878 follows a Dismemberment of the empire: now that is deemed essential for maintaining the equilibrium, while the “Concert of Europe” is again assuming an active role.

As it occurred, Hundred Years’ Peace ended in Sarajevo. Grammar school history textbooks attach this event conveniently to Gavrilo Prinicp, but with his 1914 gunshots he “ended” the century of peace just as certainly as Columbus “discovered” America (e.g. Fromkin 2005; Stone 2005). European stability was already lost, and the First World War that raged during the four years to follow almost with an industrial process’s inevitability was its aftermath. The great British economist, John Maynard Keynes who – frustrated – participated in the economic *modus vivendi* of the 1919 peace negotiations between the defeated Axis and the victorious Western powers.

In 1919 Keynes published the fruits of his frustration in the Economic Consequences of Peace. In it, he accused the victors on committing a tragic management error while dealing particularly with the defeated Germany. To him war reparations were a showcase example of the politicians’ total misunderstanding of the interlinkages that had made the Hundred Years’ Peace possible. With retaliation-style reparation policy, he argued, preconditions for a sustainable continental peace were squandered from the start – a dramatic error repeated by the Soviet Union after WW II with East/Central Europe and Finland unlike the West having already learned its lesson.

In fact, as Keynes noted, in 1919 entire Europe was in a critical situation. In France, Italy and Germany public finances were in a catastrophic state, and this was no even the worst of it. Speaking of the tools of economic management and basic instruments for defining one's role in international interaction and exchange, Keynes was shocked to realise that in Russia, Poland, Hungary and Austria there hardly existed a thing that could have been called a state budget in the first place.

To Keynes the signs that could be read from this evidence were clear enough. Mechanisms of the European stability-creating financial apparatus were badly disturbed. What was all too obviously to follow from it all was a head-start to Great Depression, and via that an overture to WW II. Keynes left the British Ministry of Finance Peace Negotiator team and returned to Cambridge, with the Economic Consequences of Peace published even in Finland (though in Swedish) already in the year following the original's printing[9]. The European academic public seems to have understood what was too difficult to the politicians to comprehend, even with the backing of hundred years' successful track record. Four years of warfare organised on the basis of nation states had wiped the preceding European experience away.

Of course, there was the silver lining. The 1919 mistake was not entirely repeated after 1945 with the Marshal Plan pouring new financial resources to (Western) Europe instead of extracting them[10]. What followed, in due course from this was a global, finance-driven economy that became slowly resumed with an eventual breakthrough after mid-1980s.

[9] The translation must have taken place with minimal delay, as Keynes himself dated the original only in November 1919.

[10] True, the aid created obvious political dependencies, but with Europe's own emergent integration profile and later "eurodollar" deposits it cannot be maintained that with the European Recovery Program the US merely cuffed its European beneficiaries. Moreover, it is good to remember that despite of the war reparations that the Soviet Union demanded from some of its new allies, also the immediate post-war Eastern European economic growth was remarkable. Probably it was even higher than that of the West due to more modest interwar starting-point (e.g. Aldcroft 2001, 129).

5. Russia: on the verge of knowledge economy – eternally?

Without Russia (or more correctly: the Soviet Union) we might not have innovation policy structured as we know it today. So, are we right to proclaim innovation policy, innovation society and even knowledge economy as profoundly Russian brainchildren? Maybe not quite, but as noted by Mariussen (2001, 10-11) modern innovation policies are to some extent something that the Sputnik, the satellite with which the Soviets started the space age in 1957, did to all of us. To some extent the Sputnik certainly was a hallmark of a knowledge economy of its era, but, as we very soon became to clearly see, it was not simply the end of a race for number one position in the space, but a starting shot to a fierce, decades' long match for the championship. The evolutionary effects of the Sputnik started to trickle down, first of all to the Western market economies that now had an obvious warning-sign: what would be the outcome if the knowledge resources and industrial performance of the West would not be put in a more coordinated action. Thus, the birth of modern (Western) innovation policy thinking jumped the gun thanks to the Soviet technological threat – however imagined it was in areas such as quality industrial and consumer electronics that the eager market waited to be flooded with.

The Cold War bipolar world made itself visible also in the field of technological development. On the one hand, the West was anxious about the Soviet bloc's industrial espionage as part of the ideological economic warfare, and applied strict export restrictions to a wide range of strategically important high-tech products. On the other hand the various Western integration organisations such as OECD, NATO and EU, developed their own agencies to monitor, co-ordinate and actively facilitate technological development. The transnational era in innovation policy had begun, which also reflected in a vast net of specialised knowledge-creating agencies attached to the UN (e.g. Luard 1977). Before long this transnationalism was engulfed by the global competition among the Triad powers, the US; Japan and the EU. Particularly the EU as a regional (i.e. not national) actor developed the transnational innovation policy practices to their full with Framework Programmes that had international mobility and support to multinational research centres as well as strategic co-operation with its key competitors as explicit targets eligible for European supranational financing from the European Commission's own resources.

The fall of the Soviet Union marked a change also in the European technological space. In their postcommunist stage the prospective new Member States needed major technological upgrading in order to take, later on as EU Members, as constructive roles as contributors to the European technological capacities as possible. Thus, the transnational features in innovation policies needed to be fostered and extended beyond the existing external boundaries. European technological space was widening.

This being said, it must be added that “the transnational” embedded in the development of knowledge-driven business processes is an extremely complex phenomenon. For instance, as noted by Mariussen (2006a, 227-232) the Nordic business systems differ from each other in terms of their innovation capacities, no matter how fundamental similarities the Nordic Countries as “national” economies share. Yet, as he notes in another instance (Mariussen 2006b, 247) much of what constitutes the transnational is generated by restless people in a constant search for new opportunities. In part their search is orchestrated by policymakers who try to promote their interests in networks of power, assisted by trans-national institutions, both formal regulations and agreements, and informal rituals of mutual understanding. These, in turn, may help them in protecting some ideas in a continuous flow of events and help them to get matured as policies to back up innovation systems in their processes of fuelling businesses and boosting competitiveness. A key intermediary between all these components, as Mariussen (op. cit.) reminds, is learning and knowledge-processing activities that facilitate it.

Now, my favourite question that I always am inclined to raise whenever hearing about posh ideas of new forms of governance, learning organisations, or design of business of policy processes goes: *would this work in Russia?* The late Finnish professor of Russian language and literature, Erkki Peuranen (1996), opens his enchanting book “*Takaisin Venäjälle*” (Engl. “*Back to Russia*”) with the Russian idea in a nutshell. The idea equals with a tragedy: there is so much of everything. Thorough consideration and due decisions are not necessarily needed. One can simply take from the vastness. He continues that a nation, such as the Germans, that constantly attempts to build a perpetual-motion machine, invents all things practical as mere spill-overs while being on the business. But a nation that itself is a *perpetuum mobile*, such as the Russians, seems to have already invented everything that really is worth being invented.

So, I ask my favourite question again, rephrasing it with the help of Peuranen's advice: what might be the Russian conditions for getting the most of the transnationally operating processes that feed the economic system with knowledge and insights alike to rejuvenate and redesign the business processes for ever enhanced competitiveness in the global market? How about Russian organisations learning from the experiences in the outside world? How about Russian actors getting attached to emergent, evolutionarily extending networks with few formal hierarchies but a great deal of information shared openly in an exercise of mutual benefits distilled from selfish aspirations? How about Russian decision-makers counting on institutions whose influence among actors is not backed with power and authority but mutual acknowledgement (and compensation) of weakness and insufficiency? The more the core of knowledge economy shifts away from industrial chain of command for producing the technology and the closer it draws to social innovations of managing its fine-tuned components, the more probably the general tune of the answers grows sombre.

A sign of some sort of "backward transnationalism" can be seen in the Russian industrial corporations' international operations. Vahtra and Liuhto (2005, 245) refer in this instance to a specific group of enterprises they call the Patriots. These are corporations controlled by the state, active in the strategic industries, having often dominant positions in their target markets, and, finally considering political goals superior to the business rationality. Such corporations are found from among the actors that operate on the most global industries, such as oil and gas. The Russian leadership is free and willing to define virtually whichever sectors as strategically important to the nation. However, if it wishes to take measures to reflect this basic inclination, a more centralised economy and effective chains of industrial command and financial control are needed as tools. A process like this would dramatically reduce the possibilities of the Russian economy to take advantage of the transnational possibilities, and bring it back to some sort of closed world logic. It would leave Russia on the verge of the knowledge economy as seen as an emergent and evolutionary transnational exercise.

The Russian *vertical of power* and its consequences to territorial co-operation is discussed in Elina Rantalahti's article in this volume. Yet, despite of all hardships in establishing feasible macro-level operation environments or territorial special economic zones, there are attempts to create particular economic spaces that would be genuine stepping-stones for transnational actors in the knowledge-based economy to the Russian operation environment.

6. Technology interfaces as civilisational frontiers

Particular institutional forms exist to provide interfaces between knowledge created in deliberate, often publicly funded research and development facilities and industries to utilise it in production. These interfaces are known, with slight definitional differences as technology centres, industrial estates/parks or science/business parks (e.g. Lehtimäki 2005, 47-49). As a component of deliberate regional development and planning a distinctive European character appears to be embedded in their creation.

To begin with we need to turn back to demographic phenomena. During the post-war modernisation and industrial restructuring period the development of settlement structures in North America and Western Europe started to differ. This era witnessed a large-scale de-concentration and sprawl of the American cities, whereas the European cities remained to a much greater degree attractive population centres (e.g. Hall & Hay 1980, 225). A parallel development can be seen in the way of how the sites for creating new technologies were located in the urban structure (e.g. Meier 1985; Leknes & Lervåg 2005). Space-consuming sprawl was taken into stricter control, which helped European cities to defend their focal position as theatres of human life and civilisational evolution. Here the technology centres and were they were often located had their vital role to play.

Of course also European cities face urban sprawl[11], and so do Russia's large metropolitan areas. For the newly emerging affluent classes the traditional Soviet-era domination of high-rise blocks is giving way to suburban or "exurb" settlement pattern, which produces new periurban fringes (Sturyk 1996, 208-210; e.g. Kotkin 2006, 108; Szelenyi 1996, 314-315; Fishman 1997). It is typically in "urban edges" with prime accessibility between the traditional inner cities or downtown areas and these new fringes that the new technology centres are found, together with a great deal of knowledge-intensive industries. With these locations they form at best particular kinds of magnets or islands with centripetal impact on their surroundings. In this capacity they attract commuter flows, create demand for a wide range of services, and form clusters of housing, jobs and recreation (Ylä-Anttila 2004). They thus contribute to the emergent urban form and civilisation led by cities – instead of diluting the idea of urbanity to the vastness of the surrounding rural landscapes. In the case of Russia such phenomena within the recreation of urban structure can all be lumped together with the *leitmotif* of an overarching socio-economic transformation.

In the Russian context we could thus speak about technology centres as particular civilisational frontiers in several senses. In the following the approach is, however, narrowed to ideas of what an economy could achieve through institutions such as technology centres and what would that kind of value added assume from the rules of the game prevailing in the societal setup that surrounds the centres. What also needs to be done is to distinguish the potential Russian technology centres from the *actual* ones, those that date back to the Soviet era and were/are embedded in the military-industrial complex (e.g. Markusen et al. 1997). Their value is not to be underestimated: they made innovations such as the Sputnik possible, sealed from the rest of the world and the publicity until the time was ripe to introduce their outcomes in all thoroughness (e.g., Kohonen 2003). Aside these massive institutions it is obvious that new kinds of technology centres are needed for organising technological development differently. Unlike the traditional centres with clear national agenda they are assumed to reflect the transnational

[11] Actually, the phenomenon in its modern form is well-known in Europe. Even measures to control it in the UK started hand in hand with the birth of professional urban and regional planning in the turn of 19th and 20th centuries. By the 1930s deliberate legal means were constructed against the sprawl, even if their actual power was limited in the face of economic incentives for finding properties waiting to be developed in the metropolitan outskirts (Hall 1985, 39). However, the idea of bridling spontaneous growth was introduced as an institutional tool.

features of business, with forms still largely to emerge and take shape in the Russian context.

But how should one summarise the ethos of modern trasnational technology interfaces? To begin with, a great deal of hype blurs the prevailing discourse on the clustering of various interwoven activities along the value chain where original research-based innovations are capitalised[12]. Thus it is no wonder that Valtonen (2005) speaks about a gap between the theory of knowledge-based industrial cluster development and how developments take place in the real world. Yet, we can hardly claim that this all has taken us by a surprise.

For the last twenty years – an era that has witnessed the existence of most of the contemporary technology centres – we have been aware of the replacement of the traditional Fordist mode of production with something new. As an "interim audit", Tödtling (2000, 70) summarised a great deal of characteristics attached in earlier debate to a post-Fordist regime of industrial development. They include the use of flexible technologies for customised products, but also decentralisation of functions within large firms, acknowledgement of the importance of horizontal information flows and a prominent role of small networked firms. Moreover, and importantly for the transnational agenda, there is an attested need for institutions that operate not only locally or nationally but clearly transnationally, active in the fields of economic development and knowledge production (e.g. Nauwelaers 2001).

Based on Valtonen's (2005, 115) conclusions one can well claim that the gap exists, because we have chosen so. Instead of evolutionary, market-led emergence of clusters they have been deliberately developed to promote particular goals such as adding the production's knowledge intensity or related aims of policy agendas such as the Lisbon Strategy. Thus, clusters and the technology interfaces that house them are to be seen particular cultural and societal – or in Braudelian terms civilisational creations. Consequently, all cleveages that may complicate the daily interaction among actors from different civilisational domains are assumedly present when technology interfaces from these domains meet.

[12] On the other hand, Gernot Grabher (2000, 178), reviewing the East German transformation at the German 1989/90 reunification, notes the apparent parallels between the socialist *Kombinate* and market-based industrial districts as one form of technology interfaces.

7. Consequences: an example from the Baltic Sea Region

Instead of conclusion a reference can be made to the consequences of the above described situations. History shows that even if we are prone to conflicts in situations that involve interaction across boundaries from one cultural or state system to another, conflicts do not have to escalate. Bad news, instead, appears to be that togetherness is most easily constructed when there exists an external instance, whose otherness highlights the elements that keep “us” united.

An important observation can be made here. Cultural boundaries do exist and, despite the all-amalgamating globalisation, ethno-cultural boundaries can develop into real civilisational boundaries through divergent economic, political or demographic developments in different societies. Thus, it is of utmost importance that such civilisational differences are not allowed to develop to deeper-lying sense of otherness and mutual incapability to recognise and identify the “others” intentions concerning the nature of inevitable interaction. Interaction, in turn, appears to be inevitable due to numerous interdependencies created through the economic interlinkages across cultural and civilisational boundaries. Business is a common language, even if the final motivations for being in business relationship may vary.

One of the challenging cultural (even if not strictly civilisational but with some civilisational flavours) boundaries that highlight the modern technology and knowledge-based developments can be described in the context of broad regimes of societal governance that meet in a shared geographical space (e.g. Karppi & Retailleau 2003). Baltic Sea Region is an example of such a geographical interface, one between the Nordic/Scandinavian universal welfare model and a model that reflects the European post-cold war socio-economic transitions. In the “old” western world it has been customary to speak of transition more likely as a process than as a model. It is hence seen as a kind of developmental track that societies with emergent or newly established markets and regimes have chosen. Often the societies in transitition are addressed with a generic formulation “new democracies”, even if a more realistic expression could be “new markets”. As a group they are signified by a varying degree of economic freedom as well as challenging geographical dimensions, ethnic relations and population bases that at best add particular dynamism to their economies but seldom contribute to the qualitative development of democracy as a generic principle. In many respects it can be maintained that the two regimes meeting each other in the Baltic Sea Region represent European extremes in societal governance.

In the Baltic Sea Region also two technology-utilising regimes and due information society models meet, differing from each other in line with the overall societal governance models (Karppi & Takala 2007, 75). However, they evolve in a definite, shared territorial context increasingly featured by networks that cross an all the more imaginary boundary between the two spheres of governance. Differences between general patterns and models can be made visible in specific industries and fields of research, particularly in areas with rapid economic development and most radical technological changes. Biotechnology is one of the industries laden with great expectations and duly framed in a broad institutional setup created to support its development. Major streaks of societal governance and ideological approaches culminate in the dynamics of developing the industry.

Ideological choices constitute fundamental division lines when societies decide on mechanisms through which prospective growth industries are promoted. The two basic models to be relied are either (1) centralized management through formal institutions with due control and coordination or (2) market-based and decentralized mode of governance. The overwhelming majority of world’s governance systems balance between these theoretical extremes, yet leaning more or less explicitly towards the one or the other. The forms that this balancing takes can be seen in the Baltic Sea Region, and in the development of the region’s biotechnology industries.

For the current Estonian mode of societal governance with strong market orientation in several walks of life and policy formulation the market is an obvious choice. Biotechnology can be seen to constitute a field of industrial and scientific aspirations with major market potential. Thus, getting attached to the market-centred solutions emerging within the industry has a substantial appeal. They stand for both financial and operative resources, the latter including interfaces with biotech enterprises worldwide – even if failure rates within new industries tend to be generally high. To Estonia being a pioneer in developing market-centred approaches might give remarkable competitive advantage compared with, for example, Finland, clearly more reluctant to take these steps in the same pace. On the other hand, as it has been recently noted by Pálsson and Rabinow (2005), this boundary may not be that decisive after all. Common challenges typical to the industry and the culture of breaking the codes of nature unite actors and institutions, as does also the public's notable distrust in the industry.

How and where to find common arenas to lead the cross-cultural or "civilisational" dialogue and bridge the varying approaches, conventions and valuations for a common cause. A "transnational argument" would obviously emphasise environments where interaction blooms in its most multi-faceted forms. Cities and technology agglomerations are thus revealed as particular environments where exchange and rendezvous create most feasible conditions for intersubjectivity and a generally tolerant atmosphere. Without labelling the sparse settlements and rural areas as breeding-grounds for resistance against any cross-cultural encounters and cosmopolitanism, it is obvious that certain features of centre-periphery patterns are discernible while assessing the locational dynamics of cross-cultural technology and other interface growth.

This claim can be backed with some persistent historical features of how urban life gets its expressions. Joel Kotkin (2006, 21) maintains that the key features that define the western urban ideal sprout from the ancient competing Greek city-states, from developments that "*incubated an aggressively urban consciousness that would resonate with city-dwellers for centuries to come*". Thus, even if we would not even try to understand the Russian soul as its purest, we can understand the urban dynamics met, most obviously in Moscow or St. Petersburg, however different these cities are in-depth (ibid., 106; e.g. Peuranen, 1996, 73). This dynamics both infiltrates into and encapsulates but also becomes bred in and by the professionals who work in the technology interfaces found in these metropolises. Features like this make cities so important as economic worlds and civilisations that structure them meet each other. Moreover, as Lester and Sotarauta (2007) note in their important work-in-progress contribution to our understanding of innovative milieus, these features may appear in a myriad of forms the world around, all of them potentially leading to success – or not.

8. Final remarks

Time for the final question that so automatically becomes expressed in the context of developments in Russia. Should we feel optimistic or pessimistic? As the previous Chapter’s last sentence underlines, potentials for success does not equal with potentials turned into success. A lot is needed in between, and this lot has to an important extent to do with the cultural and civilisational aspects of how enterprises and other organisations work and how high-quality institutional support is rendered to these workings.

Thus, we need to acknowledge the need for interfaces to serve as arenas for exchange and intersubjectivity while getting accustomed to meaningful co-operation in the simultaneous creation of new technologies, social innovations and paradigms of good governance, public and private. We need to tone down the shades that manifest the dissimilarities, features that alienate, and acts that create insecurity and anxiety for the unexpected. The true challenge is, if this is possible – particularly if the question is put in a cultural or civilisational context. The mutual sense of otherness between Russia and the West stems from a much deeper historical root than that of the 20th century. The Soviet era has relatively little to do with the all of it, as the mutual distrust and alienation is as old as the Russian nation, state and statecraft from the first millennium (e.g. Longworth 2005). The civilisational content of not being alike has had time to mature and get a sturdy institutional bearing.

A question per se is if the global age and the challenges faced by the mankind will let immediate geographical neighbours refrain from uniting their powers for a common cause. As it was noted above, business as a mutually understandable “language” and markets as an institutional “grammar” could be seen as a way to alleviate distrust and learn more and more profound degrees of interaction. History needs not be re-written or cultural cornerstones put aside: they show us the dimensions and the very meaning in our efforts to design new mindsets simultaneously as we design new structural platforms for interaction in the form of technology centres or science parks.

A weak spot for the entire reasoning, however, lies in the macro-institutional developments. In this area Russia may still remain imprisoned by the experience of the way of how its co-existence with the West has historically unfolded[13]. This, I argue, is among the key transnational challenges for further steps of European East-West integration.

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[13] Including to a significant extent the partly traumatic experiences in Russian nation- and empire-building during the last 1200 years.

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A future role of foreign firms in Russia's strategic sectors[14]

by Kari Liuhto[15]

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1 Introduction

Experiences of foreign firms operating in the Russian market differ to a great extent depending on the industry in question. The majority of the foreign firms, for instance, in retail trade, have been very satisfied with the skyrocketing revenues generated by the domestic consumption boom. On the other hand, several foreign corporations operating in a natural resource sector, particularly in the oil and natural gas business, have expressed their growing concern over the strengthening grip of the state. The following quotation aptly describes the aforementioned situation in the oil and natural gas business.

"*The Russian authorities' attack on Royal Dutch/Shell and its Japanese partners at the Sakhalin-2 project has been broadened, embracing three other major projects that are wholly or majority foreign-owned. The moves seem intended to advance Russian interests on two fronts: to increase national participation in these four major projects*[16] *and to revise the revenue-sharing arrangements in Russia's favour. … Legislation now in preparation insists that all 'strategic' oil and gas deposits be under majority Russian control*" (BEE 2006d, 1-2).

The growing direct involvement of the state in the so-called strategic sectors of the economy has raised several questions, such as ***which industries are to be classified as strategic, what is the future role of foreign firms operating in these industries, which authority in Russia will be responsible for implementing the legislation on these strategic sectors, and how changeable are the laws dealing with the strategic industries in the future?***

These questions puzzle many foreign companies operating or investing in Russia, and hence, ***the main objective of this article is to position Russia's key industries in the strategic governance matrix, i.e. to analyze the growing risks created by the expanding political economy in Russia for a foreign investor*****.**

[16] The following four projects are referred to: ExxonMobil-run Sakhalin-1, Sakhalin-2 formerly controlled by Royal Dutch/Shell, the Kharyaga consortium managed by Total and the Kovykta field led by TNK-BP. These projects involve perhaps the largest foreign investments in Russia. In December 2006, the Russian State turned the clock backwards by forcing foreign corporations to reduce their stakes so that Gazprom gained a majority ownership in the Sakhalin-2 (BOF, 2006j). Similar re-nationalization may also happen in other aforementioned fields (TD, 2006q). Some analysts have already started to call the re-nationalization of natural resources as "resource nationalism" (AC, 2006k, 3).

2 A brief overview on the historic development of strategic policies in Russia[17]

Russia's strategic policies are closely linked with Vladimir Putin's career. Putin stressed already in his dissertation in 1997 that raw materials are the basis for Russia becoming a superpower in the short run, and that there should be tougher state regulation alongside market mechanisms. He also emphasized the need to create conditions for investment, including foreign companies in appropriate conditions (Jack 2004)[18]. Putin's goal is to "*increase its [Russia's] attractiveness to foreign investors while enhancing Russian state control*" (Olcott 2004, 3; for reference see Balzer 2005, 219).

The implementation of the strategic takeover started without major public notice after the adoption of the first economic program of the Russian Government, i.e. after the election of Putin as the President of the Russian Federation in spring 2000. The first tier of the reform included many legislative changes, such as changing the Land Code and the third part of the Civil Code. The second tier was meant to cover more narrow areas, such as the natural resource sector, in which the government started the development of Water and Forest Codes and the new subsoil law[19]. The implementation of the second tier of legislative changes started in Putin's second term (IEP 2005).

Russia's strategic agenda became a matter of wider public knowledge rather soon after Putin was elected for a second term in spring 2004. Several statements stressing the need for the state to control strategic natural resources already appeared in the media in the second half of 2004 putting public pressure on the government to start preparing a new law on subsoil use, aiming at barring foreign companies from directly owning strategic resources (Lanes 2005).

[17] The strategic policies refer to the underlying ideology and practices of Russia's presidential administration and the Russian Government, which aim at increasing the state's direct and indirect control over strategic sectors. These policies are termed as strategic since the discussion about the state's stronger participation in the Russian economy is frequently labeled under the term strategic, though these policies are more aimed at increasing the state's control than improving the strategic governance of the state.

[18] Although there exist well-grounded doubts that Putin personally would have had very little time to write his dissertation [the thesis of the candidate of science] while he served the St. Petersburg city administration and the Kremlin, it is a noteworthy detail that his dissertation deals with the strategic governance. For a closer analysis of the thesis, see Balzer (2005).

[19] The former subsoil law was adopted in 1992 with significant amendments in 1995 (IEP 2005).

In April 2005, Putin (2005) brought the core idea of the strategic policies to the global limelight in his Federal Assembly Address[20]. He stated as follows: "*investors sometimes face all kinds of limitations, including some that are explained by national security reasons, though these limitations are not legally formalized. This uncertainty creates problems for the state and investors. It is time we clearly determined the economic sectors where the interests of bolstering Russia's independence and security call for predominant control by national, including state, capital. I mean some infrastructure facilities, enterprises that fulfill state defense orders, mineral deposits of strategic importance for the future of the country and future generations, as well as infrastructure monopolies. We should draft and legally formalize a system of criteria to determine the limitations of foreign participation in such sectors of the economy. Simultaneously a corresponding list of industries or facilities will be determined that shall not be extended or receive extended interpretation. Some industrialized countries use this approach and we should also use it.*"

In June 2005, Prime Minister Fradkov appointed Natural Resources Minister Trutnev to be responsible for the subsoil law development, and the Russian Government submitted the first draft law to the State Duma, which did not give unreserved support for the law (RIA 2005).

In October 2005, Trutnev stated that Russia should limit foreign participation in three main areas. First, his ministry wanted limits on foreign participation in auctions for natural resources that are scarce, such as diamonds, uranium, and quartz. Second, foreign firms were to be banned from large mineral deposits with more than 150 million tons of oil and one trillion cubic meters of gas. He named three such fields; the Titov and Trebs oil field in Timan Pechora and the Chayadinskoye gas field in East Siberia. He also added that Euroasia's largest gold deposit, Sukhoi Log and the Udokan copper field would also be classified as strategic. Third, foreign participation was to be restricted in fields close to military sites (Alexander Gas & Oil 2005).

In addition to these restriction plans related to strategic natural resources, the Russian Government aims at restricting the participation of foreigners in areas related to national

[20] Some analysts claim that "*the notion of restricting foreign investors' access to strategic resources was first formally set out by President Vladimir Putin in his 2005 Federal Assembly Address [April 2005].*" (AC 2006b, 3).

security. In March 2006, Economic Development and Trade Minister Gref released information about a bill aimed towards restricting foreign access to 39 types of activity linked with the production of weapons and military hardware, nuclear materials and nuclear facilities, the space industry, and aviation (Interfax 2006)[21].

After a heated debate on the strategic agenda in the spring of 2006, the discussion received even more negative tones in summer 2006, when Trutnev suggested a lowering of the bar for strategic oil and gas fields (TD 2006a/b). According to BEE (2006a 7), "*the Natural Resources Ministry is now [June 2006] considering a proposal to lower the thresholds to 50m-100m tonnes for oil and 500 bn cu meters for gas.*" If the lowering of the bar would finally be implemented, it would mean that a larger number of oil and natural gas fields would fall under the category labeled as strategic.

The laws relevant for strategic governance are expected to enter into force in 2007 (OECD 2006a; RIA 2006e). Even if the new legislative framework for strategic governance are to be put in place and the **siloviki**-originated[22] **oligarchs**[23] have already taken a stronger grip over certain strategic sectors during the past few years (Colton 2002; Åslund 2005b), the strategic policies have not reached their final form, as the following quotation indicates. "The government will also continue with its policy of establishing state control over the so-called commanding heights of the economy – which is being extended from Russia's energy and metals resources to include other sectors" (BEE 2006f, 3).

In a similar tone, Deryabina (2006, 1) writes: "*the plan for the next several years is to establish 30-40 major holding companies in crucial economic sectors, in which the state will hold at least 50%. … The consolidation of state assets in these holdings can proceed*

[21] The Russian Government has already earlier produced a list of strategic enterprises, which are not to be privatized or sold to foreigners (RIA, 2006d). According to Deryabina (2006, 1), "*as of mid-2006, the list of strategic companies included 514 federal state unitary enterprises and 548 joint-stock companies, where the state is the main beneficiary.*" In fact, this list originates from August 2004 (Kremlin 2004).

[22] Individuals with backgrounds in roughly a dozen power ministries, such as the Federal Security Service (formerly the KGB), Ministry of Internal Affairs and Ministry of Defense, are usually called siloviki (Riviera & Riviera 2006).

[23] According to Åslund (2005a 6), "*the popular meaning of an 'oligarch' is a very wealthy and politically well-connected businessman, a billionaire, or nearly so, who is the main owner of a conglomerate and has close ties with the President. In traditional parlance, an 'oligarchy' implies the rule of a limited group of people. It might be more appropriate to call the oligarchs plutocrats, because their power is focused on money.*"

in at least three ways. One way is to consolidate downstream assets of enterprises and joint-stock companies controlled by the state. The United Aircraft Corporation was set up in this way. … Another way is to buy requisite assets at market prices. … For example, not only state-controlled nuclear power plants, but also companies that produce equipment for the nuclear energy industry, will be incorporated in the Nuclear Energy Industrial Holding. … And the third way is to establish state control of corporations in any sector without buying a controlling stake, but by replacing their management with loyal functionaries. This method was tested in the AvtoVAZ car manufacturer."

Deryabina (2006, 2) continues "*the results of the Russian government's policy on the domestic and foreign markets are so far uncertain. Stronger economic intervention of the state can make good quite a few negative consequences of the policy advocated in the first 10 years of the reforms. In particular, it can help Russia regain its leading positions in many sectors. But the price may turn out to be excessive. The young Russian market is being forcefully removed from the invigorating influence of competition, and the inertia of a monopoly-based economy may become uncontrollable.*"

As strategic governance has not yet received its final form, it stresses the importance to search for an answer to the underlying rationality behind strengthening state intervention into the economy. In order to do this, one should analyze Russia's key industries in terms of their importance for both national security and economic security.

3 Accomplishment of research

The accomplishment of this research started in summer 2005, when the Russian State's direct interventions into business became more frequent, more forceful, and hence more visible. During the following 18 months, the researcher had a chance to discuss with several of Russia's political and economic decision-makers, such as ministers, members of the State Duma both from conservative and liberal ends, central bankers, regional decision-makers, academics, advisors to government bodies, among other Russian experts. In addition to numerous Russian experts, the author exchanged ideas with many CEOs of the large foreign corporations operating in Russia.

Despite these illuminating discussions, one should stress that the secondary data forms the core of the data used in this article[24]. The researcher has collected relatively large amount of information and news database related to the strategic thinking in Russia, i.e. the author has collected numerous company analyses, business reports and news from Russia and outside the country. The main themes focused upon in the data collection have been the development of the regulatory framework, the level of control exercised by the Russian State via direct ownership or through the Kremlin-friendly oligarchs[25], the consolidation processes in various industries, including the ownership development of major business groups, and the strategic importance of these industries either to national security or the economic functioning of the country.

The author has tried to be as objective as possible in analyzing such a massive amount of written material. To decrease the possible subjectivity of the researcher, many quotations have been included in the text. The obvious shortcomings of this paper cannot be denied, since several documents related to strategic policies in Russia are not public or the public expressions of them are deficient, ambiguous, or even dubious. The author has tried to fill in the gaps in the public data with interviews and discussions. All in all, some 40 interviews have been undertaken to carry out this report.

In order to improve the readability of the paper in the hectic world of today, the author has tried to make the report as concise as possible, which naturally makes it impossible to explain all the background developments in full detail. However, the rather wide reference list aids a reader to deepen his/her knowledge on the background events.

As the strategic governance revolution in Russia proceeds apace, it is necessary to stress that this article was completed at the end of 2006, and hence, this article should be considered as a work in progress rather than a final report.

[24] As the interviews play only a side role in this research, a listing of the persons interviewed seemed to be unconstructive.

[25] Oligarchs' friendship with the Kremlin is rarely based on patriotism but rather on the symbiotic relationship, where the state gives undervalued assets to oligarchs and in return expects loyalty. Tompson (2005, 163-164) states aptly that "*the oligarchs' fortunes have always depended on state patronage, and the state's attitude towards them remains critical to their survival. That is why they work so diligently to 'colonize' state structures. Oligarchs who fall out of favor with the authorities can soon find themselves out of business, if not out of the country.*"

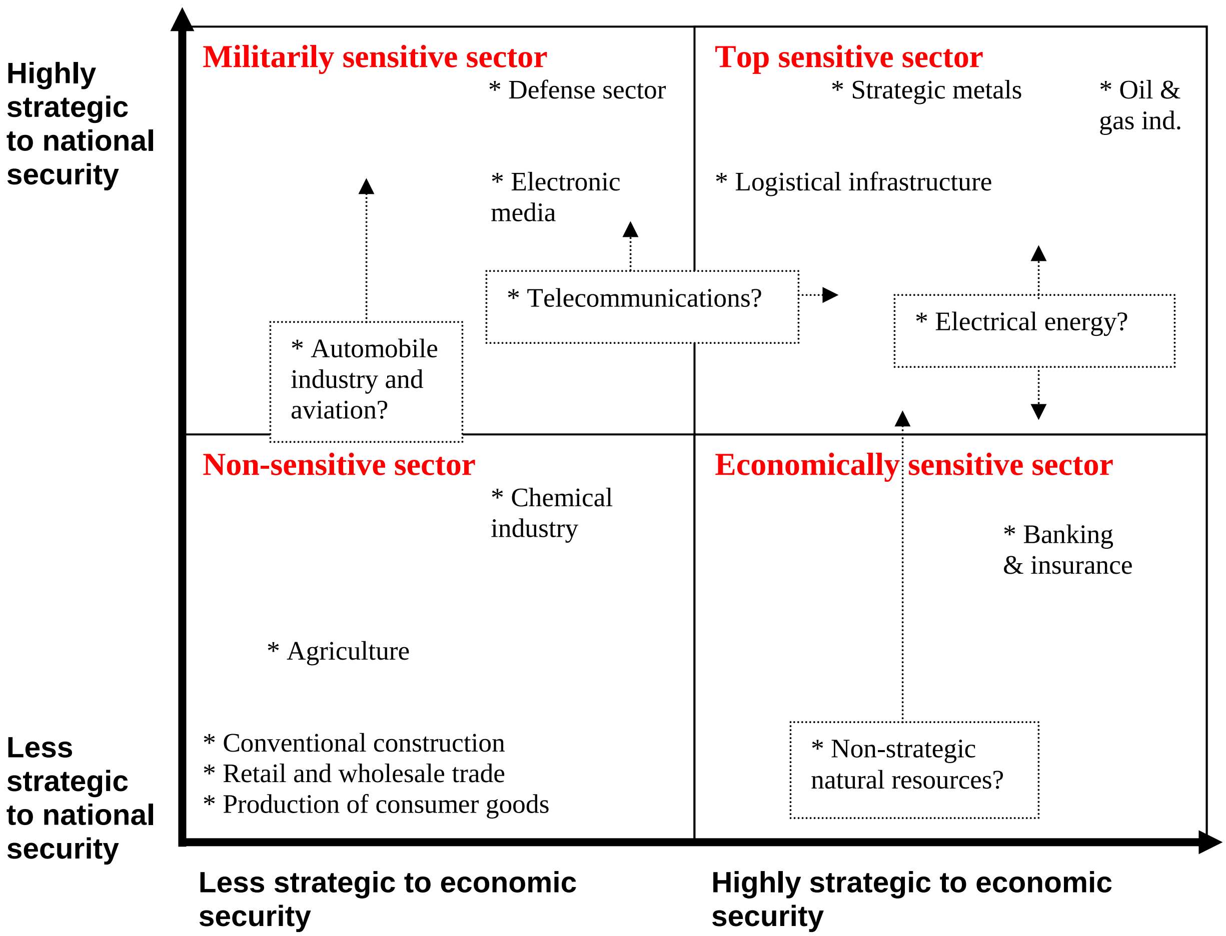
4 Some of Russia's key industries positioned in the strategic governance matrix

The author aims at positioning some of Russia's key industries in the strategic governance matrix by using two dimensions, i.e. to what extent an industry is strategic for the national security and the national economy. With these two parameters, the Russian economy is divided into the following four sectors: 1) The militarily sensitive sector; 2) The economically sensitive sector; 3) The top sensitive sector; and 4) The non-sensitive sector.

The militarily sensitive sector is highly strategic for Russia's national security, just as the economically sensitive sector is highly strategic for the country's economic functioning. The top sensitive sector stands for those industries which are highly strategic for both national and economic security. On the contrary, the non-sensitive sector has lower strategic importance in both of these dimensions.

Before analyzing these sectors in a more detail, one should emphasize five aspects. First, foreign companies are not allowed to invest in all the sectors relevant to national security, such as the intelligence services, customs and police operations etc., and therefore, the aforementioned industries have been left out of the matrix. Second, the economic security component does not show the industry's significance for the GDP but rather the industry's role in the overall functioning of the economy. Third, the precise positioning of any industry in the matrix is an extremely difficult task since these industries are very broad and anything but homogeneous. Despite the aforementioned complexity, the author has tried to place the core of the selected industries in the matrix. Fourth, it is impossible within this article to place all the essential sectors in the matrix, and therefore, the author has selected some of them to illustrate the underlying strategy agenda in Russia. Fifth, these industries are in flux, and as a sign of it, the researcher has indicated some industries, which are likely to change their place in the strategy mix in the near future.

Figure 1 **Positioning Russia's key industries in the strategic governance matrix**



Non-sensitive sector

Production of consumer goods: Consumption-oriented industries do not affect either Russia's military security or economic functioning, and thus, they are of a lesser importance to the strategic governance of the Russian Federation. To the strategic masterminds of Russia, it is of a lesser significance whether consumer goods are produced by a Russian company or a foreign one as long as production takes place inside the country. Assumingly, the Russian leadership prefers domestic production over the imported goods, and hence may be tempted to use various measures to hinder the import of consumer goods in the future. I believe that the attempts to slow down imports via various administrative measures will continue, even after Russia has joined the WTO[26].

The temptation to slow down imports with various administrative practices is obvious, since the imports keep growing extremely fast – close to 30 per cent in the first half of 2006 – and the share of consumer goods in imports has become larger. Even if over 40 per cent of the Russian imports consists of machinery and vehicles, one should not forget that passenger cars represent nearly a tenth of the total imports, indicating that the consumption-orientation in imports is increasing along with the rising living standard. The development in Russia's retail trade also refers to a high import-orientation. The share of imports in the value of retail trade has risen to over 45 per cent (BOF 2006a/b/c).

Retail and wholesale trade: In the beginning of the 1990s, Russia reminded one in many respects of a bazaar economy. This was natural outcome since the centrally planned system was suddenly dismantled and retail trade attracted numerous new agents, as the starting of a retail business did not require a considerable investment. The liberalization of imports filled these small retail entities with imported goods. Since the massive devaluation of the Ruble in 1998, domestically-produced goods have gained a foothold in the Russian retail market (TD 2005).

Over the last decade, hypermarkets and supermarkets have sprung up in Russia's more affluent cities. Consumers in the larger conurbations, who tend to be more time conscious, have become quickly used to shopping in more modern environments and have been willing to pay a premium for the convenience factor. Consumers in the regions, however, remain more sensitive to price. Despite such a change in the retail sector, open air markets, kiosks and pavilions, at which the vast majority of people did their shopping in Soviet times, still account for approximately 80 per cent of retail spending, although the savings that they offer have virtually diminished (BOF 2006b).

[26] Just a few days before the Christmas 2006, several thousand trucks were awaiting their access to Russia in three border crossing points at the Finnish-Russian border. The total length of these three lorry lines exceeded 100 km, stressing the need to speed up the customs and other imports-related procedures at the Russian side of the border. The Finnish-Russian border is not the only location in Russia, where Soviet-type lining has re-appeared.

As competition intensifies and retailers put increasing pressure on profit margins, the market will be forced to consolidate further (BEE 2006b). As an example of a further consolidation, one can give the rather fresh acquisition of Pyaterochka[27] over Metronom for approximately USD 200 million (TD 2006g).

Even if a considerable consolidation process takes place in trade and some oligarchs are involved in this process, it can be argued that the retail and wholesale trade belongs to the non-sensitive sector, and most probably, this sector will also remain open for foreign investors in the future. Due to trade's low political risk, relatively small investment requirements, and high growth[28], many foreign retail chains have recently been established in Russia. For example, Wal-Mart, the world leading retail chain with over USD 300 billion in revenues seeks, to enter Russia along with many other foreign retailers (AC 2006g).

Conventional construction: Some 130,000 companies operate in the Russian construction business, and over 95 per cent of these firms are privately-owned. The share of the foreign construction corporations in the Russian construction market is around five per cent, the Turkish enterprises occupying approximately 2-3 per cent, the Finnish firms around one per cent, while the remaining foreigner firms account altogether for one per cent of the market (RT 2006).

Construction can also be positioned in the non-sensitive sector as it does not contain major security concerns. Despite this general rule, there are some peculiar cases, where a construction project led by a foreign company has been taken over by a Kremlin-friendly corporation in a suspicious administrative manner (RL 2006). Non-transparent administrative manners emphasize the fact that some companies are more equal than others in Russia, even if they would operate outside the political economy.

[27] Pyaterochka is Russia's largest grocery retailer and it operates in some 20 Russian regions. In Moscow, the company accounts for a third of the modern grocery retail space (TD 2005).
[28] Retail sale volume in Russia has increased annually approximately 10 % and major multinational firms have reported a 15-30 % growth of sales in US dollar terms in the past few years (BEE 2006b).

The domestic construction companies obviously use even non-legal measures to improve their position against foreign competition, but however, the Kremlin's official position towards foreign competition in construction seems to be rather neutral (Putin 2004)[29]. Thus, it can be argued that the construction sector contains only business risk though one has to acknowledge the fact that the construction business is overwhelmingly shadowed by corruption, since authorities at all levels are connected with it, i.e. land selling and leasing of land, construction permissions, numerous inspections etc.

In the case of constructing strategic sites, such as nuclear power stations, ports and other strategic logistical sites, the preference is nonetheless given to domestic corporations regardless of their competitiveness. Occasionally, foreign firms may participate in these strategic construction projects as subcontractors, if the domestic companies lack the required skills.

It is important to note that some Kremlin-friendly tycoons have recently intensified their activities in construction. For example, Russia's leading aluminum oligarch Deripaska acquired a 75 per cent-stake in Glavmosstroi, with the intention of turning the Soviet behemoth into a modern construction leader (Troika 2006h). One may only guess the true motives of this acquisition.

Agriculture: Even if agriculture's share of the Russian GDP is not particularly high (around 6 %), one should bear in mind that agriculture employs a tenth of the Russian workforce and close to a fifth of the Russian imports consists of food and agricultural products (EIU 2006b; Korchagina 2006). For a country with a population exceeding 140 million, the large foodstuffs imports are a security concern, especially if the global situation of the foodstuffs safety worsens due to bird flu, mad cow disease or some other cause.

[29] In summer 2006, Putin invited foreign construction firms to Russia to take part in Russian projects to build roads and seaports, modernize airports and work in housing and communal services (RIA 2006b). Even if this message from the Kremlin would be sincere, the researcher believes that the Kremlin messages are not always executed on the lower level, if they are not followed by the Kremlin's control.

Increasing strategic attention towards agriculture may have been observed. The national priority project on agriculture is one sign of the growing strategic importance of the agriculture[30]. Although agriculture has received more federal attention, one should keep in mind that the share of agriculture and the national priority project related to it in the overall federal budget is small[31]. Though the state's financial allocations to agriculture are relatively modest, it is interesting to notice that some Russian oligarchs, possibly guided by the Kremlin, have started to invest in agriculture, although the return on investment is considerably higher in several other sectors (EIU 2006a; Korchagina 2006).

Chemical industry: Russia's chemical industry represents some six per cent of the country's industrial output. Although nearly 8000 firms operate in the sector, 90 per cent of these companies are small (Kommersant 2004). Despite the large number of small entities, the industry is dominated by a dozen corporations. In fact, 10 chemical corporations, excluding petrochemical corporations, reach the list of Russia's 200 largest companies. The state possesses significant ownership stakes in the major corporations, but the industry as a whole is, to a large extent, privatized.

The chemical industry plays a rather important intermediary position in the Russian economy. It provides materials to several key industries, such as the oil and gas business and even to the defense sector (Vahtra & Liuhto 2004). The military-connection makes the chemical industry more sensitive, though it still today can be classified as belonging to the non-sensitive sector. Should the military drift in Russia continue, it cannot be completely ruled out that the chemical industry would move towards the security sensitive sector, i.e. more parts of the chemical industry would end up in the hands of the new oligarchy formed by the businessmen having their earlier career in the army or the security services.

[30] Russia's Ministry of Agriculture, under the auspices of the President, launched a priority national project Agro industrial complex development program at the end of 2005 (PEI 2006).

[31] The state has allocated around half a billion US dollars for the national priority project dealing with agriculture. Here one should remember that Russia's federal budget revenues amounted to approximately USD 175 billion in 2005. In other words, Russia's national budget in that year was less than 10 % that of the USA (CIA 2006).

Militarily sensitive sector

Defense sector: The position of the army and the defense sector as a whole has strengthened in Russia during Putin's two presidencies. In 2006, Russia's total military expenditure rose by almost 30 per cent, excluding the impact of inflation (Cooper, for reference see Warfare 2006)[32]. Most probably, Russian military expenditure also continues its fast growth in the future. The increased budget spending is, on the one hand, due to the fight against terrorism as well as military modernization, and on the other hand, due to the country's overall aim at strengthening its military capability (Moscow News 2006; RIA 2006a).

Despite the increased budget spending on defense, one should not forget that Russia's total military expenditure is less than USD 40 billion. In comparison, the US military expenditure is over ten times larger (CIA 2006; DID 2005/2006). Looking to the aforementioned figures, Russia's increased defense spending does not look so worrying, since the weakening of the army's control over tens of thousands nuclear warheads would be a more threatening factor.

It can be argued that the increased military spending in Russia indicates more about the priorities of the Russian Government rather than the hidden militarization of the country. In this context, one should not keep in mind that approximately 18 per cent of the Russian population lives under the poverty line (CIA 2006)[33].

Although Russia's defense sector is large, it is much different from the Soviet military complex, which included vast civilian production. Since the major part of the civilian production under the defense sector has either been privatized or has collapsed, the defense sector does not offer many investment opportunities for foreign investors. Besides, the Russian Government is reluctant to allow foreigners to take over companies important to the army. Defense Minister Ivanov's opinion on the future development of the Russian aviation industry underlines the aforementioned conclusion (Kremlin 2006).

[32] According to Julian Cooper, national defense accounted for 2.7 % and the total military expenditure 4.3 % of the Russian GDP in 2005. In other words, national defense represented around 15 % and the total military expenditure some 25 % of Russia's federal budget expenditure (Warfare 2006).

[33] In comparison, the respective figure in the USA is some 12 % (CIA 2006).

In 2005, Russia's official arms exports came to USD 5-6 billion, and the figure is estimated to climb to USD 8 billion in 2007. Rosoboronexport is not only Russia's official arms exporter but it has also become an influential actor in Russia's metal-related business[34]. In November 2006, Rosoboronxport accumulated a 66 per cent-share in VSMPO-Avisma, the globe's leading titanium producer.

Automobile industry and aviation: In 2006, Russia is estimated to assemble some 850,000 automobiles, including foreign models. AvtoVAZ is clearly the dominant car producer in Russia. The company's annual output reaches 700,000 vehicles. In addition to domestic production, over 600,000 cars are estimated to be imported (RIA 2006f).

At the end of 2005, Rosoboronexport took over the largest automobile producer, AvtoVAZ, and soon thereafter, the consolidation plans of the main actors in the Russian automobile industry have received support from the Kremlin (Moscow Times 2005; AC 2006a). Besides Rosoboronexport, some Kremlin-friendly oligarchs own significant stakes in the leading automobile producers (Åslund 2006).

Despite the state's consolidation attempt around AvtoVAZ, it seems evident that foreign automobile producers will not invade the Russian automobile market via imports alone but particularly via increasing production inside Russia. The Russian State cannot stop the foreign invasion, unless it changes the rules of the game, i.e. restricts foreign ownership in the industry, which does not seem a likely alternative, at least under the current presidency.

The consolidation process of the Russian automobile industry is reminiscent of that of aviation. In the beginning of 2006, Putin urged the creation of national champion in this industry (TD 2006f), and the merger of the main Russian agents, such as Ilyushin, Irkut, MiG, Sukhoi, Tupolev and Yakovlev (Crotty 2006). The state became the majority owner of the aviation construction holding, the United Aircraft Construction Corporation (TD 2006k). Foreign participation in Russian aviation is to remain modest, and it will be restricted to civil and transport aviation (Kremlin 2006).

[34] It was peculiar to notice that Rosoboronexport was one of the main sponsors of the national ice hockey team of Russia in one of the international ice hockey tournaments organized at the end of 2006. Even if the advertisements of the arms exporter in sports should not be over-dramatized, it does not show the best judgment from those involved.

The consolidation in the Russian automobile and aviation construction industries has heated up discussion on the motives of state-led integration (BOF 2006d). Some argue that the state aims at regaining control over these industries in order to improve their competitiveness, i.e. the state tries to secure the jobs that these industries provide[35]. Others argue that strengthening military drive in the economy (or the militarization of the oligarchy[36]) and desire to control all the key industries are the hidden motive behind re-nationalization. Should the latter scenario occur, the military sensitivity of these industries will increase considerably in the future.

Telecommunications: Russia's fixed lines are controlled by state-controlled Svyazinvest. This holding possesses controlling stakes in the seven regional telecoms and in Rostelcom, a monopoly of long-distance in Russia and international calls (AC 2006j). The Russian Government has discussed for several years about the privatization of Svyazinvest (TD 2006d).

In the beginning of December 2006, Russia's Economics Ministry informed about its aim at reorganizing the company by consolidating Rostelecom and the seven regional telecoms into Svyazinvest itself, which could then be listed (AC 2006j). However, a few weeks later the Telecommunications Ministry rejected the plan (TD 2006s).

If Svyazinvest is fully privatized one day, it seems that this move is not done in order to genuinely privatize the industry, but in order to raise private capital for the further modernization of the sector, while keeping control in state hands, either via direct ownership or via a Kremlin loyalist[37].

[35] More competitive foreign companies would obviously be a better guarantee to save jobs in the industry in the longer run rather than an artificial and costly saving attempt by the state.
[36] Kryshtanovskaya and White (2003) found that a quarter of Putin-era political elites have received a military education, compared with 7 % of the Yeltsin elite in place ten years earlier. On the other hand, Riviera and Riviera (2006, 141) argue that "*even during the presidency of former KGB Lieutenant Colonel Putin, the Russian elite is considerably more bourgeois than militocratic.*"
[37] It needs to be remembered that Sistema already owns a 25 %-stake in Svyazinvest (TD 2006t). It is not easy to conclude how close Vladimir Evtushenkov, the Chairman of the Sistema Board, is with the Kremlin (Independent 2006).

Mobile telecommunications has practically been almost completely privatized. Russia's mobile communication is dominated by three actors: MTS, VimpelCom and Megafon. Together these three main telecoms held some 85 per cent of the Russian mobile telecommunication market at the end of 2006 (AC 2006h).

The main owner in MTS is a Russian company, Sistema, with majority ownership. VimpelCom is led by the Russian Alfa Group (33 %) and Norwegian Telenor (27 %). Megafon, a Swedish-Finnish Telia-Sonera is the main owner with over 40 per cent, but the Russian Alfa Group has strong interest in increasing its ownership stake from the current one (25 %).

Deutsche Telekom's departure from MTS and Alfa Group's aggressive or even hostile ownership policy in Vimpelcom and Megafon have intensified the speculation on the future position of foreign firms in Russian telecommunications (TD 2006c). Even if Gref's statement (RIA 2006c) - "The Russian Government has forgotten all about telecommunications, thank God, so it's one of our most briskly developing sectors. If the government undertakes to regulate the telecommunications and mobile communications sector, we will have no mobile phones [left]." – is encouraging, one may only hope that this statement will remain valid after the election of the new president and the formation of a new government in 2008.

Slow privatization of fixed lines and the aggressive behavior of the Russian mobile corporation close to the Kremlin[38] indicate that the state has not abandoned its interest in controlling the telecommunications business. This is understandable since the telecommunications is an important tool for the army, the police and the security services. Significant further delays in the privatization of the fixed line operator[39] and the intensified indirect state support for the Kremlin-friendly Alfa Group would signify that this industry continues climbing higher in the security ladders, and makes it more risky for foreign investors.

[38] Alfa Group's main owner Mikhail Fridman is believed to have close connections with the Kremlin.
[39] Currently, it seems that the privatization of Svyazinvest is delayed, at least until the presidential elections of 2008 (TD 2006s).

Electronic media: Putin (2005) declares that the state must "*ensure that national television fully takes into account Russian civil society's most relevant needs and protects its interests. We need to establish guarantees that will ensure that television and radio broadcasting are as objective as possible, free from the influence of any particular group, and that they reflect the whole spectrum of public and political forces in the country.*"

Despite the noble goals referred to above, Russia's free electronic media has considerably stagnated in this decade. Even if state control over Russia's printed media is not as strong as one could assume from the Western news[40], the country's electronic media, particularly the national TV channels, has been taken over by the state or corporations close to the Kremlin (Koltsova 2006)[41]. Although there are over 2000 radio stations and online media grows rapidly (EJC 2006), they play a much more modest role in opinion formulation than does television, as over 80 per cent of the Russians consider the national TV channels as the most important news source (Compiler 2006a).

While the use of the Internet in Russia lags behind the developed world, there is wide availability of political information both from domestic events and foreign ones on the Web, and its popularity, particularly amongst the younger generation, widens. In 2005, the number of Internet users in Russia exceeded 20 million, whereas in the beginning of the millennium it was just over two million (PPE 2006)[42].

Oates (2006 29-37) analyzes the Russian media as follows: "*Russia technically has a diverse system of media ownership for its major media outlets, but realistically there is no central media outlet that can challenge the Kremlin's monopoly on power and information. In this way, the Russian media have in a broad sense come full circle back to the media environment of the Soviet period. … As a result of the high-profile arrest, subsequent exile and further legal pursuit of the two major media oligarchs, other media owners and*

[40] Interesting takeovers are also taking place in the printed media, for a closer look see Compiler (2006b).

[41] The first national channel – Public Russian Television (ORT) is the largest TV channel in the country with 140 million viewers. TV channel Russia is the second national channel with some 50 million viewers. NTV used to be the only private Russian TV channel with the status of a national channel, but after the hostile take-over by Gazprom, there are no longer any independent national channels in Russia (EJC 2006).

[42] In addition to analyzing the position of Russia's media, one should analyze in further studies the activities of the news agencies, such as Interfax, Itar-Tass and RIA Novosti, which produce the majority of the raw material for the analysis shown in the media.

investors are now very aware of their vulnerability. By setting this example, the Putin administration has made it clear it will selectively apply the tax code and other laws to silence and even shut down media outlets that consistently oppose the presidential line. Thus, Russia retains mixed ownership of media outlets, from tiny regional newspapers to vast national television channels, but there is now virtually complete state control."

To summarize the analysis on Russia's electronic media, one should stress that the electronic media is not as much strategic with regard to national security as it is for political hegemony, and hence, it is not a major surprise, that "*during the past year Gazprom has been on something of a media-buying spree, and most observers say that this latest acquisition [Komsomolskaya Pravda], if the deal goes through, is another sign that the Kremlin wants to exert more control over Russia's media landscape before the presidential elections scheduled for 2008*" (BEE 2006f, 10).

The electronic media can be classified as belonging to either the security sensitive sector or even to the top sensitive sector. The more political leverage a media outlet possesses, the more risky it becomes for any investor, be it a domestic or foreign one.

Top sensitive sector

Electrical energy: The holding called RAO UES forms the backbone of the Russian electricity sector. The companies belonging to this group generate approximately 70 per cent of all the electricity produced in Russia. As the corporation uses a great amount of natural gas in its electricity production it is highly dependent on Gazprom's deliveries[43]. RAO UES is to be divided in 2007 into regional electricity generating companies with an official goal to enhance competition in the field (TD 2006o).

In addition to RAO UES, state-owned Rosatom is a major player in energy production, as it controls the nuclear power stations in Russia. At the moment, nuclear energy generates around 16-17 per cent of Russia's total electricity production, and its share is to increase up to 22 per cent by 2015 (BOF 2006f; TD 2006e).

[43] Presently two-thirds of Russia's electricity is based on thermal generation, with nearly two-thirds of that provided by natural gas (BOF 2006g).

Through breaking RAO UES currently led by former vice-prime minister Chubais, one of the key figures of the liberal opposition, and by the strengthening the position of state-run Rosatom, the government either consciously or unconsciously tightens the Kremlin's grip over the electricity sector. Furthermore, Taraskin, Director at the Ministry for Industry and Energy, has stated that there is a proposal to include the electricity sector, particularly wholesale generating companies, in the law on strategic industries (Interfax 2006).

As the electricity energy sector is a high voltage issue, its security sensitivity may soar in the future. Therefore, it is of the utmost importance to track into whose hands the privatized energy assets from RAO UES will fall. Here, it is necessary to remind oneself that privatization in Russia does not necessarily mean that the state would not retain indirect control over them via loyal functionaries, and hence, two arrows pointing both up and down have been drawn in the strategic governance matrix depending on the results of the privatization of RAO UES.

Logistical infrastructure: Putin's (2004) address to the nation indicates as follows: "*the state must control the development of the country's infrastructure for a long time to come – I am convinced of this. Still, private investment will also make an important contribution to creating a branched transport infrastructure of high quality and reliability.*"

Russia's transportation strategy until 2020 is also ambiguous in terms of its strategic governance. On the one hand, the strategy stresses a need to increase competition, privatization and de-monopolization in the country's logistics. On the other hand, it explicitly emphasizes the strategic importance of the transportation system to national defense and national security, and hence, underlines the importance of directly controlling its future development (e.g. Transport Strategy 2005).

I personally believe that the maritime terminals and airports, the main railway network and the inter-city road system, the major telecommunication links, and the pipelines in particular belong to the top sensitive sector, while the logistical services can be positioned to the consumption-based non-sensitive sector. However, even the currently non-sensitive logistical services may jump into the top sensitive sector, if the military-orientated policies gain further weight in Russia.

For a foreign investor, Russian logistics offers both high growth potential but also high risks. The Russian State allows foreign firms to operate in the soft sides of the logistical sector, i.e. logistical services and the non-sensitive parts of the logistical infrastructure, including road construction. On the other hand, the state's interest in controlling the strategic infrastructure, such as pipelines, has grown even further.

I argue that the hydrocarbon pipes are strategically even more important for the Kremlin than are the hydrocarbon reserves per se. As the majority of the oil transport is conducted through pipes, the Russian State practically controls, with these pipelines, the private oil majors. In addition to domestic control, the pipelines have gained weight in Russia's foreign policy. The pipelines do not only build bridges between Russia and its customer countries, but they also build dependency with unpredictable consequences, if the siloviki-type of economic policy gains more foothold after Putin's presidency.

Strategic metals: The strategic policies are clearly observable in strategic metals, such as aluminum, titanium and some other strategic metals. It seems that the state wants to take over the leading industries involved in exploiting strategic metals and consolidate them under one or several holdings.

The state's interest in aluminum is understandable, since Russia ranks as the world's third largest producer of aluminum after China and the USA, and she exports three quarters of her total production abroad (Liuhto & Jumpponen 2003).

In the beginning of 2006, the aluminum sector was controlled by Russian Aluminum (RusAl) and the Siberian-Urals Aluminum Company (SUAL), which represented almost 90 per cent of the country's total aluminum production. At the end of 2006, Russia's aluminum industry experienced a considerable consolidation, when RusAl and SUAL merged with Swiss-based Glencore. The conglomerate is the globe's largest producer, and it is controlled by Kremlin-friendly Deripaska (AC 2006e; BEE 2006e; BOF 2006e; Moscow Times 2006b). The merger will likely make competition in the Russian aluminum products market almost impossible for outside companies (Fuss 2006).

If the state has resumed its control over the aluminum industry via a Kremlin-loyalist, control over titanium production was taken through an acquisition. In 2006, VSMPO-Avisma dropped into the hands of Rosoboronexport (AC 2006d; Moscow Times 2006a).

The Kremlin's interest in this company is not only due to the fact that VSMPO-Avisma is the leading titanium producer in the globe[44]. Perhaps, the major reason for the acquisition is the creation of a national champion in special metals around this company. Now, the Russian State is well positioned to proceed with its strategy of creating a specialty metals holding. One may anticipate acquisition with an aim at consolidating several companies involved in the production of titanium and molybdenum alloys, including some in Kazakhstan and Ukraine (TD 2006j).

The state interest in Norilsk Nickel is obvious, as the company has significant reserves of strategic metals. Besides vast reservoirs, the company is a global seller in many metals. Its global market share is around 60 per cent of palladium, 20 per cent of platinum, 20 per cent of nickel, 10 per cent of cobalt, and three per cent of copper (Liuhto & Jumpponen 2003). All in all, Norilsk Nickel is Russia's leading metal giant, and hence, it is highly likely that strategic policies with decisive measures will reach the company sooner rather than later. The early signs of the state acquiring Norilsk Nickel were already experienced at the beginning of 2006, when the state wanted to acquire a significant stake in the company via Alrosa, a state-owned diamond company (Finanz 2006; Kommersant 2006).

Russia is responsible for approximately six per cent of global steel production. The country's steel production is heavily concentrated. The four largest corporations – Evraz, Severstal, Magnitogorsk and Novolipetsk – account for over three quarters of the Russian output. Despite the fact that Russia's steel production is heavily concentrated already at the moment, it seems obvious that the state-orchestrated consolidation waits around the corner (Liuhto & Jumpponen 2003; AC 2006c/f).

"*There is considerable speculation that the former owner of Sibneft, Roman Abramovich, is acting as the Kremlin's stalking horse in building a national steel champion by seeking to take over steel company Evraz, with a view to building it up and then perhaps seeking a merger with one of the other major Russian steel enterprises – Severstal, Novolipetsk or Magnitogorsk*" (BEE 2006c). Some of the Russian steel majors have already started to internationalize their ownership structure through initial public offerings (IPOs) abroad, perhaps with an aim to avoid being swallowed by the national steel champion.

[44] VSMPO-Avisma produces around a third of the world's titanium sponge.

Oil and gas industry: Russia has substantial oil and natural gas reserves. According to British Petroleum (2006), Russia possesses around six per cent of the globe's oil reserves and over a quarter of the natural gas reservoirs[45]. Furthermore, Russia is, with her 12 per cent-stake, the second largest producer of oil and the largest producer of natural gas, representing over a fifth of the global gas production. As Russia consumes only a minor part of the hydrocarbons it produces, the country has become the leading exporter of natural gas and the second largest exporter of oil after Saudi Arabia (CIA 2006; EIA 2006).

The oil and natural gas business ranks as the most sensitive industry out of all the Russian businesses, as it is the principal source of the country's budget income and export earnings. Energy accounts for two-thirds of Russian export earnings, nearly 40 per cent of the public sector revenues, and approximately a quarter of the total production (Sutela 2006).

Although around 100 companies produce oil in Russia, oil production is in the hands of five vertically-integrated majors (Liuhto 2002), namely Lukoil, TNK-BP, state-owned Rosneft, Surgutneftegaz, and state-controlled Gazprom. These five corporations were responsible for 80 per cent of Russia's crude oil production in 2006 (TD 2006n).

After the acquisition of Yuganskneftegaz by Rosneft and the acquisition of Sibneft by Gazprom, state-led companies currently represent at least a third of all Russian oil production. Presumably, the state's share will grow significantly in the future.

It is not a completely excluded scenario that the state reintegrates all the state-owned oil units under one holding. Certain steps in that direction have already been taken between Rosneft and Gazprom (TD 2006m/p).

Lukoil's CEO Alekperov has stated that the Russian oil and gas consolidation will continue. He predicts that in the future, consolidation of the current 11 oil majors, including Gazprom, will result in the existence of just five large oil and gas companies. His comments suggest that three Russian oil majors will be merged into larger units (TD 2006n).

[45] Because the information on Russia's hydrocarbon reserves is classified, one cannot verify British Petroleum's figures. Some experts argue that Russia's oil reserves are at least 1.5-2 times larger than those indicated by British Petroleum. However, this does not necessarily mean that their utilization would be economically feasible, unless the world market price of oil would significantly grow.

In addition to the strong position of the state in oil production, the state also controls oil pipeline companies. It has been speculated that during this decade, the state might integrate its two pipeline companies, Transneft and Transnefteproduct, under the same holding, and hence, strengthen this holding's position, both in the domestic market and abroad. Here, one should keep in mind that the rapid unification of these units is everything but likely (TD 2006p).

If Russia's oil industry was privatized in the 1990s, the natural gas business has practically remained in the state's close possession since the break-up of the USSR. The sector is dominated by Gazprom, which produces over 80 per cent of the natural gas, controls the gas pipeline, and has an export monopoly over gas. The artificially low price[46] of natural gas inside Russia has not motivated private producers to increase their gas production[47].

Gazprom is perhaps the most strategic corporation in Russia. This company alone generates several percentage points of the Russian GDP. Moreover, it contributes significantly to the state budget and supplies Russian industry and households with inexpensive natural gas. Therefore, it is understandable, why the government has kept its control over Gazprom. Even if the Russian State sells a larger part of Gazprom to private owners, including foreigners, one should not consider that such ownership liberalization would mean that the state would be abandoning its control over it.

Investing in the Russian oil and gas business has become a form of Russian roulette for foreigners. The revenues are high but the risks of political intervention are even higher. At the moment, it seems that the state allows foreign investors to benefit financially from the development of the oil and gas industry but is extremely reluctant to give control to foreign companies, i.e. Western capital and know-how is accepted but control is not given in return.

[46] The natural gas price in Russia is some USD 40-55 per 1000 cubic meters of gas depending on the customer, while Russia sells natural gas to Western Europe with prices around USD 200-250 (BOF, 2006g). The difference cannot only be explained by higher transport costs but by massive scale subsidizing to Russian industry. As superficially low gas prices lead to as inefficient use of this natural resource, the Russian State loses tens of billions of dollars annually. The Russian Government plans to raise the domestic gas price to USD 100 by 2011 (AC, 2006i).

[47] At the end of 2006, there are signs that some Russian oil majors, such as Lukoil, might plan to increase their natural gas production via closer co-operation with Gazprom (TD, 2006r).

The current development trend indicates that the Russian State intents to increase control over oil magnates, and reduce the possibility of any oligarch becoming a high-profile political player in Russia. Perhaps, the Yukos affair and color revolutions around Russia have pushed the Russian leadership to rather extreme measures to control the oil and gas business, as it is the most strategic sector of the economy and perhaps the most important financial source of their political campaigns (Balzer 2005).

Economically sensitive sector

Non-strategic natural resources: Non-strategic metals, land[48] and forests[49] are economically sensitive in Russia, since giant economic values surround them. Land and forest ownership seems to be a highly political question in the country, and therefore, their privatization has been partial at best.

To underline the conclusion above, Putin stated in October 2006 that he would not sign a law allowing the transfer of forests to private ownership (TD 2006i)[50]. The decision not to privatize forests may infer that Russia is worried about foreign ownership of the Russian forests, and particularly higher competitiveness from foreign forestry firms. As large economic values surround non-strategic natural resources, it is possible that the Kremlin directly and indirectly supports Russian firms over foreign ones in the future.

Banking and insurance: The Russian banking system continued its integration in 2006. By November 2006, Russia had 1203 active credit organizations licensed to carry out banking operations (of which 1156 were banks), down from 1253 (1205) at the start of the year (EIU, 2006b). Despite the beginning of the consolidation, it is easy to conclude that Russia has too many non-competitive banks. Many of these banks were established in the 1990s to serve one corporation or a small number of clients.

[48] Land, and particularly the fresh water it contains, could become a strategic issue, if the global fresh water situation worsens.
[49] Russia possesses a fifth of the globe's forests.
[50] Despite fact that the private forest ownership is not allowed, it needs to remembered that the long-term leasing of forests becomes possible with the new Forest Code, which enters into force in the beginning of 2007 (Compiler 2006c).

Even if the amount of banks is large in Russia, Russian banking is concentrated, and state banks dominate the sector. The state controls around 20 banks via federal/regional authorities or state enterprises. These state banks hold 70 per cent of the population’s deposits and 40 per cent of loans to the economy. The three major state banks are Sberbank, Vneshtorgbank (VTB) and Gazprombank, which together own some 40 per cent of the assets in the banking sector (Pollisinski 2006).

According to proposals put forward by Russia’s Finance Ministry, the state will reduce its presence in banking. The ministry proposes to start with the partial privatization of VTB, by reducing the state’s stake in the bank from 99 to 51 per cent. The proposal also includes a reduction of the state’s share in Sberbank from 67 to 51 per cent within the next seven years. However, before the proposal would become effective it should be signed by Putin (EIU 2006b).

Russia’s entry in the WTO puts high pressure on the country’s banking, and thus, Putin has stressed the need to further consolidate the banking system via creating large financial conglomerates. Some analysts have a rather reserved attitude on the state-based mergers. Some experts (TD 2006l, 7) have stated as follows: “*The concern is that the creation of financial conglomerates will be based on state banks such as VTB and Russian Development Bank, rather than improving the competitive environment for commercial banks by reducing the dominance of the state banks.*”

In the beginning of 2006, approximately 40 wholly-owned foreign banks and some 90 banks with foreign ownership operated in Russia (Satrom & Zhdanov, 2006). A historical quota has restricted foreign capital participation in the Russian banking sector, and therefore, only 12 per cent of Russia’s banking assets are in foreign hands (EBRD 2006)[51]. Despite their approaching WTO membership, the Russian Government wants to reserve the right to limit foreign ownership to 50 per cent of the total assets of the country’s banking system (BOF 2006h).

[51] In comparison, the foreign share of the banking market was in Estonia 99 %, in Finland 68 %, in Germany 10 %, and in Sweden 9 % (European Central Bank, for reference see SK 2006).

All in all, it can be expected that a major merger wave will wash over Russian banking in the forthcoming years[52]. Most probably, state banks, such as Sberbank (the population's savings), Vneshtorgbank (external affairs), Gazprombank (the raw material sector) and the Development Bank (strategic national projects) will star in the future transformation of the country's banking sector. The most probable scenario is the creation of national banking champions with the state's majority ownership. Also some genuinely private banks, among them a handful of foreign players, will gain a significant foothold in the Russian financial market. However, the state-led consolidation will be forceful.

Russia's insurance sector was occupied by more than 2000 firms at the end of the 1990s. Thereafter, the number of the insurance firms has decreased considerably. Despite a large number of players in the insurance business, the field is relatively concentrated. In 2004, the five largest insurers, Rosgosstrakh, the Capital Insurance Company, Ingosstrakh, RESO-Garantia, and the National Insurance Group, accounted for a fifth of all the premiums[53].

Foreign access to the Russian insurance market has been restricted. The Russian insurance industry is subject to a 25 per cent-limit on participation by foreign entities in the aggregate capital of the Russian insurance companies (Satrom & Zhdanov 2006). After Russia's WTO membership will be realized, the quota for foreign participation will increase to 50 per cent. This limit will not be reached any time soon since the foreign share in the charter capitals of Russian insurance companies at the beginning of 2006 amounted to less than five per cent (Apostille 2006).

Even if the amount of foreign ownership in the Russian insurance business is modest, it is likely to grow after the WTO membership, and hence, foreign insurers will bring to the Russian market much needed competition and dynamism. However, one should not predict a revolutionary turnaround, either for the better or for the worse, i.e. a gradual reform seems the most likely outcome in the Russian insurance business (Medvedkov 2006; Rubin 2006).

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[52] As an early warning of the approaching merger wave in the banking system, Minister Gref stated in December 2006 as follows: "*We plan to create the bank by pooling three big banks – Vneshekonombank, Russian Development Bank and Export-Import Bank*" (IT 2006).

[53] In the middle of 2006, SOGAZ, Rosgosstrakh, Ingostrakh, Maks and Capital were the five leading insurers in Russia (Expert 2006).

5 A summary of the strategic policies in Russia

The invisible implementation of the strategic policies started soon after Putin was elected as president in the year 2000. However, these strategic policies did not receive much public attention until April 2005, when President Putin gave his annual address to the state. Thereafter, many observers have wondered which sectors, which natural resource sites, and perhaps which individual companies will be excluded, either partially or completely, from the foreign investments. The situation is still without its final answer.

Since one cannot understand Russia's strategic agenda only by reading the relevant laws, one should search for the underlying rationale behind the strategic thinking from elsewhere. One way to go beyond the official façade is to analyze Russia's key industries in terms of their importance for national security and economic security. Using these two dimensions, the Russian economy can be divided into four sectors: 1) The militarily sensitive sector; 2) The economically sensitive sector; 3) The top sensitive sector; and 4) The non-sensitive sector.

The militarily sensitive sector is highly strategic for Russia's national security, just as the economically sensitive sector is highly strategic for the country's economic functioning. The top sensitive sector stands for those industries which are highly strategic for both national and economic security. On the contrary, the non-sensitive sector has lower strategic importance in both of these dimensions.

The top sensitive sector is formed mainly by those industries, which are either explicitly named in the subsoil law or they are otherwise on the Kremlin's watch list. The defense industry automatically belongs to the military sensitive sector, but also some civilian industries, such as telecommunications, have certain characteristics which lift them into the military sensitive sector. Banking and insurance are the backbone of the economy but as they are not highly sensitive in terms of military security, they can be regarded as belonging to the economically sensitive zone. Consumption-related industries are the core of the non-sensitive area.

Should the strategic policies strengthen in Russia, the following analysis conducted by the OECD (2006b, 6) is easy to agree with: "*The expansion of state ownership overall must be regarded as a step back. The Russian state's track record as an owner of industrial and* *financial companies is poor. The corporate governance of many state-controlled companies is problematic and state interference in the operations of such companies often distorts the development of the companies themselves and the markets they operate. The expansion of state ownership in important sectors will probably contribute to more rent-seeking, less efficiency and slower growth. The trend towards greater state ownership should be reversed in order to improve performance and reduce opportunities for corruption and rent-seeking. At the same time, more needs to be done to strengthen the corporate governance of those companies that remain in state ownership, especially as regards transparency, and to provide for a clearer separation between the state's roles as owner and regulator in those sectors in which it fulfils both roles.*"

The position of foreign companies in the four sectors of the strategic governance matrix differs a lot. The sensitive sector contains an extremely high political risk for foreign firms. Correspondingly, foreign investments in the non-sensitive zone do not face any direct political interference, though administrative abuse may still be frequent, i.e. foreign operations in the non-sensitive sector face only a business risk with non-federally-orchestrated administrative harassment. In the militarily and economically sensitive areas, a foreign firm faces varying levels of political risk depending on the lobbying power of the Russian competitor.

Should the strategic policies strengthen, it would probably lead to a weakening position of foreign firms in industries outside the non-sensitive sector, and a lowering of foreign investments in the sensitive industries. However, the faster FDI growth in the non-sensitive industries compensates for the lowering FDI in the sensitive zone, and therefore, the overall FDI inflow continues its growth, at least in medium term.

As the majority of Finnish companies operate outside the top sensitive sector, perhaps with the exception of Fortum, the overall risk of Russia's 'strategic governance revolution' to the Finnish economy is still acceptable. Though most of the Finnish companies are out of immediate political risk, one should keep in mind that the future of Finnish investment in the industries, such as telecommunications, strategically-sensitive logistics, banking and insurance, and forestry, may possess an unpredictable political risk.

To end, it should not be forgotten that a sufficient amount of control leads optimally to stability, predictability and economic growth. However, an over-controlled economy leads to immobility and accumulating societal tension. Should the latter alternative occur in Russia, this would turn the country's economic strategy into economic tragedy.

The economic tragedy looms if the strategic policies will spread in an uncontrollable manner. Russia's possible WTO accession may aid in holding down the uncontrollable spreading of the strategic policies, but it does not give a full guarantee for foreign investors against unpredictable changes in the Russian strategic governance in the future (Åslund 2006).

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Outward FDI of Russian enterprises: lessons and policy recommendations[54]

by Peter Zashev, Peeter Vahtra, Kari Liuhto

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1. Introduction

Russian outward foreign direct investment (OFDI) has not been in the spotlight of researchers and policymakers for long. Only 10–15 years ago Russia was in the midst of its messy economic transition. The country's economy shrank to a size smaller than the economy of tiny Portugal and any prospects to see Russian economy reviving soon were seen as improper optimism. Now the Russian economy has not only managed to maintain 8 years of high economic growth but it also managed to create companies that can be considered national champions. These champions demonstrated and executed ambitious international ambitions that put quite few Russian companies as actors in the global arena. These developments happened so rapidly that only few academics and experts managed to recognize the trend in time and follow it with constant business monitoring, analysis and policy papers.

At the same time after the collapse of the Soviet Union the Newly Independent States (NIS) also went through their own process of economic transition to a market economy. Some, as Belarus, preferred to opt for what the Belarus Government finds to be the attractive features of the Soviet system. Others, such as Ukraine and Kazakhstan preferred the path of more radical reforms that in one way or another had their fair degree of success. One of the important ingredients of their reform strategies was the attraction of foreign direct investment (FDI). Back in the 1990s it would have been impossible for the policy makers in these countries to predict that the very impoverished Russia would be one of the main investors in their economies.

Even if impossible to imagine it back then that is exactly what is happening at present. These processes are not just now starting to be monitored more precisely and are still not well understood. The serious consequences stemming from this comparative lack of data monitoring and analysis are that the implications for all stakeholders involved in the process, be it the Russian companies themselves, the Russian policy makers or their counterparts in the countries recipients, are far from being addressed and discussed. That is precisely the gap, which this research paper aims to start filling by dealing with several important questions.

This paper is built in three parts that are followed by conclusions and policy recommendations. The first part demonstrates the growth of the Russian OFDI and highlights the industries that are characteristically more active in the Russian OFDI. The second part analyses the presence of certain geographic pattern in the direction of the Russian OFDI and their strong orientation towards the Commonwealth of Independent States (CIS) countries. The third part logically continues with two important issues characterizing the Russian OFDI by stressing the need to create a typological model of the international operations of Russian companies as such model may help to classify and analyze different types.

The report ends with some tangible policy recommendations that can be extracted from the presented data and its analysis. These recommendations are divided in three groups: 1) to the policy makers in the countries receiving Russian investments, 2) to policy makers in Russia, and finally 3) to managers of those Russian companies actively involved in Russian OFDI.

2. Growth and geographical division of the Russian outward FDI

In quite unique way that differ from most economies in transition, capital outflows from the Russian Federation have repeatedly exceeded capital inflows. In addition, the ratio between outward and inward FDI is considerably higher for Russia than for any other Central and Eastern European countries (CEEC). The recent years have witnessed growing variation in the overseas investment practices by Russian entities and the Russian enterprises are gradually engaging into more demanding investment schemes, compared to mainly export-supporting activities of the early 1990s.

The growth of the Russian outward FDI

The OFDI stock from Russia has risen rapidly since 2000, from USD 20 billion to almost USD 210 billion in 2006 (Table 1). The significant increase in the OFDI stock can be attributed both to an improved data registering system and an increase in OFDI flows during the period.

Table 1 Russia's outward FDI stock, year-end, USD million

	2000	2001	2002	2003	2004	2005	2006
Direct investments abroad	***20141***	***44220***	***62349***	***90873***	***103692***	***146679***	***209558***
Equity capital and reinvested earnings	18470	42167	58357	86532	96804	139046	206619
Other capital	1671	2053	3992	4341	6888	7633	2939

Source: Central Bank of Russia 2007

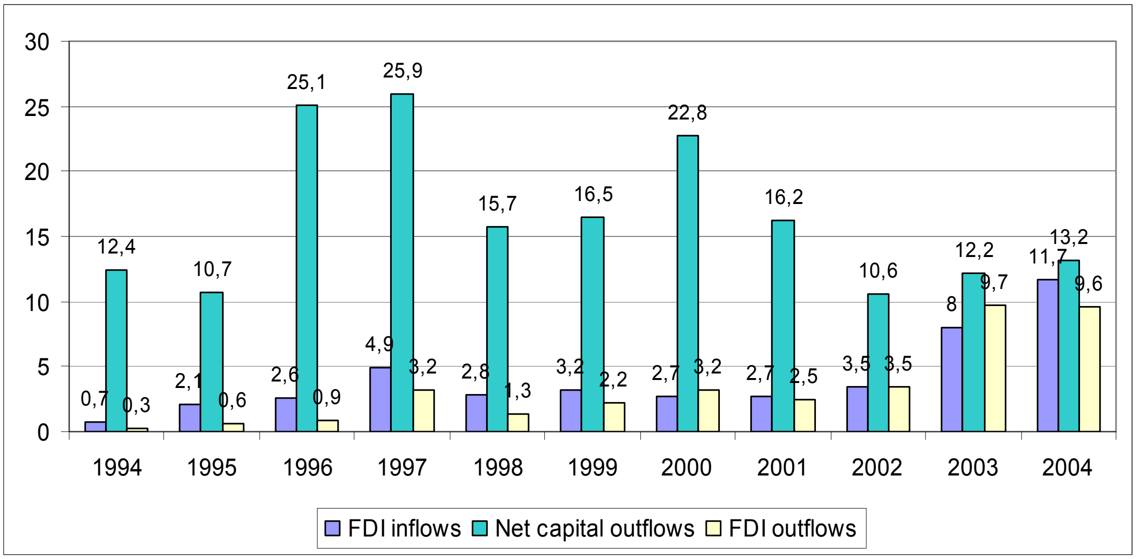
The growth in the Russian investments abroad is among the highest in the world, and in comparison to other CEECs, Russia's outward foreign investments are manifold to any other countries. Although widespread controversy still exists concerning the total amount of Russian investments and capital abroad, it is widely acknowledged (e.g. Loungani and Mauro 2000; Buiter and Szegvari 2002) that the actual figures are considerably higher than suggested by the official data. Recent improvements in reporting of balance of payment data provide more reliable estimations on the capital outflows. According to the Central Bank of Russia, net capital outflow by non-financial enterprises and households from Russia amounted to USD 181 billion between 1994 and 2004 (Figure 1). When this total amount of capital outflow is considered, Russia ranks among the 10 largest investors and capital exporting countries in the world (Kalotáy 2005; Bank of Russia 2005). However, this figure only provides the vague estimation on Russian capital and purchasing power abroad.[55]

Regarding the OFDI from Russia, few particularities should be pointed out. First, Russian companies have invested substantial amounts of capital through third countries and offshore locations. For instance, the continuously high rank of Cyprus among the investing countries to Russia indicates the existence of investment trans-shipping vehicles of Russian origin in Cyprus. In other words, Russian entities possess investment companies registered to Cyprus, through which funds are brought back partially in form of FDI, and the tax and other benefits offered to foreign investors are obtained (e.g. Kalotáy 2003). Certainly, Cyprus is not the only country through which Russian capital returns home but

[55] Various estimates are provided on additional capital flight from Russia. According to the European Commission, the non-recorded capital flight from Russia totaled USD 245 billion in 1992–2002 (EC 2004). One can, thus, only estimate the total amount of capital that has left the country under registered and non-registered investing and capital exporting schemes. Authors believe the actual amount of capital transferred abroad from Russia to be manifold to the registered transfers and investments.

there are a number of factors supporting the assumption that to a significant degree the capital conveyed out of the country is the source of foreign investments to Russia from many investing countries (Grigoryev & Kosarev 2000).

Figure 1 Russian FDI flows and net capital outflows, USD billion



Sources: Bank of Russia 2007; UNCTAD 2007

Second, besides capital round-tripping, the FDI inconsistencies root to the operations of Soviet enterprises abroad, the assets of which were often inherited by contemporary Russian companies. Understandably, reliable valuation of these assets becomes essentially problematic. Third, the composition of capital outflows from Russia highlights widespread misreporting and undervaluation of revenues from abroad. Put differently, Russian companies systematically undervalue their export earnings and report remittances against fictitious imports and transactions in securities. Only in 2004, this item on the balance of payments sheet of the Russian Federation accounted for almost USD 26 billion.[56] In comparison, the foreign direct investments by non-financial enterprises and

[56] The item “Non-repatriation of exports proceeds, non-supply of goods and services against import contracts, remittances against fictitious transactions in securities” appears on the asset side of the financial account of the Russian Federation, and was valued at USD 26 billion in 2004. The total assets of non-financial enterprises and households under financial account amounted to USD 33 billion in 2004.

households amounted to USD 10 billion in 2004. It appears reasonable to argue that at least part of these unregistered capital outflows has been used for investment purposes abroad by Russian entities.

The most active Russian investors can undoubtedly be found in the natural resource-based industries and oil, gas, and metal sectors in particular (see: UNCTAD, cross-border M&A database). Up to date, the majority of Russian OFDI has been carried out by relatively few industrial giants, often powered by their strong export revenues. In estimation, oil and gas sector covers nearly 60% of the value of OFDI by Russian companies, thus, following the country's export structure. The ferrous and non-ferrous metals account for around one fourth of Russian companies' investments abroad. The metal sector is by degree the fastest growing industry in Russia when measured by the extent of foreign activities of its leading enterprises. Further, the value of oil, gas, and metal sectors' investments tends to be manifold to those of other sectors. Apart from traditional natural resource-based industries, the Russian telecommunication companies have aggressively sought markets and assets abroad, and especially so in the neighbouring CIS countries.

Drivers of the Russian outward FDI

The recent years have witnessed considerable improvement in investment practices by Russian companies. In the initial stage of transition, weak domestic business environment caused the surge in capital flight from the country. The reasons behind investments in the early 1990s often stemmed from scarce domestic investment opportunities and weak ownership protection. Recent developments in OFDI from Russia suggest increasing variation in investment motivations between industries. Whereas the initial stage of internationalisation included export-supporting activities for many companies, numerous Russian enterprises have engaged in more demanding operations abroad in recent years. Especially foreign acquisitions have become notable.

Table 2 Motivations of Russian OFDI

Motivations	Corporate examples
Efficiency-seeking motivations (e.g. compulsion to control the entire value chain)	E.g. the oil companies' acquisitions of retail assets in the CEE and Baltic countries
Strategic asset-seeking motivations (e.g. securing infrastructure functionality abroad)	E.g. acquisitions by Yukos of Mazeikiu Nafta in Lithuania and Transpetrol in Slovakia, Severstal's acquisition of Rouge Industries in the USA
Resource-seeking motivations (e.g. accessing to natural resources)	E.g. the oil companies' upstream acquisitions in Middle East, South America and CIS, acquisition by RusAl of Queensland Alumina, Norilsk Nickel's acquisition of Gold Fields
Market-seeking motivations (market expansion in neighbouring countries and far a field)	E.g. telecommunication companies' acquisitions of mobile operators in the CIS
Political (foreign policy) motivations (using economic and energy resourc es as a means to advance foreign policy goals)	E.g. the state-owned energy companies' expansion near abroad

Source: Vahtra & Liuhto 2006

Russian companies are acquiring assets abroad to strengthen their market positions, expand their global reach and access natural resources. In this regard, OFDI has in general helped increase the competitiveness of Russian firms, particularly those in the resource-based industries. An important motivation of OFDI by Russian oil companies is to internalize or control the whole value chain internationally.

The acquisition of the Bulgarian oil refinery Neftochim by Lukoil illustrates the point. In addition, Lukoil possesses a wide infrastructure network in the Baltic States and several CEE countries. In the beginning of 2005, the company announced the acquisition of 100% of the second-largest petroleum retailer in Finland, Teboil, and its sister company, Suomen Petrooli. The deal is valued at USD 270 million and provides Lukoil with a strong foothold not only on the Finnish, but also on the Scandinavian petroleum markets. Through the acquisition, Lukoil is capable of considerably altering the competition structure on the Finnish market with its own petroleum products.

The recent acquisitions by two of Russia's leading metal and mining companies serve as examples of resource-seeking investments. In 2005, RusAl finalized the purchase of a 20%-stake in the world's largest aluminium refinery, Queensland Alumina (QAL) of Australia. The value of the deal amounted to USD 460 million. The acquisition is extremely strategic in nature, strengthening not only the RusAl's raw material stock but also the company's position in the world aluminium markets. The acquisition is to expand RusAl's raw material base by more than 20%, and further expansion of QAL is expected in near term. In 2004, Norilsk Nickel acquired a 20% -share in one of the world's largest gold producers, South Africa's Gold Fields in a largest individual FDI by a Russian company. The value of transaction amounted to USD 1.2 billion. Henceforth, the acquisitions provide both companies with significant additions to their resource bases and assets, and add to the companies' global scope of activities.

Examples of market-seeking acquisitions by the Russian firms can be found from the telecommunication sector. Through active expansion, the Russian telecom companies have strengthened their positions in the neighbouring CIS region. In that particular market, Russian companies lead the race for market shares, pioneering the expansion of foreign companies to this lucrative market area. In 2004, the Russian leading mobile operator, MTS, acquired a 74%-share in Uzbekistan's leading operator, Uzdunorbita, for the price of USD 121 million. With its recent acquisitions in the CIS region, MTS has successfully entered one of the fastest-growing and most unsaturated mobile market areas in the world, strengthening the company's leading position among the Russian mobile operators. In turn, Russia's second-largest mobile operator, VimpelCom, acquired a stake in Kazakhstan's second-largest operator, KaR-Tel, for USD 425 million. Given the strong economic position of Kazakhstan among the CIS countries and a low mobile penetration rate of the country, the acquisition is bound to provide VimpelCom with strong growth opportunities. Examples of strategic asset-seeking expansion by Russian firms relate to the specifics connected to the target markets. For instance, Severstal's acquisition in 2003 of US-based Rouge Industries effectively helped to solve the problem of US steel import quotas and provided the Russian producer with an access to the largest and perhaps one of the most protected steel markets in the world.

Yet another specific dimension of Russian business expansion abroad is connected to the international activities of the state-owned enterprises. In several instances, the Russian energy resources may serve as a considerable foreign policy tool especially in the Russia's neighbouring areas highly dependent on Russia's energy supplies. By supporting the active expansion of the state-owned energy giants, Russia effectively manages its interests in the region. The recent energy dispute between Russia and Ukraine alleviates the strong leverage of Russian energy companies in the CIS region and the possibility of using economic and natural resources as means to advance political objectives.

Although the large TNCs inevitably control the Russian business expansion abroad, the role of small and medium-sized companies (SMEs) is increasing. The investment motivations essentially differ between the large enterprises and SMEs due to the incomparable operational and financial resources. Whereas the large Russian enterprises are engaged in cross-border mergers and acquisitions to improve their global market positions, the Russian SMEs predominantly seek for niche markets abroad. Market- and technology-seeking investments dominate the international expansion of the Russian SMEs.

Due to the relatively low experience level and scarce financial resources, the Russian SMEs have thus far mainly targeted the assets in the CIS and CEE markets. Very few Russian SMEs publicly announce their foreign acquisitions and their operations abroad remain largely unknown for the media, authorities, and researchers alike. The SMEs responsible for OFDI from Russia often include leaders in narrow market segments, such as some particular electronic appliances. Estimating the total scope of international activities of these companies becomes extremely complicated due to low public coverage of the operations. However, despite the low level of publicity of the foreign asset purchases by the Russian SMEs, the development is highly positive and numerous Russian SMEs have already entered the CIS and the EU markets.

3. Russian investments in the CIS

For many Russian companies, the CIS region has been the first step on their way towards the global markets. The Russian natural resource-based companies already hold a strong grip on some particular segments of the CIS markets and have moved their focus beyond the CIS, whereas the manufacturing and telecommunication companies have more recently entered into their first investment projects in the CIS region. However, in several instances, the CIS markets are as strategic a target for Russian companies as the Western markets. In many occasions, the assets controlled by the Russian companies in the CIS countries also tend to be more controversial in nature, such as energy and infrastructure assets.

Destinations and players in Russian outward FDI in the CIS countries

According to the authors' estimations, the main countries receiving Russian OFDI are the EU and the Commonwealth of Independent States (CIS). Although systematic data on geographical distribution of Russian OFDI is currently not provided by any statistical institution, the EU is estimated to accommodate nearly a half of Russian outward investment stock, whereas the share of CIS stands around one fifth. Another major receiver of Russian investments is the USA with an estimated share similar to that of CIS (Kalotáy 2003).[57] The recent investment trends by Russian companies again indicate the growing share of the CIS countries among the recipient countries of Russian OFDI. This development is also suggested by the UNCTAD (2007) data on cross-border Mergers & Acquisitions (M&A) purchases by Russian companies. Measured by the number of deals, over a half of the Russian M&A purchases have taken place in the CIS region, whereas the developed countries account for somewhat smaller share. However, the value of assets purchased in the developed economies considerably exceeds that of the transition economies. Apart from the CIS, the recent developments indicate the extending geographical and sectoral distribution of FDI projects by the Russian trans-national

[57] The authors express some doubts regarding the amount of Russian FDI in the USA, given relatively few large-scale investment projects by the Russian firms in the country. Similarly, we expect the actual amount of Russian investments in the CIS to be considerably higher due to the various capital round-tripping schemes and investments through third parties.

corporations (TNCs). The majority of the Russian companies' foreign mergers and acquisitions have taken place during this millennium, clearly indicating the growing international activity of the Russian firms.

For many companies, the CIS region is the first step on their way towards the global markets. The Russian natural resource providers in many cases already hold a strong grip on some particular segments of the CIS markets and have already moved their focus beyond the CIS, whereas the manufacturing and telecom companies have recently entered into their first OFDI projects in the region. In several instances, the assets controlled by Russian companies in the CIS countries also tend to be strategic in nature, such as energy and infrastructure assets. In addition, the Russian companies tend to be dominant players in several CIS markets, whereas in the developed economies they often hold smaller market shares and leverage in their industries. One should give further attention to the fact that the investments into CIS region by the Russian companies have dramatically increased in value during the recent years. Among the 10 largest FDI projects by Russian companies during 2004–2005, five were targeted to the CIS region (see Table 3).

Table 3 The largest foreign acquisitions by Russian companies, 2004-2005

Acquiring company	Target company	Country	Nature of business	Share, %	Value, $ mln
Lukoil	Nelson Resources	Kazakhstan/ Canada	Oil exploration & production	100	2 000
Norilsk Nickel	Gold Fields Ltd	South Africa	Gold mining	20	1 200
Severstal	Lucchini Group	Italy	Steel products	62	574
RusAl	Queensland Alumina Ltd	Australia	Alumina refinery	20	460
VimpelCom	Kar-Tel	Kazakhstan	Mobile telecommunication	100	425
Evraz Holding	Vitkovice Steel	Czech Republic	Steel products	100	287
VimpelCom	Buztel and Unitel	Uzbekistan	Mobile telecommunication	100	275
Lukoil	Teboil and Suomen Petrooli	Finland	Petroleum marketing	100	270
Lukoil	-	USA	795 petroleum stations from ConocoPhillips	100	266
VimpelCom	Ukrainian Radio Systems	Ukraine	Mobile telecommunication	100	254
MTS	Uzdunorbita	Uzbekistan	Mobile telecommunication	74	121

Source: Vahtra 2006, based on company data and media sources.

The official statistics on Russian investments in the CIS give an essentially misleading image of the reality. According to the somewhat differing Russian and CIS statistics, the CIS region accounts for between 1 and 5% of the Russia's total OFDI. In this respect, thus, one might regard Russia as a negligible investor in the region. To achieve a more realistic overview, we shall look at the following example. According to the Russian Federal Statistical Service (Rosstat 2005), the country's OFDI flows to the entire CIS region totalled USD 713 million in 2004. In contrast, the recent years have witnessed several acquisitions in the CIS by Russian energy and telecommunication majors with many of the individual transactions valued more than the total investments from Russia as reported by Rosstat. To some extent, this discrepancy can be explained by the fact that the major Russian companies invest abroad through offshore investment units and the investments are thus not shown on the balance of payments sheet of the Russian Federation.

Largely due to capital round-tripping and use of investment units in third countries by the Russian investors, one may notice considerable statistical inconsistencies in FDI statistics provided by different countries. For instance, according to Rosstat (2005), the Russian FDI in Kazakhstan for the period 2000-2004 amounted to mere USD 121 million whereas the respective figure provided by the National Bank of Kazakhstan (2007) is USD 987 million.

However, one only needs to consider, for instance, the single acquisition of the leading Kazakh telecommunication company in 2004 by the Russian mobile operator, VimpelCom, for more than USD 400 million, to notice that the official figures reported by either side are of relatively little use in determining the actual presence of Russian companies in the country. Hence, while the statistical discrepancy can be addressed to differing registering practices of FDI, we still lack reliable estimations on Russian investments in the region. To some extent, we can blame the inconsistency on both the undeveloped registering system of investments and investment round tripping discussed above. One must note that for instance in Kazakhstan, the majority of investments by Russian companies are not regarded as FDI by definition. In particular, this goes for the massive investments in the energy sector exploration and infrastructure projects, operated by existing subsidiaries or joint ventures in the country. After a company or joint venture is established, the further investments in this company are not regarded as FDI, but categorized as 'other investments' in the balance of payment sheet. However, although these investments do not appear in the FDI statistics, we claim that the estimated USD 2 billion-investments by the Russian energy companies in Kazakhstan during 2004–2005 significantly add to the leverage of investing companies in the target country. This, and other related issues will be addressed in a more detail in the later chapters. Furthermore one has again to note the visible presence of clear offshore locations as countries of origin for investments in Kazakhstan (the official Kazakh statistics put the total number of investments coming from offshore destinations at USD 1.4 billion).

Kalotay (2007) clearly demonstrates that in terms of number of projects the top 10 destinations of Russian OFDI include 4 CIS countries and 3 new EU members that will be very indicative towards the geographic focus of Russian investments.

The Russian energy empire and soft power in the CIS

Throughout the 1990s, Russia lost significant share of its leverage in the former Soviet space. As a result of domestic economic downturn and political upheavals, Russia ran short in its capacity to subsidize other countries in the region. With very few economic initiatives left to provide to other countries in the region, Russia temporarily attempted to uphold its leverage in the newly independent states (NIS) through her military resources. The strategy soon ran out of steam when many of the countries successfully sought for the assistance of international community in their political difficulties with Russia. Only a handful of former Soviet republics including Belarus, Armenia, and Tajikistan, remained their close connections with Moscow, whereas the majority of NIS quickly reoriented their economic and political preferences towards the EU and the USA.

The 21st century has brought along considerable shift in Russia's policies towards its neighbouring countries The former hard power regime backed with military forces has efficiently been transferred into that of soft power, leveraged by Russia's economic resources. After the 1998 economic crisis, Russia's economic revival was backed by soaring energy prices. From the year 1999 onwards, the Russian economy has shown impressive growth that can almost exclusively be addressed to the record-high world oil prices. The reflections of the oil sector boom have been witnessed throughout the Russian economy and in the 21st century, Russia has become an attractive business partner for many CIS countries. Along with its strong economic growth and resulting growth in consumption, Russia has re-emerged as the most feasible export market for many of the countries in the region due to the low level of competitiveness of their manufactured products in the western markets. On the other hand, the new Russian consumer products considerably cheaper than the goods imported from the West have become increasingly popular in the CIS region.

The global energy price hike has naturally had positive effects on other oil and natural gas-rich countries similar to these on Russia. Kazakhstan, for instance, has posted two digit economic growth figures for several years in a row. As industrial production and trade of the energy-rich countries have grown as a result of strengthening of domestic economies, these countries increasingly look for external markets of their production. For many, the growing Russian economy seems to have been the most viable target market. Vice versa, many Russian producers have found increasing demand for their products in the neighbouring countries, advanced by their economic growth. Understandably, this type of development has further strengthened the cross-border economic ties between Russia and other CIS countries. On the other hand, the countries not in possession of considerable energy resources have seen themselves falling more indebted to Russia along with the record-high oil and gas prices. Obviously, given the lack of alternative energy resources, the massive indebtedness has considerably weakened the political bargaining power of many such countries against Russia.

While many of the CIS countries would not essentially prefer to see themselves in a closer alliance with Russia, the alternatives might be scarce. Given the political and geographical realities, none of the CIS countries are in the position to hope for widespread and large-scale investments from the EU or the USA or closer political and economic integration with the West in the foreseeable future. Besides investments in few high-profile energy projects, limited bilateral assistance, and international trade credits or loans, the USA and Europe thus far have had little to offer to the CIS economies.

In supplement to trade dependency, much of Russia’s power in the CIS countries is being delivered by the strong presence of Russian energy companies in the region. Among the Russian energy giants, the world’s largest natural gas producer, Gazprom, and the Russia’s electrical energy monopoly, Unified Energy Systems (UES) of Russia, are the most influential bearers of Russia's leverage in the CIS. Apart from being the sole natural gas supplier to many of the countries in the region, Gazprom has equity investments in many of the CIS countries, where the company is the principal owner of national gas distribution companies.

4. Foreign operations of Russia's largest industrial corporations

As elaborated above, the internationalisation of Russian economy is inevitably dominated by the natural resource-based groups (NRGs). Raw materials account for two thirds of the Russian exports and the Russian energy and metal companies hold strong international positions on several strategic markets.

A typology for foreign operations of Russia's largest industrial corporations

The natural resource-based industries form the backbone of Russian economy, causing them to gain on significant political leverage and ambitions. Faltering business environment in, characterized by the lack of transparency, weak financial systems and imperfect legal institutions, support the emergence and survival of large industrial conglomerates exploiting the absence of functioning financial and legal institutions. Although often being far from superior in organisational practices, these financial-industrial conglomerates tend to outperform small private firms simply due to their ability to better cope with imperfect economic environment.

Examination of the ownership structures of the Russian NRGs reveals notably high degree of such ownership concentration, with the largest groups of private owners controlling 35% of the Russian industry when measured by sales.[58] The EIU (2004) provides related data on concentration in industrial assets – 10 largest industrial groups control some 38% of the Russian industrial assets. The resulting combination of Russia's critical dependency on its natural resources and the concentrated ownership of the productive assets in hands of relatively few groups of private owners, inevitably gives rise to political interests in the economic sphere.

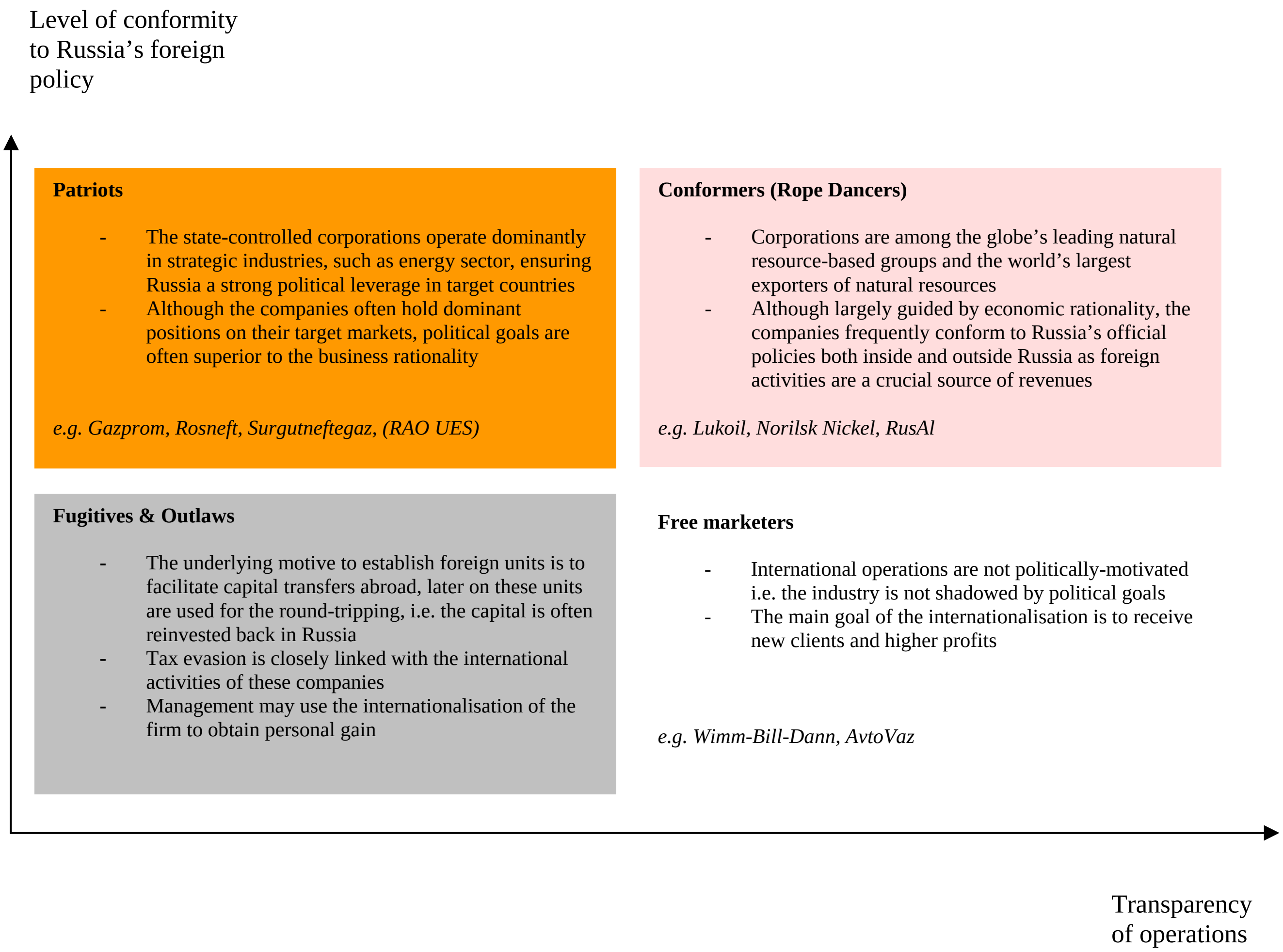
[58] In the survey, a large owner was defined as an owner or alliance controlling either 0.25% of the total sales or 0.5% of total employment of the survey sample (World Bank 2004).

Considering the international operations of the Russian companies, the relation between business and foreign policy emerge even more complex than in domestic context. Controlling extensive reserves of strategic energy resources, Russia holds substantial political leverage not only in the CIS region but also throughout Europe. In 2003, over half of Russia's export revenues originated from the strategic commodities – the share of oil, fuel and gas exports was 54% in the country's total exports and the substantially increased world market prices for oil are likely to scale up this share to around 60% in 2004. Such an export structure is inevitably resulting in mounting political ambitions, and the energy deliveries are essentially coupled with the measures of Russian foreign policy. The current restructuring of the energy sector and much-debated probe against the former country's leading oil producer, Yukos, serve as indicators of the increasing state grip over the strategic sectors of the economy.

The level of conformity to the Russian foreign policy is identified as a second dimension for classifying the Russian companies abroad. In one extreme of this continuum, one finds state-controlled conglomerates operating in strategic industries, while the other extreme is represented by smaller companies in strategically non-significant manufacturing sectors. Based on two dimensions of the foreign operations of Russian companies presented above, the authors propose the following typology on Russian companies abroad (Figure 2).

Patriots refer to the companies that are controlled by the Russian Government, comprising mainly the industrial majors in the strategic natural resource-based industries. The purpose of the international operations of the companies such as Gazprom and Rosneft, is to serve the Russian foreign policy at least as much as it is to enhance their own economic performance. Whereas it can undoubtedly be argued that the political interventions are inseparable part of the activities of these state-controlled companies, the political power of Russian authorities over the private corporations, especially in the strategic natural resource-based sector, should not be forgotten either. The researchers further argue that until the oil and gas industry, for instance, is not operating on the basis of free market for the exploration licenses and transportation quotas, the companies in the sector continue to carry out the political ambitions of the Russian Government, be it in the international business matters or domestic operations.

Figure 2 A Typology for the Foreign Operations of the Russian Largest Industrial Corporations



Source: Liuhto & Vahtra 2007.

Conformers (Rope Dancers) include the companies active in seeking international business opportunities and establishing foreign presence to enhance their performance. The size and strategic nature of these companies' business, however, forces them to balance between the business rationality and the governmental interests, i.e. the companies act according to the government policies when their business interests require them to do so. Since the level of political conformity is additionally highly dependent on the strategic significance of an industry, especially the companies in the strategic oil, gas and metal sectors are often obliged to play according to the state goals to remain in business.

Due to the fact that the size of a company largely defines its political leverage, this category dominantly includes the major natural resource-based corporations that have gained a strong foothold on the international markets. Adapting to the official policy lines often secures these companies the access to vital assets, such as the exploration licenses of natural resource sites and the pipeline infrastructure.

Fugitives include the companies purposefully established for money transfers abroad and capital round tripping or, under the worst scenario, are engaged in 'direct' money laundering and illegal activities (e.g. shadow sales of armaments abroad). Also the viable companies that are turned into money transferring units behind their facades fall into this category. Transferring capital abroad and then moving it back home through various transfer regions, used to be a common practice throughout the 1990s, but the recent measures taken by the state indicate a radical change in the laissez-faire policy of the Yeltsin era. Particularly the recent scandalous events around some oligarchs in Russian oil and metals sector indicate the tightening state policy in the matter. The internationalisation of these companies can be seen as a double-edged sword for the Russian economy. Whereas these companies can be significant players both domestically and internationally, their foreign expansion boosts Russian economic well-being. On the other hand, massive capital transfers abroad seriously harm the Russian economy inhibiting the vital domestic investments.

Free marketers comprise the companies, whose overseas activities are not considerably shadowed by political ambitions. The companies are operating either in the less strategic business sectors or are smaller in size, thus remaining relatively irrelevant from a political perspective. These companies are often profitable and employ westernized business practices, seeking strategic growth through their foreign expansion.

Whatever the type of their operations abroad, Russian companies are met with suspicion and fear. To some extent they are based on rational concerns about their background and motivation. Still in many cases both sides prefer to overdo the political ingredient versus more pragmatic stance of carefully valuing the business ingredient only.

5. Conclusions and policy recommendations

The Russian OFDI has managed in very short period of time to grow from an interesting even if insignificant phenomenon into a tangible factor contributing to what some experts call cooperative competition ("co-competition") between the EU and Russia in the their neighbouring countries.

The Russian OFDI can be clearly traced to have as their geographical focus the new EU member states as well as the Newly Independent States that emerged from the collapse of the Soviet Union and particularly Armenia, Belarus, Georgia, Kazakhstan, Moldova, and Ukraine. When it comes to their industrial focus it is clear that the most active Russian investors are in the areas of energy resources (production and sales of oil, gasoline and natural gas), power generation and distribution, metal mining and processing and telecommunications. Most of these are strategic sectors for both Russia and the countries recipients of Russian investments.

Trying to systematize the patterns that the largest Russian companies demonstrate when operating abroad the two main dimensions along which they could be distinguished were suggested as 1) transparency of operations and 2) level of conformity to Russia's foreign policy. In the case of Russian investors within these two directions one may distinguish 4 types of companies characterised by their operational strategies. These are patriots, conformers, fugitives and free marketers.

Trying to summarize the most important policy recommendations the following list presents the ones considered to be most essential:

1) The Russian FDI can be an important bridge in integrating Russia towards the EU and her neighbouring countries, and hence more supporting general atmosphere towards the legal capital exports should be created.

As discussed above the Russian investments should be accepted without prejudices or judged priory, especially when they come legally and in an open fashion. For this to happen all participants in the process must acknowledge the importance for transparency, openness and publicity of the investor and its intentions.

2) The capital exports via Cyprus and some other offshore capital havens do not increase the credibility of the Russian firms in the eyes of the recipient countries, and hence direct investment from Russia to recipient countries should be helped.

As there is little that Russian authorities can do to prevent Russian investors using offshore registered companies as investment vehicles it could be one alternative to think of raising the requirements towards investments coming from such locations or possibly even taxing them. In any case this problem deserves more attention on behalf of policy makers not only in Russia but also in the EU.

3) The Russian Government should promote more transparent policies concerning the expansion of the Russian state-owned corporations abroad, otherwise the expansion of the energy-dominated corporations will obviously meet reserved attitudes in several potential recipient countries (i.e. Russian firms should not be used as tools of the Russian foreign policy or Russian foreign policy should be more liberal).

4) The Russian Government should promote the expansion of the Russian SMEs abroad, by establishing/strengthening the activities of the Russian investment promotion agency (information about investment possibilities, legal issues, investment loans, etc.).

If there is one thing where the Russian policy makers so far fail to see the opportunity it is in the potential of Russian SMEs to internationalise. For all their importance as national champions the Russian TNC neither need governmental assistance in their exports nor represent significant share of the employment in Russia. Thus the main effort should be redirected to internationalising Russian SMEs that are in much bigger need of assistance. To the contrary the attempts of the Russian authorities to lobby for huge Russian multibillion enterprises are seen by many as political bullying and have the opposite to the intended effect.

5) The Russian Government should intensify the fight against illegal corporate activities of the Russian organisations abroad, including the smuggling, prostitution, drug trafficking, and illegal sales of armaments.

The very fact that Transparency International should recognize Russian companies to be among the most active bribe payers speaks in itself that the issue is out of hand and could be serious impediment for the further internationalisation efforts of Russian TNCs.

6) The expansion of the Russian corporations is chiefly based on the internationalisation of the corporations active in natural resource sector, and hence the internationalisation of more knowledge-intensive firms should be promoted by giving favourable investment loans to these firms.

7) The expansion of the Russian tourism abroad increases, and the expansion of the Russian tourist firms could take the advantage of growing Russian private consumption abroad.

8) The Russian legal FDI in 1995 was some USD 3 billion. Now 10 years after, it already approaches USD 150 billion, thus it seems rational that the Russian banks follow their clients' internationalisation abroad.

9) The accession of Russia in the WTO and OECD would help Russia to create better image in the eyes of the recipient countries, and therefore, Russia's accession in the aforementioned organisation would help the expansion of the Russian corporation abroad.

10) The Russian Government should support the leading Russian business schools in creation of advanced training courses on international business for Russian company managers with the help of the leading Western scholars and academic institutions.

11) The governments of the recipient countries should be more tolerant towards the expansion of the Russian FDI, i.e. the nationality of the investor does not matter but the ownership/corporate policies of the Russian company.

12) Russian corporations should be much more active in working and demonstrating that their expansion abroad is not only about money and a vertical integration of natural resources based industries but also about modernity be it technological, managerial, environmental or ethical.

Thus the process of Russian OFDI is a two ways street in which all stakeholders should strive to adjust and understand the concerns and ambitions of the other side. There is hardly a better way to build bridges and business networks between Russia and the EU that account both their political and business interests.

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PART 2 – SECTORAL/REGIONAL VIEW ON THE NEW ROLE OF RUSSIAN ENTERPRISES

Modernisation of Russian pulp and paper industry: lessons from Finland

by Anna Korppoo

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1. Introduction

Energy efficiency has been a topic of discussion and focus of policies in the OECD since the 1970s oil crises. However, the issue is fairly new in Russia as a result of the Soviet attitude to energy consumption. As the country was rich of energy resources, almost no attention was paid to the efficiency of energy use (Rautava & Sutela 2000, 31). The result is the well acknowledged inefficiency throughout the economy.

The inefficiency of energy use by the Russian pulp and paper sector peaked in the mid-1990s. The situation is now normalising to the pre-transition levels (Korppoo 2007), and the efficiency of energy use could further improve should the sector be modernised. As the Finnish pulp and paper sector is more energy efficient than that of Russia, Finland can provide lessons which factors can drive the modernisation of the sector, and which issues may deter it.

This study is based on case studies of pulp and paper plants in Russia and Finland. Semi-structured interviews were carried out with 13 plants in the Russian regions of Karelia (4) and Archangelsk (3), and in Finland (6). The case studies aimed to cover the development of energy efficiency and technology as well as the drivers and barriers to modernisation investments. Modernisation was chosen as the main concept of this study because both capital cycle and retrofit of existing production capacity with or without the motivation to improve energy efficiency or save energy were targeted.

2. Methodology

The task set for the PhD study (which this article is based on) was to establish the reasons why Russian pulp and paper plants modernised or did not modernise their equipment, compare this to Finland and estimate the impact of the modernisation to the development of energy efficiency. As a result, the methodology had to include both qualitative and quantitative research methods. Qualitative methods were used to collect and analyse material on the development of technology on plant level and the reasons driving or deferring modernisation. The development of energy efficiency was measured by using quantitative methods.

The development of energy efficiency was compared between the Russian and Finnish plants based on the Energy Efficiency Index (EEI) method which aims at separating the changes of energy efficiency from the structural changes (Blok 2003, 120; Phylipsen et al. 1998, 41-42). Most of the data used was collected directly from the case plants, however, not all of them were able to provide numeric data. Also some regional / country level calculations were carried out in order to triangulate the outcome of the plant level case studies.

The development of technology was analysed by collecting data on the capital cycle of plants between 1960 and the time of the interview in 2004–2005. I developed a recording methodology in order to facilitate the comparisons of capital cycle between the plants by collecting all changes of equipment in a timeline of each plant in a table. I called this the technology path methodology, and used it for explaining the developments of plant level energy efficiency as well as for comparing the statements of plant representatives on drivers and barriers to modernisation to real modernisation activities carried out.

No well-established method to analyse *drivers and barriers* was available in methodological literature, however Sorrell et al. (2004) have worked on the methodological side of barriers to energy efficiency. Critical analysis of the material collected by interviewing representatives of pulp and paper production units was conducted by systematically filing the data available of the drivers and barriers to modernisation in the case study database under themes, and later categories, emerging from the material (Berg 2001, 103). Six main issue clusters emerged from the interview material: funding, corporate policy, technology and raw material, energy saving and other policies, energy prices and tariffs, and market signals. An additional category on transition and attitudes was added to the analysis of the Russian plants.

Drivers of and barrier to modernisation and the qualitative data they were based on were compared between the chosen Russian regions and Finland to establish whether Finland could provide the Russia lessons how to support the modernisation of the Russian pulp and paper sector.

A literature review was conducted on drivers and barriers to energy efficiency as no written material on drivers and barriers to modernisation was available. The results of the case studies were compared to this literature review and lessons to the theory were recommended.

3. Pulp and paper sector in Finland and Russia

Pulp and paper sector is characterised by its wide mix of products (Farla et al. 1997, 749), international market (CEPI 2003, 3) and energy intensity in tandem with the potential to recover both heat and electricity from the waste streams of the production processes (Nilsson et al. 1995, 12). Globally, pulp and paper industry is very concentrated into the hands of few international corporates. Competition is based on both prices and quality, depending on the product.

The Finnish pulp and paper sector is an important industrial sector accounting for some 12% of the value of total industrial production in 2004 (Statistics Finland 2006). The products have developed from bulk to speciality products since the 1960s (VTT Energy 2001, 138), and the ownership has concentrated into few corporates (Finnish Forest Industries Federation 2006, 13). Energy has always been a scarcity factor in Finland as the country's endogenous energy resources are limited to bio fuels and peat in the absence of fossil fuel deposits. Finland hosts a concentration of pulp and paper know-how as the world leading pulp and paper engineering consultancy as well as various equipment producers are based in Finland. In addition, majority of European paper engineers graduate in Finland that provides the sector with well trained labour and research facilities. The efficiency of energy use is very high in world scale comparison. Heat efficiency has improved steadily since the 1960s, however, the intensity of electricity use per tonne of product is increasing as a result of a shift to speciality products which require more complicated production processes, and therefore, are more energy intensive to produce. (Korppoo 2007.) The Finnish government is implementing successful energy efficiency policies on the pulp and paper sector mainly based on voluntary agreements and government grants.

Russian pulp and paper sector was built during the Soviet times when location of the industrial site or its energy consumption was not an issue. Industrial activities were typically concentrated on few regions per industrial sector. Pulp and paper industry was never a strategic industry, and therefore, not a priority to the planning agency. Existing equipment were rather fixed than replaced with new capital stock. As a result, the energy efficiency of the capital stock was very low in the last days of the Soviet Union (Smushkin 2004). After the systemic change, a large share of the equipment was decommissioned as it was not fit to produce anything there was demand for in the competitive market (Korppoo 2007). In addition, as demand fell in the newly created market, a lot of the capital stock was operating on less than full capacity (IEA 2002, 233-234). As a result, the sector experienced an inefficiency peak in the mid-1990s which normalised towards the end of the decade as production volumes started growing. No significant modernisation investments have been carried out in the case regions since the systemic change, and most improvements of energy efficiency are likely to be caused by the decommissioning of the obsolete equipment in the early 1990s. The main products are bulk products, and some of the products are low quality compared to the world market average (Lesprom 2004, 6). The Russian regions have their own energy saving policies which are based on the federal energy saving law. In the case regions the implementation of the energy saving policies had largely failed due to institutional problems as well as the lack of financial support.

4. Main drivers and barriers[59]

The most important barriers to modernisation in *Karelia* and *Archangelsk* are the lack of capital including bank credits and non-payment problem with local administrations, low energy price, the lack of enforced property rights, pressure by local administration to finance social programmes, and the lack of government support to general infrastructure in the region.

The most important drivers to modernisation in *Karelia* and *Archangelsk* are mostly market signal related, including increase of production capacity, reducing cost price, competitiveness, making profit and quality of product. Also fears of bankruptcy fuel

[59] The rest of the article is based on Korppoo (2007) unless otherwise indicated.

modernisation. Energy price was reported as a driver to modernisation by quite a few plants, however, in practice modernisation measures have focused on switching from the market prices fuels, mainly heavy fuel oil, to own or local bio waste. This provides evidence that regulated energy prices, namely electricity and gas, are not high enough yet to spur modernisation while the market priced oil is worth switching to a cheaper fuel. The high share of energy costs of the total production costs was mentioned as a driver as well.

The most important *barriers to modernisation in Finland* are also related to the availability of capital as the plants report that the investment quotas allocated by corporates are too small[60]. Also the lack of profitable energy saving opportunities due to the high level of energy efficiency is regarded as a barrier to further energy saving, and it was widely argued that capital cycle i.e. investments for other reasons that energy efficiency provide most of the efficiency improvements. Unfinished government policies which may influence the taxation of fuels were mentioned as barriers.

The main drivers in Finland include market signal related issues such as increasing production capacity, quality of product and cutting cost prices. Corporate practices to compare plants within the corporate, and to invest in the Best Available Technology (BAT) were regarded as important drivers to modernisation. Government energy saving policies, especially grants for energy saving investments, were recognised as drivers by most plants. Energy price was mentioned as a factor, and a driver, but it was not emphasised as the most important driver.

It is significant that the main barrier and main driver recognised in both countries is the same: the lack of capital and market signals. However, plants are lacking financial resources for different reasons. In Russia there is no funding due to the poor investment climate and in Finland due to corporate strategies which dictate the allocations of financial resources. Based on the identified level of modernisation conducted, the barrier is much more serious in Russia than in Finland.

[60] Corporate collects profits and allocates financial resources strategic way.

5. Main lesson: lack of a structural reform of the economy blocks other lessons

The unfinished structural reform of the economy, and especially, the lack of enforced property rights

a) strongly contribute to the poor investment climate which can be observed as the lack of financing and short-term thinking; and

b) make it impossible to implement energy policy tools as they require a clear economic framework to support them.

Currently, most investors, both domestic and foreign, are avoiding Russian pulp and paper industry as property rights are not fully enforced, the rules of the game are untransparent to outsiders, and the rule of law is yet to penetrate the regional administrative practices.

Finalising the structural reform of the economy would introduce hard budget constraints by forcing the unviable companies out of the market as a result of the enforcement of bankruptcy legislation. The reform would also improve the availability of investment loans as unviable companies would go bankrupt rather than to the next bank when they run into financial difficulties, and longer-term thinking, including investment planning, would become possible in a stable business environment. In Karelia, ownership structures have not improved much even though most case study plants have been declared bankrupt in the 1990s.

Lesson: The lack of completed structural reform of the economy is a macro-barrier to modernisation, and it must be solved before focusing on detailed policies. In the absence of the reform most of the other lessons do not apply.

6. Interdependence of reforms and policies: energy saving as an example

The performance of *energy saving policies and measures* were regarded as positive in Finland and mostly negative in Russia. The Finnish set of policies and measures has been a success[61] and plants have participated actively in implementation while the Russian regional energy saving legislations have spun off only few measures or positive results and none of them in the pulp and paper sector.

Both the Russian regions had similar problems with energy saving policies and measures, namely the lack of implementation, the lack of funding, and the lack of clarity how the declared policies should be implemented. This was partly due to the lack of central coordination of implementation as regional energy saving legislations are based on the federal energy saving legislation, and partly due to the lack of attention by the regional administration.

Strategic planning of policies as packages together with their implementation coordinated way is crucial. Both the Russian regions had in principle outlined some good policy tools, but they remained unlinked and they were too numerous. A policy package must have clear goals, and each policy tool needs to have a well-defined role which contributes to the overall goal of the policy package. Each tool needs an implementation plan, and a responsible agency. New policy tools must also be coordinated with the existing framework of policies in order to include only measures which are functional in the general legislative framework.

Choice of policy tools must be based on the possibility of their implementation, and the expected outcome. Targets should be expressed in numeric terms that are strictly enforced or otherwise rewarded in the case of good performers. It is awkward to launch a policy which has no fixed target as was done in the case of both regional energy saving policies. General targets are inadequate as it is impossible to evaluate the success of the

[61] The voluntary agreements have facilitated significant energy savings and cuts in greenhouse gas emissions. For instance, in 2003 the agreements initiated the saving of 4.7 Twh of heat and electricity, and 1.7 Mt of CO_2e. According to an independent review, as a rule joining organizations perceive the voluntary agreements as binding and the scheme has worked well to achieve its goals (KTM 2005).

implementation of the policies against general targets, such as ‘higher level of energy efficiency.

The financial aspect of a planned policy is crucial. The current regional policies have suffered from the lack of funding as part of the planned financing was supposed to come from the private sector, and there has been hardly any public money available for implementation.

In addition, constant evaluation of the outcomes of the implementation is a key to success. Stakeholders must be engaged in implementing the measures and this activity has to be supported both financially and by providing an easy and structured way for the stakeholders to implement the measures. However, given the Russian attitudes and the prevailing lack of responsibility, voluntary approaches like the Finnish may not work and may have to be legislated in order to stand a better chance of enforcement.

Increasing energy price is crucial. The current low level of energy prices does not stimulate modernisation, and any energy saving policies are bound to fail if the price level remains low. Without the financial driver of achieving savings from energy costs, it must be accepted that the level of efficiency is not going to change significantly. However, the success of an energy saving policy package depends not only on the level of energy price but also on the state of the economy which creates the rules of the game as a framework for business activities. Without hard budget constraints, certainty of ownership rights, neutral and effective administrative conduct and energy price on a level which makes energy worth saving, it is impossible to implement a successful energy saving policy package.

Lesson: Finnish energy saving policies and measures are well planned, clear and supportive to each other. They also include economic incentives, and are supported by the energy price which is high enough to make energy saving profitable. Revision of Russian energy saving policy along these lines would contribute to their effectiveness, however, without finalising the structural reform of the economy, including administrative reforms, the implementation of specific energy saving policies is impossible.

7. Additional problems caused by arbitrary administrative practices

In both countries the plants expected general support from the authorities to the sector. Russian plant managers felt that the federal government was not providing enough support to building forests roads, while the Finnish authorities were praised for the permission to build fifth nuclear reactor as it contributes to the energy security of the country.

In practice, the regional authorities require some of the Russian companies to continue fulfilling social responsibilities as they used to do in the Soviet Union by contributing financially to social schemes. Some of the plant managers argue that it is necessary to keep the authorities satisfied in order to avoid difficulties. This enforcement of unlawful tax schemes is based on the threat of difficulties the regional administration could cause, such as revising an informal agreement between the administration and the plant how to adjust the implementation of environmental legislation which is too strict to be implemented as such, arranging tax or other inspections or withdrawing support to international funding applications. No empirical evidence of such things happening to any of the plants included was identified, but the interview evidence suggests plant managers fear this could happen should they refuse to contribute as requested. At the same time, local authorities fail to pay for the heat the plants deliver which can be regarded as a kind of governmental fee in practice as the plants have little chance to change the situation.

Administrative reform in the regional level is another requirement for large scale modernisation of the Russian pulp and paper industry. Currently, the arbitrary conduct by regional administrations makes the future unpredictable for businesses, and therefore, too risky to invest in modernisation. The way Finnish and Russian plants see their relation with the authorities[62] is dramatically different. In Russia, implementing legislation is negotiable while in Finland the rule of law is non-negotiable and based on the ruling of courts.

First, regional policies should be planned based on long-term strategies and policies should be coordinated by studying the potential impact of new policies in the existing framework. Involving stakeholders by consultations and in the implementation of policies improves the chances of success of policies. Second, implementation of policies requires

[62] In the Russian cases mostly regional authorities, and in the case of Finland with national level authorities.

division of responsibilities and accountabilities between public agencies. Setting targets is important in order to review the work that reflects the success of implementation. For now, policies have been based on the division of responsibilities between agencies in the case regions, however, no serious targets have been set and the outcomes of policies have not been reviewed. In general, implementing policies has not been taken seriously by public officials. Consequently, the third important reform needed is dealing with this misconduct of officials. The legally set roles of regional officials must be enforced, stakeholders encouraged reporting misconducts, and officials punished when they fail to follow the code of conduct established by law.

Lesson: The Russian authorities are arbitrary, and companies have fewer tools to fight for their rights as authorities can arrange difficulties for them. Implementation of laws can be ‘negotiated’. Introducing administrative reforms to create a neutral governance system similar to that in Finland basing activities in law in transparent manner would support confidence in the business environment by contributing to its predictability.

8. Corporate ownership introduces strategic thinking

The main difference between the countries is the ownership arrangement of the plants which is reflected throughout all the drivers and barriers. In Finland, corporate ownership has penetrated through pulp and paper sector. All the Finnish plants included into this study are owned by a corporation. In Russia, independent ownership structures dominate while corporate ownership is only emerging (see Table 1). Martinot (1995, 124) reports how the high degree of control of the company by labour causes significant resistance to economic efficiency measures such as reducing the workforce. It seems that in Karelia, bankruptcy has been used as a tool to restart the same business again in some cases.

Table 1 Ownership structures of Russian plants compared to some indicators

Plant	Ownership	Strategic planning	Role of energy experts	Modernisation*
1 KAR	20% foreign	Not obvious	Unclear	Average
2 KAR	Insider	Some signs as specialising	No	Low
3 KAR	77% foreign but controlled by insiders	Not obvious	Unclear	Low
4 KAR	Outsider Russian holding company	Yes	Established	Average
5 ARC	50% Russian companies, 30% insiders	Not obvious, even though strategy mentioned but inertia in decision-making	Established	Low
6 ARC	Mainly owned by foreign company	Some signs	Established	Average
7 ARC	26% Russian corporation, 25% Russian bank, insiders	Yes, competition between units of corporate	Established	High

*Key to levels of ‘modernisation’: Low – below 20%; Average – 20-50%; High – over 50%.

Corporate governance means that a single unit has much less decision-making power than independent plants do, but the investment potential of a corporate is much larger than that of an independent unit. Corporate strategy acts as a guideline to investments in Finland, where the competition of funding between the units of a corporation is a factor of daily life. Even though some Finnish plant managers argue that the basic investment allocation by the corporation is too small for their needs, they also recognise that if the unit wins the funding competition inside the corporation, funding large investments is easier than it would be for an independent unit.

Based on the scrutiny and strategic planning of a corporate, investments are allocated to the most cost-effective and strategically favourable proposals. In Russia, investment related decision-making tends to be less structured and planned than in Finland. The time span of investment-related decision-making is considerably shorter, and the uncertainty of the future in general and property rights specifically make investments with longer payback period unattractive or even impossible. Also inertia in decision-making was observed in some cases. More investment planning was reported by corporate-owned plants that suggests that insider and mixed ownership patterns promote investment planning less than corporate ownership. Table 1 illustrates that modernisation has been more active by plants owned by outsiders.

The role of energy experts is a good example of the differences between the governance systems. Energy experts have an established role in investment related decision-making in Finland, but less so in Russia. However, Russian plants with elements of corporate strategy had more often established the role of energy experts in decision-making than those which had no corporate strategies (see Table 1).

Lesson: Corporate ownership supports modernisation because corporate strategy guides investments contributing to the coordination of the modernisation process. Competition between units delivers the most cost-effective investment decisions, and corporates can afford larger investments than independent units. However, corporate investors currently avoid Russia due to the unfavourable investment climate which could be improved by finalising economic reforms.

9. Higher energy price makes energy worth saving

Energy price was regarded rather as a factor than a driver to energy saving in Finland while Russian views were less clear. Finnish corporates provide their units with electricity and heat below market prices as does the Russian government by subsidising energy prices which might both act as a barrier to energy saving in theory. However, prices are significantly higher in Finland than in Russia as shown in Table 2. Even though the Finnish corporates provide plants with below market energy prices in Finland, energy use still remains more efficient than in Russia.

Table 2 Comparison of industrial electricity and fuel prices between Karelia, Archangelsk and Finland in 2003

	Unit EUR/	Karelia	Archangelsk	Finland
Electricity	MWh	21.68	36.29	71
Heavy fuel oil	t	71.04	84.25	265.8
Gas	1,000 m3	26.94	24.81	193.0
Coal	t	22.63	21.4	106.7
Petrol	t	302.87	287.36	1292.5

Sources: Karelkomstat 2004, 126-127; Archangelskii oblkomstat 2004, 94; Teollisuuden ja Työantajien Keskusliitto 2004; Adato Energia 2003, 39.

Russian experts claim that the current energy prices are high enough to stimulate energy saving. Even though energy efficiency has slightly improved since 1991, no major modernisation waves can be observed in the technology paths apart from some exceptions. This suggests that the improvement of energy efficiency is more likely to have been caused by the wave of decommissioning obsolete equipment in the early 1990s. As a comparison, the high level of energy efficiency in Finland provides evidence that prices are high enough to stimulate energy saving. Consequently, it can be concluded that the Russian prices are not high enough so far. The views of the Russian energy experts that energy is already expensive enough may be based on social rather than economic grounds.

But growing energy prices will not make much difference in Russia if companies are operating under soft budget constraints i.e. not accountable for all their spending as outstanding debts are not routinely challenged, and debts to authorities can be deleted by an administrative action. Economic accountability is a framework required for energy pricing instrument to deliver energy savings. The trend to switch to cheaper fuels was observed both in Finland and in Russia which would suggest that the market mechanism works, and that budget constraints are either hard or moving to that direction in Russia. The share of energy costs of the total production costs is dramatically higher in Russia than in Finland, and in Russia many low hanging fruits of energy saving are still available.

Lesson: Energy price is high enough in Finland to stimulate energy saving, but in Russia no significant changes have been detected which suggests that energy prices remain too low to trigger energy saving. The Russian potential of energy saving is so large that increasing energy prices should make energy saving attractive easily as long as budget constraints are hard. The experience of fuel switching triggered by price differences of fuels would suggest that economic reforms have moved far enough to make price increases encourage energy saving, and therefore, market based energy prices could work even in the absence of the structural reform of the economy.

10. Government support is needed

Lack of funding seems more acute in the case of Russian plants than the Finnish plants. All Finnish plants have their annual funding allocation from the corporate, and the potential to receive more funding for the best proposals, while there is a constant shortage of money in most cases of the Russian plants as profit is not enough to cover investment needs. The basic difference of backgrounds is significant. The task of the Finnish plants is to keep their fairly up-to-date and well maintained equipment functioning as efficiently as possible with a limited but annual funding allocation, and without direct link to the sales of products. Most Russian plants are trying to update their mostly old and out-of-date equipment with only very limited funding earned by running the mentioned equipment, and therefore, very dependent on the profit made. For the Finns it is possible to plan investments as the equipment is mostly running fairly smoothly while when Russian equipment fail, and in many cases there is money to fix only the most acute failures.

High interest rates and unavailability of investment loans are results of the risks investors experience, and the short-term approach of the Russian economy is a reaction to the ongoing change in the economy. The attitude of banks makes sense; why lend money over long periods of time and let borrowers delay beginning repayments when property rights and political developments on the highest level remain uncertain. The stability of the Finnish system provides a more reliable basis for banking business, and consequently, similar problems do not occur in Finland.

Modernisation of the pulp and paper sector is, indeed, a significant task, and the sector needs financial support from the state in Russia if a large-scale modernisation is desirable for the government within the next decade. Grants and tax breaks could, therefore, encourage the private sector to act faster. Whether the government should provide direct financial support to industrial sectors invites a wider discussion, and one may argue that this should not happen in a market economy. But the scale of modernisation need is very significant, and as the pace of modernisation has been slow during the first 15 years of transition, some of the production infrastructure may physically collapse before the investment climate improves enough to attract investments to modernisation. Focused grants distributed through a bidding process[63], and tax breaks against desirable performance by industrial actors[64] have been applied in market economies, and would be unlikely to cause damage to the emerging market economy.

Lesson: As resources for modernisation are limited in Russia, not all required modernisation can be implemented. Russian economy remains an unstable business environment, and therefore, fails to attract investments. As a result, in the absence of further structural reforms of the economy, the only way to provide enough financial resources for a wide scale modernisation of the pulp and paper sector within the 2000s is to provide government support.

11. Conclusion

Based on the case studies of 13 plants, the main driver and barrier to modernisation were found to be the same in both of the countries, market signals and the lack of capital, however, the latter was caused by different reasons. The drivers and barriers found suggest that there are various lessons from Finland to Russia, but their application to Russia is dependent of solving the macro-barrier, the lack a structural reform of the economy, including an administrative reform, which still prevails in the country. The only major lesson that would apply at some extent before the macro-barrier is solved would be higher energy price as there is evidence that differences in fuel prices already spur action in Russia.

The lessons that could be applied after finalising the economic and administrative reform include promoting corporate ownership which tends to involve corporate strategies that support modernisation, and introducing a well-planned and coordinated package of energy saving policies including grants and tax breaks to reward well-performing actors.

[63] The Finnish government distributes grants for energy saving investments.
[64] Hennicke et al (1998, 72). Denmark has introduced tax breaks to different types of energy use, and to companies which join a voluntary scheme. According to IEA (2003, 51-52), Japan has implemented policies to provide tax breaks to companies implementing desirable energy saving measures.

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The transition of Russian mining industry

by Veikko Kärnä

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1. Introduction

A short description of the study and research questions

The phenomenon focused upon in this study is the transition of a state from socialism to capitalism, the transition of an economy from a planned economy to a market economy, and the corporate ownership from state ownership to private ownership. The subsequent purpose of the study was to find out what has happened within this phenomenon at the industry and enterprise level in the Russian Mining Industry (RMI) during the years of transition from 1990 to 2006.

The main research question is defined as: *What institutional changes in the RMI and mining enterprises during the transition period from 1990 to 2006 can be identified?*

New institutional organizational theory is used to explain the phenomenon. Furthermore, in addition to the research questions above, the aim of the study is to test if a Western organizational theory can explain the development of an industry in a transition economy. Another purpose of this study is to deepen the understanding of the changes of organizational practices that have occurred. Organizational practices in this study are defined as being institutions like "archetypes, scripts, typifications, categories etc" (Scott 1995, 52), which are main elements of new institutional theory in organizational studies.

Methods used in the study

As no single organizational theory can explain how such a phenomenon as a firm's transition from a planned economy to a market economy arises, exists and develops, the chosen research method is a multiple case study (see Yin 1994), the aim of which is to find a theory to explain the phenomenon. The purpose is to look for theories, which are possible to find in each case (see Järvinen and Järvinen 2004, 75). In a case study, although no new theory is found, the case can reveal new knowledge that better explains what reality looks like.

The selection of case study enterprises was made after the pilot study phase, which gave evidence that the RMI had been split into two groups: one which was organized according to the old Soviet way of vertical integration, and another which was only mining raw materials and operated without its own processing facilities.

There were several eligible enterprises in Russia, which matched the minimum case selection requirements. Finally, two mines were chosen: “Ugol” producing coal and “Mineral” producing a mineral. These mines were located in different regions of Russian Federation.

The case study evidence from “Ugol” and “Mineral” were analyzed through theory bound analysis. This kind of analysis can solve some of the problems of evidence based analysis by abductive scientific reasoning. This type of analysis begins with an evidence based process, but at the end of the analysis an existing theory is taken into use. The data analysis is lead by a guiding principle, which has some theoretical connections, but does not directly base itself on theory.

In the theory bound mode of analysis the empirical data and theory alternate in the mind of the researcher. They interplay between themselves, and the researcher tries to couple the evidence and theory together through coercion, intuition or creativity, which can lead to new hypotheses or theory.

In this study the case study evidence consists of different kinds of data including elite interviews and critical incident questionnaire results. The purpose has been to combine one or more research methods, e.g. to triangulate. In this study the case study data source has been triangulated (Handbook 2004, 130). The results of the elite interviews (first data source) have been contrasted with the results of the questionnaire of the critical incident method (second data source). Thus, two methods, e.g. interviews and a questionnaire have been used, in addition to other documentation and data in order to collect material for analysis from two different data sources, e.g. top and middle management.

All the data from the “Ugol” and “Mineral” case studies has been analyzed by traditional qualitative research methods, e.g. grouping and classifying. The analysis has been accomplished through intuitive grouping, which can be seen as part of the abductive reasoning.

2. Transition of Russian mining industry

The structure of RMI during Soviet era

Karnouhov divides the developments of the RMI during the Soviet Era into seven different phases. These phases are presented in Table 1 as follows:

Table 1 The phases of the development of the Soviet & Russian mining industry

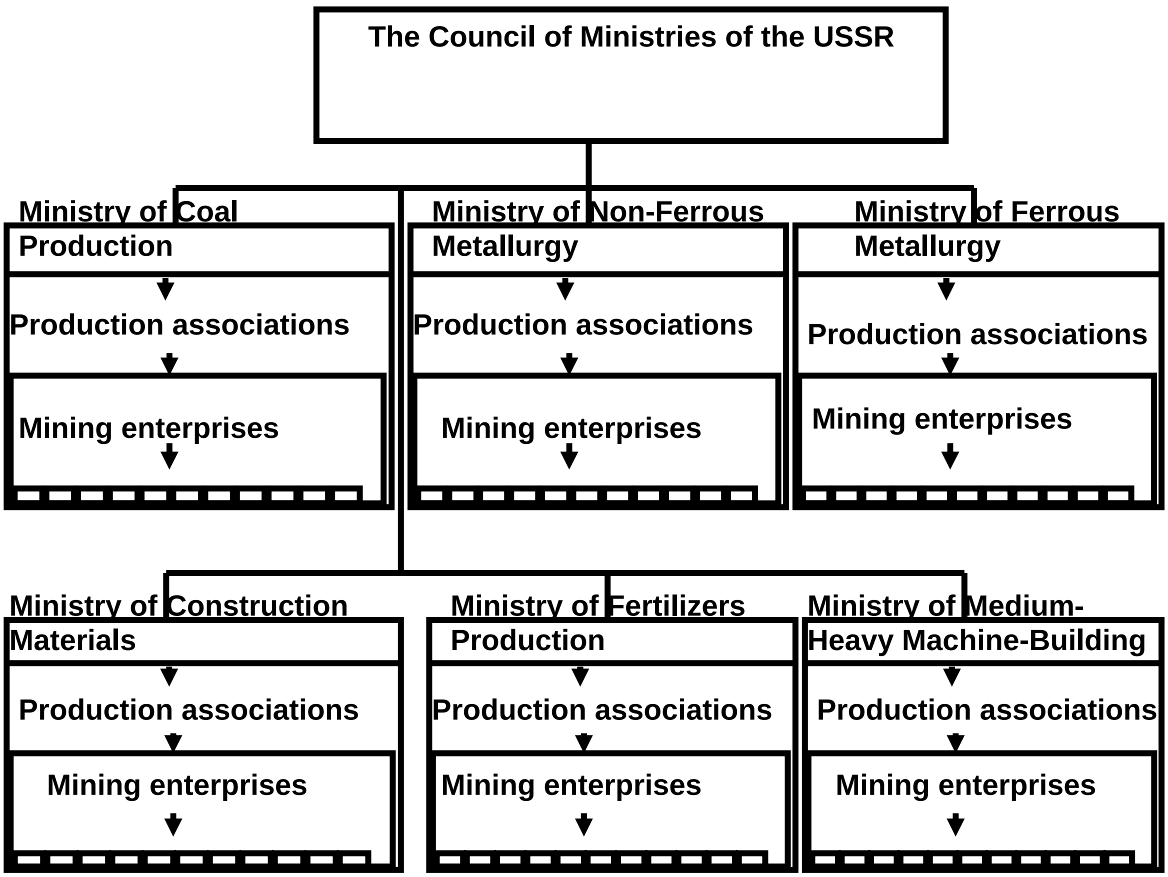
1917 – 1920	War and early communist period
1920 – 1928	New Economy Policy period
1928 – 1940	Collectivisation period
1940 – 1945	World War II period
1945 – 1985	Re-construction period
1985 – 1990	Perestroika period
1990 →	Transition period

Source: Karnauhov 2004.

Before Gorbachev's Perestroika policy the Soviet mining industry was managed by several industrial branch ministries. The main mining ministries were: the Ministry of Ferrous Metallurgy for the Production of Ferrous Metals, the Ministry of Non-Ferrous Metallurgy for Non-Ferrous metals, the Ministry of Medium-Heavy Machine Building for Uranium Production, the Ministry for Fertilisers, which oversaw the excavation of phosphates and other minerals to be used in soil fertilisation, the Ministry of Construction Materials, which took care of the production of aggregates, stone blocks and other construction materials, and the Ministry of Coal Production (Gondusov 1999). In accordance with Figure 1 (Gondusov 1999), the structure of the mining industry at the beginning of Gorbachev transition policy is presented. Note that all six ministries had similar internal structures.

All the ministries of the Soviet Union were subordinate to the Council of Ministries, and Gosplan, the country's planning organisation, co-ordinated their production. All the different ministries of mining were organised according to the principle of vertical integration (Gondusov 1999).

Figure 1 The mesostructure of the Soviet mining industry at the end of the 1980's



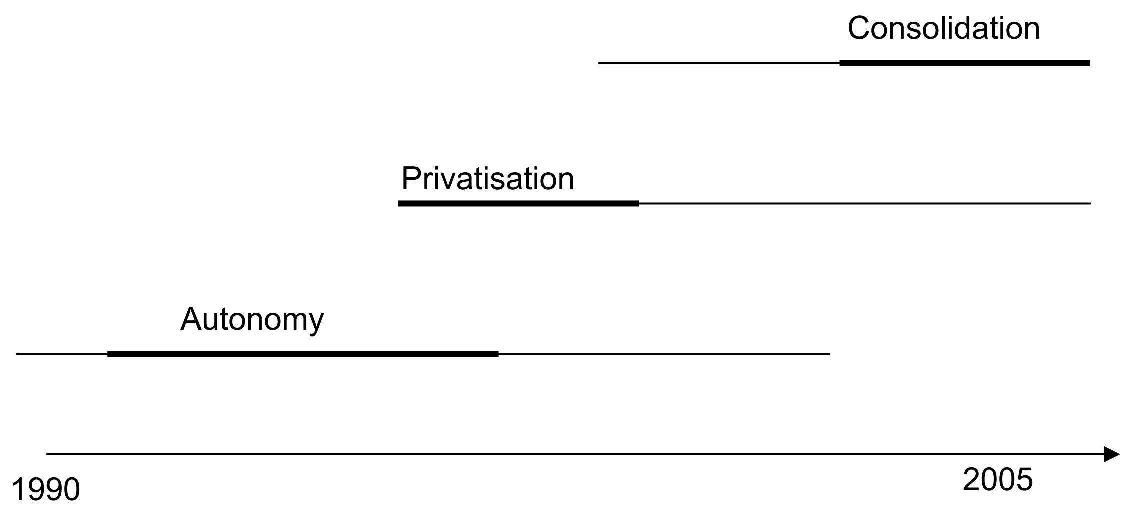
Source: Gondusov 1999

Vertical integration meant that all of the minerals and metal ores of the whole country were produced so that one ministry was in control of one metal's production. Thus, the Ministry of Non-Ferrous Metallurgy was in charge of excavating all copper ore in the Soviet Union, as well as its subsequent processing into final products like slabs, tubes, strips etc. (Galchenko 1999).

Phases of transition in the 1990's

The phases of the transitional development of the RMI from 1990 onwards identified in this study are: autonomy, privatisation and consolidation. Autonomy is regarded as comprising the Russian liberalisation and stabilisation phases of transition together with the preceding privatisation. Privatisation period is self-explanatory; it is the phase in the early 1990's when Russian enterprises were privatised. The third transitional phase, consolidation, is regarded as the post-privatisation phase of transition, when Russian industry was grouped into larger entities. The phases of transition are presented in a time line in the following Figure 2.

Figure 2 Phases of transition in a time line



Furthermore, as a result of the consolidation, new phases in the transition have been emerging: modernisation of the enterprises, organisational changes in the management systems of the mines and increased focus on environment among others.

3. Results of transition

Current structure of RMI

The transition process of the RMI has lead to oligarchic ownership. The lion's share of the mining industry is now in the hands of a few business giants that are financially independent and ready for international cooperation in order to develop new, riskier mining projects in and outside the Russian territory (Global Business Reports 2005). Such conglomerates are for instance Eurazholding, Severstal, Norilsk Nickel, Rusal, UMMC, out of which Norilsk Nickel controls the nickel production, Rusal the aluminium production, and UMMC the copper production together with Norilsk.

However, it is important to notice that the Russian state is an important actor of the RMI. The government of Russian Federation still owns very important mining companies, for instance Alrosa (diamonds) and Tvel (uranium). There are also from time to time rumours on the marketplace about the state's attempts to increase its ownership in Russian mining companies (Helmer 2004; WPS 2006). Some analysts have noticed that together with Vladimis Putin's nostalgic longing to Soviet traditions, the security officers of earlier KGB, the siloviki, have seized power in the state owned companies, and their sometimes peculiar behaviour is a sign of their commitment to these power organs (Ikonen 2007). Ikonen notes that according to the Economist newspaper the power organs can seize power in business enterprises, but they are poor company managers. It is feared that the dirty methods of the "siloviki" are driving away potential domestic and foreign investors. Additionally, the Russian mining tycoons seem to be afraid of the power structures, and they do not want to annoy the "siloviki"; thus, it is sometimes hard to see, where the Kremlin changes to Oleg Deripaska's empire (ibid).

The internationalization of RMI

There are only few foreign owners of RMI, and they are mainly minority owners. Although there are not many private foreign owners of Russian mines, there seems to be a growing interest in Russian mining assets (Luciw 2005). Earlier, there have been attempts in the world wide mining community to start mining businesses in Russia, but because of their negative experiences, there has been much caution when investing in the RMI (Helmer 2004).

The failures of Star Resources at Sukhoi Log, Pan American Silver at Dukat, Archangel Diamonds at the Grip pipe in the Verkhotina field (see Helmer 2000), Celtic Resources at the Neshdaninskoye project in Yakutsk (Wade 2002) and Norsk Hydro at the Rasvumchorrr mine in Kirovsk on the Kola Peninsula are not encouraging for the foreign mining companies, who basically are not afraid of the risk of mining in Russia, but of unfair treatment by Russian institutions towards foreigners (ibid).

There are, however, some successful foreign investments into Russia's mining industry. Such stories include Bema Gold at the Julietta mine, High River Gold in Buryatzoloto, Kinross Gold in Kubaka and Harmony Gold in Mnogovershinnoye (Wade 2002). The Kubaka investment cost 250 million US dollars, and one of the major reasons for its success was the special ukaz by President Yeltsin, which gave the mine the possibility to sell its gold directly abroad, if Russian central bank reserves did not buy the gold produced by Kubaka (Koponen 1999). The difference in organisational efficiency compared to Russian mining enterprises is significant as noticed by the Russian working on the mine. There are no endless cigarette smoking breaks at work as in Russian owned mines (ibid).

Investment has not been one way though as Russian companies have also begun their global advancement (see Liuhto 2003). For instance Norilsk Nickel has bought Stillwater palladium mine in the USA (Redman 2003), and Gold Fields in South Africa (Aaltonen 2004; Interfax 2005). The purpose of such purchases is not to protect Russian capital by moving it abroad, but to secure both distribution and supply systems to provide palladium to the U.S. auto industry and, thus, virtually control the world's palladium market (Bregman 2003).

Some of the Russian metal giants have become truly global majors in metals. One such example in addition to Norilsk Nickel would be Rusal, world's largest aluminium producer, having global presence in 5 continents and 19 countries. Out of the sales of aluminium products, CIS countries count today only 23%, whereas Europe ranks as number one with 38% of Rusal sales (Kremer 2007).

Some Russian companies have started their IPO's (International Purchasing Offering) in large Western stock exchanges. Their purpose is to get new capital to Russian companies, but some offerings have been criticized by the international press of being unfair or even as PR-punts (Helmer 2005). In result some foreign owners have purchased minority shares in Russian mining companies.

Furthermore, the new law on raw materials has boosted international co-operation within Russia. Norilsk Nickel and Rio Tinto, an international mining major, announced exploration and joint venture development in Russia in January, 2006. The companies signed a co-operation protocol establishing the formal terms governing the joint venture. The agreement entails the establishment of a joint venture exploration and development company, owned 51 per cent by Norilsk Nickel and 49 per cent by Rio Tinto. Initial exploration efforts will concentrate on opportunities in the Siberian and far-eastern federal districts of Russia (Norilsk Nickel 2006).

Two contrary directions of structural development

The ongoing consolidation of the private part of RMI is twofold; there are two directions which are contradictory (Butrin 2004). The first direction is vertical integration as per the old Soviet system. A typical example of this would be the UMMC (Ural Metal and Metallurgy Complex) owned by the mining tycoon Iskander Muhamedov and his allies. UMMC is a vertically integrated business, where the mines owned by the group produce ore and/or concentrate for the smelters of UMMC, only. The slabs produced from the smelters are then used in the polyproducts production of UMMC. Mining is regarded as an intracompany source of raw materials for the group's own factories.

Another direction of the RMI is to regard mining as an independent raw materials business (Butrin 2004). A typical example of this would be the Russian iron ore mining enterprises of Mihailovski and Lebedinski, who as privatised companies trade only with their own raw materials selling them to processing plants, which are owned by separate business groups. No vertical integration exists there.

Butrin states that the independent raw materials business has become the norm in other industries than non-ferrous, ferrous and coal mining industries (Butrin 2004). He presents some examples from silver production (Polymetall) and the non-metallic mineral market (PIK-group). Furthermore, he points out that some companies having the vertically integrated structure as an axiom from Soviet times can have new mining projects, which are separated from that group's vertically integrated business structure. This is evident in SUAL's Srednetimanskoye bauxite project, production which SUAL are ready to sell to the group's external sources.

The Russian vertical integration holdings structure has not proved to be very effective (Butrin 2004) and one can say that it is against the global practices of Western mining companies (Global Business Report 2005). It is common practice in Western countries to concentrate on the core activity, and everybody prefers to outsource (ibid). The Russian mesostructure with vertical integration has a Soviet background, and the vertical integration model in use in Russia today is a very specific model of vertical integration (ibid).

Holding and management companies in Moscow

The privatised part of the RMI is now owned by new holding structures, which are mostly situated in Moscow. In a way these holding companies can be regarded as remnants of the past. As during the Soviet era when Soyuznikel ran the whole of the country's nickel production in a vertically integrated fashion, it is now Norilsk Nickel, which is doing the same. Power has returned to Moscow, because the key personnel of these enterprises are located there, and they have the authority to sell the metals and buy equipment for them (Popov 2005).

The consolidation process has affected the mines so that they are now parts of big companies, which control them from their head offices. The mines' role has diminished, and they employ a position of the production unit. The mines have lost their direct contacts with banks, insurance companies and other structures, and the holding company's head office has taken charge of such operations. Furthermore, the sales of ore and purchases of equipment have usually been transferred to the head office of the concern (Popov 2005).

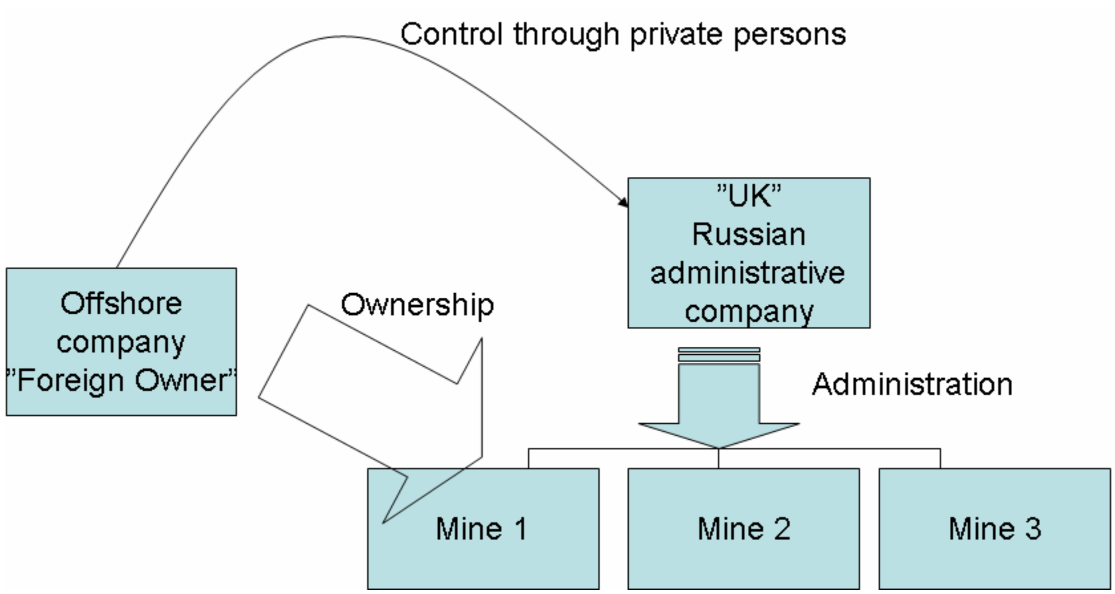
It is now the head office of the holding company that takes care of such operations (Fortescue & Rautio 2005). The mine has close contacts with other mines belonging to the same holding, but not to other competing mines. The processing plants in its own holding company are its closest partners. The local authorities have also taken up a very important position in the organisational field for the mine in question.

One interesting and very much Russian feature (accepted by the country's legislation) in today's mining industry in Russia is the use of so called management companies to run the business. These, so called UK's (Upralyayuschaya Kompaniya, Управляющая Компания, Management Companies) are legal companies, which do not own the mines reporting to them. The mines report to the UKs, which might own a mining licence, but the actual running of the mine is carried out by the mining complex, which is owned by an offshore company. This structure enables the owners of the mine to secure their ownership of the mine in case the government has ambitions to take over the mine from its Russian owners. The idea behind this kind of arrangement is that the UK is owned by private people, close to the owners of the mine. Under the law the responsibility for any errors by the management lies with the UK. Thus, if charged by the tax authorities the mine with its legal owners cannot be punished nor confiscated by the state; it stays under the control and ownership of the Russian businessmen behind the offshore companies. The UK's would bear the consequences of legal sentences. These structures started to appear at the time of Yukos court case (Subbotin 2005). One example of a UK is the Rusal organisational structure (see Rusal 2006).

Such a structure could be regarded as the owners' strategic attempt to oppose the dictate of the state, and guard against attempts of the state to nationalize the company as happened in the Yukos case. The formal structure of a UK is allowed in Russian legislation.

Figure 3 illustrates the structure of a UK company with regard to the owner of the mine, and to the mines themselves.

Figure 3 The management company's structure



The alliance of business and government

One peculiar aspect in the RMI's development trends is the alliance of the mining business and local power structures. According to Delovoi Kuzbass magazine (2005) three mining enterprises of the Kuzbass region signed a cooperation agreement with the local regional (oblast) government in April, 2005. Yuzhkuzbassugol already signed this agreement for a second consecutive time with a regional government, and Sibuglemet with Raspadskaya ugolnaya kompaniya joined them. According to this agreement both the enterprises and the town, where the companies work will be developed according to agreed principles. Furthermore, before these companies a group of local companies had already signed similar cooperation agreements. According to Delovoi Kuzbass among them were: SUAL, Mechel, Kuzbassrazrezugol, Sibirsky Delovoi Soyuz, Severstalresurs, Prokopyevskygol and Belon, i.e. practically all the producers of coal in the region.

Similar information can be found in other regions. Interfax reports from Chita in April, 2005 that the administration of Russia's Chita region, which is home to the giant Udokan copper field, and Arctic mining and smelting giant Norilsk Nickel, had signed a cooperation agreement. Ravil Geniatulin, the region's governor, and Maxim Finsky, Norilsk Nickel's deputy CEO, signed the deal, which covers mineral development, the drafting of wide-ranging environmental programmes and the creation of favourable terms for attracting investments and putting them to effective use. Norilsk Nickel reiterated its willingness to provide financial support for social programmes in the Chita region and the region's administration pledged to monitor the use of the company's funds (Interfax Hungary 2005).

Both of these agreements reveal a very interesting state of affairs in Russia. Local regional governments use the RMI to pay off the social programmes the region cannot afford. In other words these are examples of the social responsibility of the RMI, often being the only local industry in remote locations with sustainable and constant profitability.

4. Conclusion

Based on the results of this study it is possible to say that the Russian mining industry has gone through an extraordinary transitional development from the collapse of Soviet Union till today, which results in two contrary directions of structural transition. The mesostructure of the RMI is divided into two: the first is the vertical integration as per the old Soviet System. In this structure mining is regarded as an intracompany source of raw materials for the group’s own factories. The mines are located lowest on the production chain, which aims to the production of finished products, not raw material.

A second mesostructure of the RMI is to have mining as an independent raw materials or commodity trade business. These privatised companies trade only with their own raw materials selling them to processing plants, which are owned by separate business groups. No vertical integration exists there.

However, in both cases the individual mines in the Russian periphery, which had an autonomy in the beginning of 1990’s, have now lost it, and are now parts of larger holding companies.

It is also possible to say that power has returned back to Moscow. Before the transitional period of Russian mining industry there were about 6 mining ministries, which were monopolies. The Yeltsin government privatised all the enterprises belonging to all of these ministries and thus, founded several hundreds, thousands of independent mining enterprises. These mines were running their own businesses based on autonomy and independence from the centre.

After 15 years of transition, the thousands of private mines in the Russian periphery are now parts of about a dozen mining conglomerates, which have taken the role of earlier Soviet branch ministries. The autonomy of the privatised mines has been liquidated, and the mines are now in the same position, in which they were before the privatisation. The key elements of a business entity are run by their head offices in Moscow (financing, sales, purchases, investments), and the mines have only a production unit status in their organisations.

It might be added here, that the siloviki have taken over the governmental sector of Russian mining industry. The siloviki are also located in Moscow, and the governmental mines are reporting to their own central offices there.

Old Soviet structures have re-appeared, too. Centralisation of power and the vertically integrated structures are examples of these. It can be also added that the model of vertical integration in Russia has proven to be not very effective. Furthermore, similarly to the Soviet Union, the local mining companies are taken care of the social welfare of the own regions. They are paying so called voluntary taxes to the local administrations' budgets in their hopes not to have problems with the local governor in the periphery, and his staff. The separation of the state from the economy has not taken place; although it was one of fundamental goals of transition (see Sutela 2004).

Although the new owners of the RMI have made investments in order to streamline and modernise the old Soviet mines, the productivity of the mines is still low. The reason for this is that the mines' central administrations are overcrowded. In order to improve the productivity the mining industry needs to remove the old Soviet era managers from power, and start to streamline the corporations' internal organisations. This might prove to be difficult to do, because the local governors' will not be happy about the increased unemployment rate in their regions.

The favourable trend of Russian mining industry has continued after the devaluation of Russian rouble in 1998. Since that the industry has had low production costs due to weak rouble. At the same time the increasing prices of metals have heightened the profitability of the mining business, and given the possibility for the Russian mines to start to acquire assets in other countries. The Russian mining enterprises have purchased mining companies in other CIS –countries and Western mining companies. The major mining companies have also penetrated the Western stock exchanges, and released through IPO's minor quantities of their shares to Western investors. Most probably the Russian mining companies will in the future continue their efforts to globalise their activities by acquiring mining assets in Western countries.

However, the Russian own mining industry is owned mainly by the domestic actors. Foreign companies have so far purchased minor mining companies, and they have been banned from big ventures. Foreign mining companies have not been allowed to purchase share in strategic mining companies. In order for a foreigner to participate in the mining business one would need a Russian partner, who owns more than 50% of the shares of the venture. It can be estimated that, if the Putin regime will be in power after the forthcoming Duma elections and the new president elected in spring of 2008 will continue the Putin policies in the mineral resources industry, the foreign companies will have only limited possibilities to become major players in the Russian mining industry.

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Regions in Russia: between necessities and possibilities

by Elina Rantalahti

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1. Introduction

Regional development and the status of Russian regions in relation to the central government are one of the most topical issues in Russian Federation today. The “vertical of power” developed by the president Putin’s administration since the beginning of the millennium as a system of focusing power to the highest hierarchical level has launched a political, social and academic discussion in Russia of the influences the changes are about to bring. The reforms have interpreted to be as insertion of police-state mechanisms into a democratic state (Petrov 2002, 88) as well as patterns of corrupt and ineffective governance (Alexander 2004, 23). In this sense the Russian example with the wave of recentralisation offers something completely different when compared to the other current European trends of policies that enhance openness, including borders that are opened[65] and made increasingly permeable (C.f. Jones & Keating 1995; Gamble & Payne 1996; Anderson 1999).

The permeability of borders is in Europe closely related to the topic of integration[66]. In the EU level the process of integration has mainly been seen as either in federal or in functional terms. In federalism it is believed that the best way to achieve integration is through a process where the actors of the area in question develop into a federal state by voluntarily giving up. In functionalism integration is seen as a result of economic rather than political process. The government is only a relevant framework for the surrounding social community, but not a master player in the process of integration (Mitrany 1968, 62). However, applying these theories to the level of EU-Russian relations and using them as means to understand the prevailing situation is bit more tricky. The difficulty in the application of these theories lies in the Cold War legacy. There are hardly any integration theories developed concentrating on the relations between the European Union and Russian Federation. The lack of general theoretical framework makes it more difficult to examine the EU-Russian relation with respect to integration. Furthermore, it is highly unlikely that such general theoretical framework would be developed in the near future either. The geographical area that the theory should cover is simply too vast and many of

[65] As an example the EU enlargement of 2004 and 2007 when Bulgaria and Romania joined the Union.

[66] In this text the word integration is simply defined as the process of binding or bringing together two actors.

the ground assumptions of the integration theories used within the framework of (Western) Europe are simply not valid or are very different in the case of EU-Russian relations.[67]

Obviously enough, the purpose of this article is not try to produce a new integration theory that would cover whole of the relevant aspects of Russian Federation and Western world integration towards each other including the role of the European Union in it. Rather, as the examination of the whole aspect and area becomes somewhat too difficult and vast to handle, one of the remaining possibilities is to concentrate on some specific parts of the possible integration procedure that actually are possible to scrutinise and examine. This is also what is done in this article. To be more specific, the examination is done by regional basis. The regional level as the level of analysis and interest is chosen for a few of practical reasons. The first one is governability of the analysis. By defining the target of observation, it is possible to be more specific with it as the regions are not either too big or too small to observe at. Secondly, trying to explain the general picture is too complicated for a single paper.

One final confining remark has to be still done in order to be able to scrutinise the given topic. Integration can be studied in various fields, also in regional level and to bring them all under consideration would be a too ambitious procedure. That is the reason why in this article the emphasis is put on economic relations, and thus assessing the possibilities of integration from economic aspect. The choosing of economic aspects as one of themes of closer study in this article can at least in part be argued on the basis of integration theories. The integration of Russia and EU through federative routes (as in federalism) seems highly unlikely, but the other possibility, closer partnership through integrated market economy (eg. EU’s energy dependency on Russia) could be a more fruitful ground of co-operation.

[67] For example, in the theory of federalism the very basic feature of integration is the idea of the nations gradually turning into federal state. In the case of European Union and Russian Federation the result of common federal state is not very likely in the parties’ priority list.

2. Setting of the research questions and the basis for discussion

Russia collides in an interesting way with the current European development of regionalisation when compared to the Putin's vertical of power and its endeavour of recentralisation. In Russia the regional development trend seems to be recentralisation in the benefit of the federal government and in the loss of the regional actors. In the intersection of these two prevailing trends lie the opportunities and possibilities for the Russian regions. The interesting question that remains to be unanswered is the situation of single regions in Russia. As the current trend of regional development points to recentralisation, is there any possibility for a given region or regions to move against the tide?

One possibility for a Russian region to move against the tide could be through the EU-level. When thinking of the Russian borders the EU-Russian border region offers a very specific case example as no other Russian border state has a similar kind of strategy for partnership with Russia than what EU has. The EU-Russia strategic partnership and different cross-border programmes could be one option for some of the Russian border region areas as making the borders more permeable and thus perhaps also the border regions more integrated. From the EU side there seems to be strong wish for lowering borders and moving the barriers of trade. One example of this willingness for co-operation is the statement made by the President of the European Commission Barroso of EU wanting free trade between the Union and Russia (Helsingin Sanomat 2006).

Thus, the special focus of this article is to more closely examine the new possible type of regionality within the Russian Federation and to examine these regions operational principles and possibilities to operate in the Russian Federation.

On the basis of what has been previously said, the leading research question can be formulated in a following way:

- *What are the prerequisites needed in order for a Russian border region to take part in international level activity and co-operation, despite of the current wave of recentralisation?*

- *What is the role of the governmental level as making the regional level international co-operation possible?*
- *What is the role of the EU co-operation tools, namely EU-Russia strategic partnership, to give possibilities for such international co-operation?*

The answers to the set research questions are sought in a two-folded way. First, by examining the Russian governmental level actions, and by studying more closely the development of regions and regionality in Russia during the transition period. This is done in order to find out, what in general is the role of the regions in today's Russia and what possibilities do the regions have while concerning the needed guarantees from the state in order be able to act internationally.

It is important to notice, that regions within Russia are not equal in respect to the international co-operation possibilities, especially when it regards the EU-level actors and activity[68]. In this sense some regions are "more equal" and at any rate better equipped (physical & network locations among them) than the others, also some regions have the possibility to gain from the EU-level international programmes. This is the reason why in this article the possibilities offered by the EU-level are also studied more carefully by taking a look in principle (EU-Russia strategic partnership) and in practice (Road Maps for the four Common Spaces) what is taking place among this sphere.

In order to build basis for understanding, this article concentrates on three different aspects. First examining the regional reforms in the Russian Federation (especially during Putin's era) as creating basis to understand what is the status of Russian regions today. Second stage is to take a look at the EU-level and try to find out, what can the Union offer for the Russian regions that possible could enable or fortify their international level co-operation. The last target of this article is to try to find out, what could be the example region look like that would in one hand have the tools given by the government to operate internationally and that would also have possibilities to be attractive in the European scale as well.

[68] The EU-level co-operation possibilities can be largely explained by the proximity of the EU border. The closer the border, the more opportunities for the region to take part in different type of funding forums of the EU cross-border programmes.

3. Regional reforms in the Russian Federation (especially during Putin's era)

In order to find out, what is the role of the governmental level as making the regional level international co-operation possible, there is needed an understanding on the Russian governmental level regional reforms during the transition period. Before going into any deeper on the actual reforms, it should be acknowledged that there are two underlining factors influencing all the time on the reforms done.

The first one is the legacy of the Soviet Russia. In the former USSR contracts made to form the country were done between the centre and the periphery. What is worthwhile to notice is that also the "periphery", the regions, had different status when compared to each other. Some of them were ethnically based and had more rights (e.g. autonomous republics) than the administrative regions (e.g. regular krais). Thus, the regions were already during the end of the Soviet era in principle diverse in power and in status and some regions had better possibilities to gain from the prevailing situation than others. The second underlining feature having great influence on the regional reforms of the nowadays is the political development and political struggle that took place during the earlier stages of transition. (Belokurova 2006)

The federal reforms of the Russian Federation can be divided into three different levels (adapted from Belokurova 2006):

1. Times of political struggle 1989-1993

2. Bargaining federalism 1994-1999

3. New tasks for federative reforms 2000-2004

The central characteristic for the times of political struggle in 1989 until 1993 was the intense political power struggle between the Soviet Union leader (Gorbachev) and the Russian Republic leader (Yeltsin). Both of the opponents in order to secure their power tried to get support from as many Russian regions as possible. Some of the regions were promised as much autonomy as the regions wanted for a support for the leader in question. This resulted many different enforced constitutions and republic presidents.

During 1990 several Soviet Union republic leaders declared themselves as sovereign states and insisted that their laws took over those of the USSR. Lithuania went even further than this and declared secession from the Union. Latvia and Estonia followed soon, but with much greater caution. For the USSR, this was the point of no return. As a Union republic could declare itself independent of the USSR, the whole future of the Union was a question mark. (Hosking 2001, 585–586.)

After the fall of communism in 1991 the federative treaty to establish the Russian Federation was done (1992) and Yeltsin took the lead as the president of the Russian Federation. In the treaty there were done three different types of agreements. First there was the treaty between Moscow and the ethnic republics, secondly the treaty between federal centre and the autonomous oblasts (regions) and thirdly treaty between the federal centre and the administrative krais (regions). The regions of Chechnya and Tatarstan did not sign a treaty at all.

As a result of the nature of the federative treaty and the power struggles on the highest level of hierarchy regions could get as much power as they wanted and the Russian Federation was composed of strong regional level with regions different in status, privileges and power.

The second state of regional reforms bargaining federalism lasted from 1994 until 1999. During this period of time took place political bargaining between the different regions and the president's administration. The situation started when Tatarstan finally signed a bilateral treaty with the centre and got a high level of autonomy along with it. As Tatarstan had managed to gain such a power, the other republics wanted to sign similar treaties as well. This effected the signing of bilateral treaties between Moscow and republics starting from 1994, by the 1993 the oblasts wanted sign as well new and better treaties for themselves. The period of renewing treaties lasted until 1998.

The years of 1994-1998 brought altogether 41 new bilateral treaties to constitution. All these treaties were equal, but in reality the different regions had different status. The high amount of new bilateral treaties resulted from the fact that Yeltsin was running again for a president and was weak in status, so the president's administration tried to get as much support as possible from the regional level by buying their votes by promising greater regional level power. (Belokurova 2006)

As consequence these changes brought along instability in the federal level and competition between regions. The high amount of competition led to a lack of inter-regional co-operation as regions chose to be foes than friends. Because of the different type of bilateral treaties among the regions there were different standards for different regions (e.g. differences in state funding and tax payments). The prevailing situation enabled also growing power for the heads of the regions. There occurred authoritarian like systems were the head of the regions could control mass media and judiciary. The situation cause a tremendous problem of controllability for the central level: there were 81 different regions in the Russian Federation with different treaties, rights and status. (Belokurova 2006)

The third stage of reforms in 2000-2004 brought with it new type of reform needs. The newly elected president Putin faced a need for several reforms. Due to the earlier events there Russian regions were by no means governable from the view of the central administration. Also the regions were unable to co-operate with each other due to the envy and constant competition. The heads of the regions could have a great amount of power on their selves and were turning regions to their own personal playgrounds. Putin had a better stand to respond to the problems than his predecessor as during the election campaign Putin gained support through mass media, not by bribing the heads of regions.

Putin’s first reforms were done in the level of federation. All the done treaties during Yeltsin time were declared to be not valid anymore. The federal constitution was the only valid document defining the relationship between the centre and the regional level. After this federation was divided into 7 federal districts (in 2000) that were created by uniting 10-11 regions. Now, instead of 81 regions, there were only 7 districts for the central administration to operate with. As a result of the year 2000 reform, all these federal districts have presidential representatives.

In the Federation Council[69] a new order was also formed. In the preceding system each region had two representatives in the Federation Council (from 89 regions altogether 178 delegates). These were the regional executive and legislative speaker. Since January 1.

[69] CF the upper house of Russian parliament, Duma the lower one.

2002, regional executives and legislative speakers no longer serve on the council. Instead regional parliaments appoint individual representatives who are subject to regional legislative approval. (Alexander 2004 12; Morozov 2006) As an influence of the new order the regions want to send their most powerful persons to represent them in the Council. The common practice is that representative of the region belongs to the Russian political or economic elite and lives either in St. Petersburg or in Moscow. Thus, the meeting of the Council can be interpreted to be as the meeting of powerful people serving their own interest and not the meeting of regional stakeholders with regional level interests. (Belokurova 2006)

It seems to be that the ongoing shift of political gravity from the regional level towards the federal districts means reduced public control over authorities, as the delegates are appointed, not chosen by direct elections. (Petrov 2002 88.) The standard of appointing representants and shifting power to the central level can be seen as putting the grass-roots level and civil society development at stake in Russia.

In 2004 a new round of reforms came. The regional executives are no longer selected by the people, but appointed by the president. This change now brings all the regional actors under the direct control of Kreml. The question is if there is left enough motivation for regional development and enough freedom to act for the regional level players as the Kreml seems to take all the time tighter control over the regions. Although in the beginning of Putin’s presidency there was a clear need for reforms, the last one of the reforms was clearly a one step too far. (Belakurova 2006)

What can be seen as being the consequences of recent Russian regional level reform? Recentralisation and strengthening of the “vertical of power” seem to be obvious answers. The deviation from democratic federalism, as the heads of regions are no longer elected but appointed seems also to be a clear case. In fact, one can ask if the Russian Federation is an actual federation anymore (Petrov 2002 88)?

The reforms done in the year 2004 were done directly after the Chechen terrorist attack in Beslan in northern Ossetia where a group of Chechen fighters seized a school in the end resulting a death of several hundred schoolchildren. The event indicated to Putin that all the Russian regions were not under the centres control. Perhaps Putin wanted to play on the safer side and fortify his administration status still more in the regional level as well.

On the other hand, the vast geographical size of the Russian Federation and the rich history of the area seem to illustrate that the area has a tendency of having strongly centralised power running the Russian show.

To the question of what are the prerequisites needed in order for a Russian region to take part in international level activity and co-operation and the role of the governmental level as making such operation possible the answer seems in a way be quite simple. The one prerequisite needed from the governmental level is all that is in the basic phase needed. If the Russian border region does not have authority from the state level there are very few chances for the region to succeed. The regional executives and other central figures of the region (either appointed by the president or the regional parliament) most probably would rarely act against the premises given to them.

4. Tools that EU-level can offer for the regions

The following paragraphs seek to find out, what is the role of the EU co-operation tools (namely EU-Russia strategic partnership) to enable and make possible international co-operation between Russia and EU. It can be said, that the EU-Russia relations are timelier than ever: through the EU enlargement to the group of 25 member countries Russian Federation has become closer to EU than ever, at least in geographical terms of speaking. This new type of proximity offers challenges to both of the partners. How to take an advantage of it and how to diminish the possibility of the new borderline becoming a dividing line?

The European Council in Copenhagen June 1993 quite vaguely defined the countries to join the EU[70]. However, it relatively soon came clear that Russia was not part of the group of applicant countries. As this was the case, other means of co-operation between the Union and Russia needed to take place. Russia is important to EU in economic and energy

[70] "*The associated countries in Central and Eastern Europe that so desire shall become members of the Union. Accession will take place as soon as country is able to assume the obligations of membership by satisfying the economic and political conditions.*"

spheres as well as in terms of politics. Good and productive EU-Russia relations are needed in order enhance the integration instead of dividing lines.

Political and legal foundations of EU-Russia partnership

The bilateral basis for EU relations with Russia is in the Partnership and Cooperation Agreement (PCA) which came into force on 1st of December 1997. Its initial duration was for10 years and it will automatically be extended beyond 2007 on annual basis – unless either side withdraws from the agreement. In April 2004 Russia and EU agreed to extend the PCA to include also the ten new member countries that joined the Union.

The significant feature of the PCA is that it established an institutional framework for regular consultations between the European Union and Russia. At the St. Petersburg Summit in May 2003, the EU and Russia agreed to reinforce their co-operation by creating in the long term four "Common Spaces" in the framework of the Partnership and Cooperation Agreement. These fields of co-operation were decided to be common economic space; a common space of freedom, security and justice; a space of co-operation in the field of external security; and common space of research and education. Further on, the Moscow Summit in May 2005 adopted a single package of Road Maps to act as the short and medium-term instruments for the implementation and creation of the four Common Spaces.

The overall objective for the Common Economic Space (CES) between Russia and the European Union is the creation of an *open and integrated market between the EU and Russia*. It is assumed, that such action will bring down barriers to trade and investment and promote reforms and competitiveness.[71] It is not however stated clearly in the Road Map for Common Economic Space what would be the concrete tools to bring down the barriers of trade. Yet, as the President of European Commission Mr. Barroso stated in July 2006, while visiting Finland, EU would want free trade between the Union and Russia (Helsingin Sanomat 2006). Also the negotiations for the Russian WTO agreement seem to speak for the true willingness of gaining more integrated market area between Russia and EU.

[71] For more detailed information look for EU-Russia Summit in Moscow 10.05.2005 and Road Map for Common Economic Space (EC 2005; EC 2006).

One might notice something familiar in the pattern. In a peculiar way, the process of EU-Russia co-operation has reflected the same order in which European integration itself has progressed. First, there is a political declaration of goodwill (PCA agreement). In the next phase appears sectoral co-operation (Common Spaces). Eventually, free trade is established as the goal (Barroso's statement). (Sutela 2005, 23.)

The contradictive development paths of the Russia towards Europe and integration

To get back to the question what are the prerequisites needed in order for a Russian region to take part in international level activity and co-operation and the specific European Union role in it, a summarising look is now needed. First of all, the significance of Russian regions potential international players should not be undermined and especially the Russian border regions have wishes to develop into a European direction (Schlosberg 2005, 195). Also the neighbouring countries that are members of the Union, play an extremely important part, especially in the North-West and in many ways define the political development of the regions. This influence of the surrounding EU states is more indirect in nature as the politics of the Russian regions are being affected via economics and not directly. (Petrov 2005, 147.) It thus seems like the EU and the proximity of the border have influence on the Russian side as well offering thus integrative elements.

However the role of the heads of the regions as shaping and implementing Russian foreign policy is not significant. The government offices strictly control the regions' actions on the international stage. Thus is seems that the reform of the Federation Council has made the regions seem as hostages of the foreign policy of the centre, without the possibility to be the policymakers themselves. (Petrov 2005, 147.)

Although there would be willingness within the Russian regions in taking more actively part in international co-operation, the moment does not seem to be the right for it. Problems of a political, economic and judicial nature need to be resolved in Russia itself before co-operation with EU countries can advance. To activate also the regional and local level, political and economic practises need to be changed on the basis of federal legislation. (Schlosberg 2005, 195.) Here again, the answer lies in the domestic policy of Russia. EU can provide tools, possibilities for co-operation and integration, but the success of the regional level actors is still largely based on the Russian governmental level actions.

What is then needed in order for the EU-Russian integration to proceed? The prevailing situation clear indicates an asymmetry that needs to be in someway balanced before a truly fruitful co-operation is possible. This means that the EU-Russian relations must be based on shared values as well as common interest of what is perceived to be important. The rest will largely depend on the domestic Russian developments and their influence on the Russian foreign policy and behaviour. At the moment Putin's administration strives for two major goals - one of building a more authoritarian state and recentralisation and the other of trying to build a normal market economy. The question is how will the contradictive situation develop in the years to come? Here again the role of the EU is not very decisive. (Sutela 2005, 35.)

What is the role of the European Union as making international co-operation possible for Russian regions? To put it in very simple way, the role of the EU right now is to act as an enabling and supporting bystander. EU cannot solve the domestic problems of the Russian Federation, the solution needs to come from the state within.

5. Special economic zones, a special case in Russian regional policy

In the previous chapters it has been indicated that the regional level development in Russia, as well as in domestic and foreign policy measures, is largely dependent on the development paths of the central level administration. It has been shown, that due to the strong role of the central level in the matters of integration and the regional level, the EU operation tools can only be seen as enabling factors, but not as making the co-operation and integration possible, the necessities for co-operation come from the central level.

In order for a region to succeed in internationally in Russia two things seem to be required. The region would first need to have prerequisites (or necessities) guaranteed by the state to enable international economic co-operation. Also, as the necessities would have been guaranteed by the state, region would most probably benefit from the proximity of EU border and EU co-operation tools.

One answer to this question in Russia could be the *special economic zones* (SEZ). SEZs are state-run projects to establish better facilities for international investments and technology transfers for foreign enterprises coming to Russia. Better facilities for companies include privileges such as tax relief, lower social expenses and partial exemption from customs. In Russia the establishment of special economic zones has started during the Putin's presidency as Putin inspired by the Chinese and Indian examples signed in July 2005 a law enabling the function of special economic zones (Hänninen 2006). In China 6 % of country's national product are produced in similar type of special economic zones (Lukkari 2005).

What makes the Special Economic Zones particular in the Russian context are the opportunities lying under their operational principles. They could be the needed example, a sort of a test ground to see what kind of influences such integrative actions could have on regional basis. In other words, SEZs fulfil the criteria needed for a closer international integrative economic co-operation as they could be the one possibility to move against the tide of recentralisation.

6. Conclusion

It is foremost the Russian Federal government who gives or does not give the possibilities and facilities for the region to operate. That is, the necessities for (international) co-operation are created here. The secondary relation that the region looking for international co-operation has is then most likely the EU-level. However, this relation between the region and the European Union level is in a way a possibility that is offered to few regions of Russian Federation through different EU financing instruments.

Within these two spheres of combinations, the necessities offered by the state level and the possibilities offered by the EU-level, lie the *special economic zones*. They can be thus considered as to be the "extreme regions" of Russian Federation, as they today are the ones having perhaps the best prerequisites for international co-operation and integration within Russian Federation.

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PART 3 – OPERATIONAL IMPLICATIONS OF THE NEW ROLE OF RUSSIAN ENTERPRISES

Cultural spillovers of Russian outward FDI

by Peter Zashev

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1. Introduction

Foreign Direct Investments (FDI) play an important role in the development of many emerging markets. The companies involved in FDI activities have a growing role for the countries and societies they operate in through bringing across borders different values, knowledge and operational business culture. Thus the impact of Multi-National Corporations (MNCs) on host countries is important phenomenon that should be well understood and realized by managers in the MNCs and by policy makers in the host countries that are willing to create a policy framework that maximizes the MNCs presence in their national economy landscape.

This article represents the summary of several publications that address what is perceived to be relatively less explored phenomenon as the business cultural impact of the foreign investor on the host country – in other words an attempt to underline the fact that business culture and its possible impact could be very important criteria when trying to attract FDIs. The publications were based on the example of the Russian investments in the Baltic States. Structured in 3 different parts, the article starts with building some speculative framework of how business cultural spillover could be measured. The second part deals with what exactly represents contemporary Russian business culture and which of its features could be considered as more troublesome from the point of view of a country hosting Russian FDIs. The last part tries to see if in the Baltic States we find evidence to suspect or to expect some negative spill over of Russian business culture.

Instead of conclusions the article speculates what would be the possible impact for one of the Baltic States - Estonia, if the biggest shares of FDIs did not come from Finland and Sweden as they did but from Russia.

2. FDIs business cultural spillover – building framework of analysis

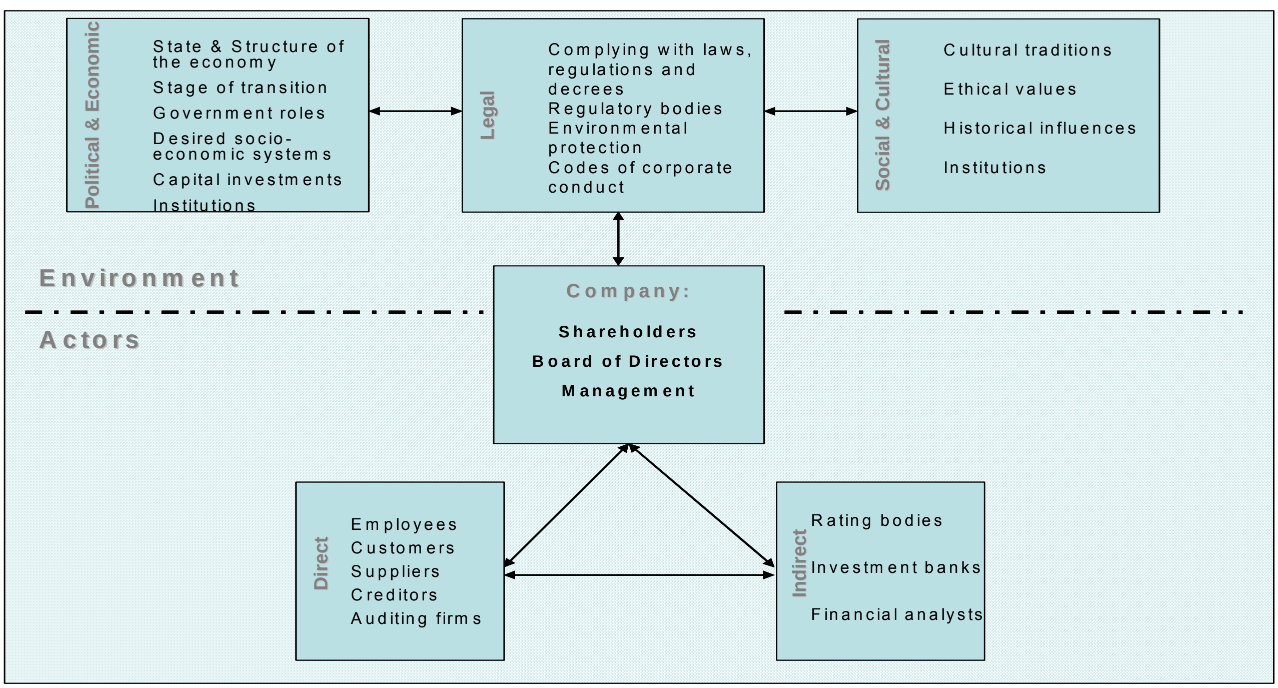
FDIs could have significant impact on number of stakeholders in a national society and economy: on the natural environment of the host country, on its institutions, on its societal norms and values and its macroeconomic foundations.

The business cultural influence of foreign investors is a subject that is still relatively unexplored by the cross-cultural management discipline. Some studies (Hennart & Larimo 1998) focus on the impact of culture on the strategy of Multi National Enterprises (MNE) and the impact of national culture on the entry mode choice and subsidiary performance (Slangen & Hennart 2002). That is they put in the focus how an enterprise, its entry strategy and operation mode are influenced by national culture and/or differences between the home culture of the company and the culture of its host country. Thus in a way at the center is the extent and pattern of international production or production financed by FDI and undertaken by MNE, which is the main subject to be explained by the eclectic paradigm (Dunning 2001). A further exploration of the cultural sensitivity of the eclectic paradigm (Dunning & Bansal 1997) argued that the importance of the OLI variables determining MNE activity will depend, among other factors, on the strategies and other characteristics of firms, including their corporate culture. Their corporate culture is on the other hand very much a product of their home environment including its nation specific features. Observing the same process vice versa will formulate the main question to be as what will be the effect of MNE activity on the host culture in general and business culture in particular. Such impact could be experienced in several ways. MNE operations could raise the standards of demand (Porter 1990) and inject an entrepreneurial spirit and foster competitiveness locally. They can have significant impact on their suppliers and thus generate a spill over effect through raising quality standards. MNE can have significant effect on labor force through, again, raising standards and productivity.

The main problem when analyzing the possible impact of business cultural spillovers of FDIs is how it could be qualified and quantified. There are many factors that should be considered. One is the size of the investor's home country and economy and the size of the country/economy - recipient of the investment. For instance, Lukoil acquisition of the Getty Petroleum marketing (gas stations chain) in the USA is unlikely to have significant cultural impact due to the geographic and economic size of the country recipient of the investment. On the other hand, the Russian investments in Latvia are more likely to have tangible impact in terms of business cultural impact as both Latvian geography and economy are considerably smaller (Zashev 2005).

Another factor to be considered is how far apart are the investor's home country and the investor's host country in terms of national cultures. The latter could be described in terms of language, religion, ethnicity, shared history etc. Or it could be compared in terms of the Hofstede dimensions. Last but not least the size of the investments should be also considered and measured not only in absolute terms but also in terms of their impact and importance for the economy of the host country. In the absence of an established methodological instrument for measuring the business cultural spill over of an international investor the paper will use some bits from a framework of analysis shown in Figure 1. The framework draws on a model suggested originally by McCarthy and Puffer (2003). It is important to note that the system should be viewed as a system of interrelated forces with different impact factors. Thus a change in any element affects others, while simultaneously affecting the company and its corporate culture at the centre of the framework.

Figure 1 Framework of analysis of Russian corporate culture



Source: Zashev 2005

According to a study by Perlmutter MNEs may differ in their inclination to transfer their home practices abroad based on their levels of ethnocentricity, polycentricity or egocentricity (Perlmutter 1969). Thus MNEs are likely to have a more pronounced effect on the culture of the countries in which they do business because of the long term and embedded nature of their activities. To repeat, the main problem is how that effect could be qualified and quantified. Especially that there are no studies that go bold enough to argue that the business culture of the investors could be valued in the most reliable of terms – in money.

Within the proposed framework this article chooses to focus on what is perceived as the three most tangible impacts of investor's business culture. In our perception that will be on its employees in the host countries, on the institutions in the host country and on the host country's legal environment. The first one deals primarily with the **intra corporate culture** – managerial styles and practices and how much attention and effort is spent on continuous learning and training of local personnel. In these directions the "good" investor would aim at raising the work quality and improving the efficiency – both having crucial impact on long-term competitiveness and profitability. In addition the investor may bring along managerial culture that will be more advanced (efficient, ethical, flexible, creative etc.) that what could be considered as average in the host country. In short foreign investors in general and MNC in particular are expected to be involved in a serious transfer of knowledge provided the subsidiary is prepared and fit to absorb these knowledge (Minbaeva et. al. 2003). This study indicated that investments in employees' ability and motivation through the extensive use of HRM practices contribute to MNC knowledge transfer.

Another crucial ingredient is the relations between the investor and the host country institutions. Two points are of crucial importance. First is the **respect for the rule of law** and believing that law is above all and one's operations should be strictly in accordance with the legislative environment. Second is the **respect for the institutions** that are supposed to create the legal environment and make sure that everyone plays according to the existing rules. Shortly, different investors (for different reasons) have different perception of what is legal and what is not, what is bribing and what is not and if corruption is a way to solve a problem speedily or a menace one should fight by all means.

Last but not least, investor's business culture could include politically biased values of serving the national (country of origin) interests. Such a bias could also have significant impact on the local society in general.

Based on these three main perceived impacts the main question in this paper is formulated as follows: *Should the policy makers in the Baltic States seriously consider the business culture of Russian investors among other factors when attracting FDI?*

3. The concerns with Russian business culture

Factors forming the contemporary business culture

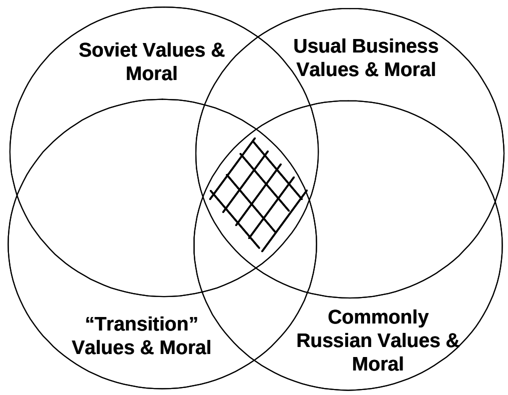
There are many studies dedicated to different aspects of Russian business culture, management. They are often focused more into some specific issue of Russian business culture. Some have more general nature (Apressyan 1997; Grachev & Izyumov 2003; Kuznetsova & Kuznetsov 2003), others focus on management perspectives (Ardichvilli et al. 1998; Liuhto 1999; Robertson et.al. 2003; De Vries et al. 2004), corporate governance (McCarthy & Puffer 2002; 2003; Perotti & Gelfer 2001) or some sadly specific for Russia issues such as corruption (Levin & Satarov 2000). These are just few of the many research papers published on the topic.

One way to describe the layers that form the contemporary Russian business culture is to unite them in four sets of factors as shown in Figure 2. The contemporary Russian corporate culture could be presented as the cross-section of these four different sets of factors and their consequent impact on collective and individual culture and mentality.

The first set is formed by the traditional Russian values and norms that distinct Russians as compared to other national cultures. The second set could be defined as those norms and values that were added / enforced to the Russian mentality during the time of the Soviet Union. The third set represents those new developments and modifications in mentality and culture that the last 12 years of transition process required from every social group and/or individual in Russia. Finally, the fourth set of factors is assembled by the influence of Western business culture whose impact constantly increases due to the increased business interaction.

A brief critical survey of the four sets is provided below focusing on the influence they have had and the features they have brought to contemporary Russian corporate culture.

Figure 2 Four sets of factors forming the contemporary Russian business culture



Source: Zashev 2004

Commonly Russian values and moral

As one of the most striking factors influencing the commonly Russian business values and moral could be underlined the near total lack of competition in the Russian social and economical life – an argument that was pointed out by many authors (see e.g. Prohorov 2002). Thus among the three main features of the Moscow state were:

- *militaristic nature* as the state had to fight external enemies and expand further geographically
- *society based on force rather than law* with clearly determined division of social groups. These groups differ by their duties rather than by their rights.
- *supreme power of the state / tsar* with not clarified and unlimited authority space

All these features were slowly suffocating the very concept of free competition in the allocation of any type of resources – human, financial, natural etc. As a result a highly centralized system was built where the state in the face of the Russian emperor had unlimited and not clarified powers. The latter were transmitted to the rest through an ever growing, slow and inefficient apparatus of state bureaucracy.

It is not by a surprise that in such conditions the competitiveness was directed mainly on attracting the attention of the supreme power through gifts, bribes and network of important acquaintances. That is how events such as the scandals of cronyism surrounding the close circle around Peter the Great or the 'Potemkin village' could be explained.

Such system will also partially explain that all prominent international Russian business projects – be there in railways, investments or simple exports were in most cases directly or indirectly sanctioned and/or financed by the state.

Soviet values and moral

The system did not change much in the soviet times – instead to a fair degree it became worse. The state succeeded into implementing total control on all activities – control which could be characterized as deeper and broader if compared to the centralized administration during tsar's times.

The Soviet state also had undefined and unlimited authority to allocate resources of all types. Furthermore the state imposed an ideological embargo that additionally stalled the system. The Soviet rule also imposed concepts such as the 'uravnilovka'1 that eliminated the link between work and pay, 'planning' versus market that geared further the bureaucracy and made cheating an inbuilt part of the economic system, 'repression' that became a state concept and thus eliminated initiative, decision making and freedom of choice.

Again, surviving and economic (and physical) prospering in the system was dependant on one's links to the state power in its various forms: communist party, state administration, military, KGB etc. Again the competition was leveled down to none as most factories obtained a monopolist status and were given predetermined figures on input and output.

The Soviet system also did not succeed to eliminate the corruption and bribing that plagued the Russian state machine in the times of the tsar. Quite the opposite, in the presence of an almost total deficit for goods and services corruption became the normal way of life. The basic lesson Soviet managers learned was that being obedient to the system through keeping a low profile was the best strategy to follow. Maximizing the requested from the planning committee input and minimizing the expected output was a common strategy.

The foreign operations of Soviet companies were an absolute state monopoly controlled by the party, the state and KGB. Officially only the Foreign Trade Organizations were authorized to link Soviet factories with their overseas markets, suppliers, partners etc. Any investment decision, be it a power plant in Cuba, factory in Sudan or military equipment to Egypt was part of a conscious centrally planned and controlled foreign policy rather than a money wise business rational based decision.

Transition values and moral

Perhaps the most interesting and intriguing period that has a considerable influence on the Russian business culture is the economic and political transition that Russia is experiencing for the last 14 years.

A dramatic (by the Russian standards) change has appeared in the form of a massive (initial) retreat of the state. Dodgy or not, fair or not, the privatization in Russia created in few years a new social group of owners – investors, capitalists, industrialists etc. Still, it must be noticed that it was not their entrepreneurial spirit that was the main factor for their success. It was rather a well build network of contacts with the government at all different levels in combination with a total disrespect for the ‘transitional’ semi-Soviet, semi-market legal system.

The state retreat in the 1990s and its inability to perform vital functions generated huge vacuum in the economic and social situation in Russia. Russian managers at the time were imposed to number of stressful forces as shown in Figure 3.

One of them was the high inflation that was making business itself a difficult task and almost impossible to make any mid- or long-term business decisions and planning. Such a high degree of unpredictability was one of the main reasons for Russian managers to be focused mainly on short term incomes, profits etc. Another reason for that was the absence of normal corporate banking (that still continues) and of bank credits to businesses. That meant that alternative sources of financing are needed. Such are provided typically very risky conditions and from very risky places.

Figure 3 Sources of pressure on Russian company managers in 1990s

Source: Zashev 2004

Another serious obstacle was the growing organized crime that was constantly trying (and to a large degree succeeded) to be deeply involved in business. Drugs, prostitution and racketeering were only the initial operations that soon went into much more sophisticated schemes such as tax dodging, money laundering, banking and privatization. In the presence of next to none existing legal system and dysfunctional courts business disputes and debt collection became a domain of activities for the organized crime.

Not succeeding into building a stable macroeconomic environment, launching a failed bank reform, not effectively combating organized crime were perhaps not the biggest shortcomings of the Russian state in the early 1990s. The worst three pressures that the state offered to businesses and managers were extremely weak and corrupted institutional / bureaucratic machine, practically disabled courts and an unrealistic tax system that made most members of the business community outlaws by definition. Surprisingly during the 1990s the state stopped performing vital duties of control and regulation but still remained the prior arbiter with the known from history not clarified and unlimited rights to interfere into everybody's business and daily life.

The fear of Russian business culture

From the presented above evidence one may jump to the somewhat dark conclusion that Russian companies are some sort of puppets in the hands of the Russian state machine, that they bribe themselves out of any situation, rely mainly on informal networking, have overmanned and inefficient labor and managerial practices and generally in their survival mechanism there is little respect for the rule of law. To some extent this description may fit many Russian companies operating in Russia.

Hence, if serious problems of business ethics plague and continue to plague the way business is conducted within Russia, the internationalization of Russian companies puts forward the question what exactly business cultural influence they spread when they internationalize? Standardization or localization - do Russian companies and executives use a standardized approach of utilizing Russian business culture or they try to adapt to the local environment? Is the statement that Russians see no problem with favoritism, price fixing, ignoring senseless laws and regulations and manipulating data (Puffer 1996) valid and do they bring such type of thinking in their foreign operations?

The discussed above assumptions provide enough reason to assume that as most worrying features of expected business cultural spill over of Russian business culture could be listed:

- transmitting dubious quality of corporate management and organization.
- underestimation of such concepts as efficiency and productivity and their direct link with personnel training and continuous learning.
- the understanding that bribing is a normal way to “speed up” or “smoothen” interaction with authorities at various levels.
- the unbroken link/dependence of Russian companies on the Russian state and resulting from it political versus economic motivation when making corporate decisions.

4. Russian business culture in the Baltic States

Russian business presence in the Baltic States

Being the 4th biggest investor in Latvia, Russia's economic interest in the country is gaining momentum. Russia is involved in the oil transit company of Latvia, gas distribution, gasoline retailing, alcohol production and others. There are three companies, fully or partially owned by Russians, among the 10 largest taxpayers in Latvia. Furthermore the Latvian banking sector enjoys a vibrant development to a large extent due to the great portion of customers that are non-residents being in their majority Russians. That is possibly one of the explanations why a country with a population of 3 million has 22 banks of which officially 3 are Russian-owned. Further interest of Russian big players such as Severstal, RAO UES and the former MDM Group will indicate that Latvia will remain an economic area where Russian companies will be active also in the future.

As of the beginning of 2004, the volume of Russian investments in Lithuania puts Russia in only 7th place. Still, it is the qualitative dimension of Russian investments that impresses. Russian companies control the 4th biggest Lithuanian bank, approximately 25% of the retail fuel market, the Kaunas power plant, and stakes in the biggest gas distribution company. Russian company owns Mazeikiu Nafta. According to some experts as of 2001 some 30% of Lithuania's GDP were associated with the refinery (Roe et al. 2001). The importance of Mazeikiu Nafta in the Lithuanian economy is further underlined by the fact that in the year 2000 the company contributed almost a quarter of the country's gross tax revenues (IBN, 2001). The 5th biggest (in terms of sales volume) industrial producer is also owned by a Russian investor. That is if not taking into account the 839 joint Lithuania-Russian enterprises and 234 enterprises of Russian capital (Miskinis 2002).

The situation is similar in Estonia but more difficult to establish the facts as Russian capital chooses indirect routes. Still tangible assets including banks, oil transit companies, gas stations etc. belong to Russian investors.

Productivity and efficiency issues

Russian companies are likely to insert their highly vertical corporate management structure where power distance is high and responsibilities are centralized in one (or maximum) several persons. That is in a contrast to the Nordic management style that puts an emphasis on coordination instead of control and prefers more flat type horizontal managerial style. What is more alarming is that Russian companies are much less likely to spent money on continuous learning and training for their personnel. Comparing the costs for personnel training in Russian banks in the Baltic States with Swedish banks one may come to the conclusion that personnel training is not among the priorities of the Russian investor.

A comparison of the 2002–2003 productivity levels between the 10 most productive industries in Russia (output volume measured in rubbles per employee) and Finnish companies from the same industrial field (turnover per employee) provides quite striking results as the closest Russian productivity gets to the levels of the Finnish one only in the food-processing industry and even there the difference is 5,66 times while the average value of the difference coefficient is 20,2 (Zashev 2004).

Of course, the Russian figures should be better by 2007 but still the gap is really impressive. Based on these facts one may argue that personnel efficiency is also not among the top priorities of Russian investors. That, however, is of importance not only for the investor itself but also for the national economy as one of its main capitals – human capital is not utilized efficiently or is not properly developed by various continuous education programs.

Respect for the rule of law and relations with institutions

According to Transparency International the cost of corruption is four-fold: political, economic, social and environmental. On the political front, corruption constitutes a major obstacle to democracy and the rule of law. In a democratic system, offices and institutions lose their legitimacy when they are misused for a private advantage. Though this is harmful in established democracies, it is even more so in newly emerging ones. Accountable political leadership can not develop in a corrupt climate. Economically, corruption leads to the depletion of national wealth. It is often responsible for the funneling of scarce public resources to uneconomic causes. It hinders the development of fair market structures and distorts competition, thereby deterring investment. The effect of corruption on the social fabric of society is the most damaging of all. It undermines people's trust in the political system, in its institutions and its leadership. Environmental degradation is yet another consequence of corrupt systems as regulations and environmental norms are ignored (TI 2006).

How can Russian investments and investors make an impact in this respect. In the 2006 Transparency International Corruption Perception index Estonia ranked 27th, Lithuania 44th and Latvia 51st. In the same ranking Russia takes 126th place (Ibid.). Thus Russian companies, managers and entrepreneurs come from an environment where paying bribes is assumed as normal even if not welcomed part of business procedures. It is not by accident then that in 2002 Russian companies were acknowledged to be among the most active bribers when doing business abroad (Transparency International 2002).

Without going in further detail it is worth mentioning that Finland and Sweden that are one of the main foreign investors in the Baltic States are accordingly ranked 2nd and 6th by the Corruption Perception (Transparency International 2006). It is obvious that the business cultural impact of foreign investors could be very important for the long term prospects of the host country to fight corruption and build efficient and non-corrupted institutions. Is it possible to quantify the damage caused by corruption? According to Transparency International the answer is no. One reason is that the related costs are of very complex nature and many numbers often can not be reliably estimated (for instance how much money is invested in corrupted officials).

The unbroken dependence on Russian state

Are the biggest Russian investors in the Baltic States emitters of official Russian state policies? To what extent have their relations with the Russian state made them dependent on it? The current ownership of OAO Gazprom shows that the company belongs 38,37% to the Russian state, 36,28% to Russian legal subjects, 13,85% to private persons, 11,5% to foreign investors (Gazprom 2004). Even though that information is not sufficient to understand who actually controls and runs Gazprom (it does not answer who are the legal subjects themselves – private or state owned) it is widely accepted that Gazprom is a state owned company that has natural monopoly over exploration, production and distribution of natural gas. As such the company's CEO would naturally be the selected and appointed by Kremlin and personally the president. It is not by surprise then that the current Gazprom CEO Alexei Miller is a personal appointment of President Vladimir Putin. Miller is the President's former colleague and, according to experts, his mission at Gazprom is more political, to transmit Kremlin policies, than economic management of Gazprom. It is obvious then that most overseas investment decisions of Gazprom must first have a Kremlin clearance. Such as the decisions to buy in Lithuania the Kaunas power plant and take stake in Lietuvos Dujos. Gazprom also owns a minority package and co-owns Latvia gaze together with the German Ruhrgas and the Latvian government. It is the same system with the Estonian company Eesti gas.

The Russian state owned Transnefteproduct plays a key role in the Russian oil business, since it owns the oil pipe system all producers need to use. Being a serious instrument in the hands of Russian government this company decided to halt oil transport through Latvia and Ventspils for most of the years 2003 and 2004. While the official reason was based on economic grounds it was a common knowledge that the issue had been political.

The financial stability of the Lithuanian oil refinery Mazeikiu Nafta, being the pearl in the crown of Lithuanian industry, was seriously endangered after the former Russian owner Yukos was bankrupted by the Russian state. Yukos is an interesting example as it shows that a completely private company is subjected to such pressure by the Russian government that it turned Yukos from the wealthiest in Russia to the verge of bankruptcy in less than one year. Yukos was internationally recognized as one of the most efficient, market driven and transparent Russian companies. However, Mr. Khodorkovski did something wrong in the eyes of Kremlin and the state demonstrated that it is intent to almost ruin the Russian most successful oil company for the sake of politics.

Lukoil is perhaps the opposite story of Yukos. It is an oil company that is approved by Kremlin where its CEO Vagit Alekperov is in good standing with president Vladimir Putin. Only in July 2004 Russian president Vladimir Putin, ConocoPhilips CEO James Mulva and Lukoil president Vagit Alekperov discussed oil and gas projects during a meeting in the

Krasnodar territory (Interfax 2004). Still only few years ago the Russian tax police have simultaneously opened criminal charges against Lukoil and its director, Vagit Alekperov for concealing revenues in “especially large amounts.” (GPF 2000) The 1995 big scandal surrounding Lukoil and its practice of mixing different gasoline types that brought them additional profit 4,6 billion rubles can easily be brought back (Rstaki 1999). Bureaucrats are who covered it back then and bureaucrats are who can easily bring it on again. Just as the Yukos case. Is it then possible to foresee if Lukoil will always stay as a favorite to the Russian government? And if not is it possible to claim that Lukoil is a competitive, stable, predictable international player?

5. Conclusions

Instead of conclusion the importance of investors cultural spillovers could be summarized on the example of Estonia. The biggest share of FDI in Estonia comes from Finland and Sweden. As of 2004 there were 430 active Finnish companies and 264 Swedish companies registered in Estonia. According to the Amadeus data base compiling data between 2002 and 2004 they employ more than 40 000 people or more than 6% from the country’s workforce (Amadeus, 2006). Together the annual turnover of Swedish and Finnish companies in Estonia amounts for approx, US$5,94 billion (Ibid.) representing a total of 26,7% from the Estonian GDP in 2005 (CIA, 2006).

Finland and Sweden are ranked 2nd and 6th in the 2006 Transparency International Corruption Perception index while Estonia is ranked 27th.. In the 2006 World Competitiveness scoreboard the Finnish economy was ranked 10th (6th in 2005) while Sweden was ranked 14th (14th in 2005) (IMD 2006). In the same time Estonia ranked 20th (26th in 2005). It is logical to assume that investors and investments originating from better ranked countries will transmit their business culture and have positive impact on the host country. One argument is the impressive improvement of Estonian ranking in World Competitiveness scoreboard during the last years. Coming from societies where rule of law is a norm, where the state institutions are rather efficient bureaucracies it is only natural they when abroad Finnish and Swedish companies will rather try to apply the same standards and corporate behavior.

Imagine that the Finnish and Swedish investments with their volume and economic impact on Estonia are changed for Russian. Russia is ranked 126th by the Corruption Perception Index (TI 2006). It is ranked 54 in terms of its competitiveness (IMD 2006). Russian companies are less productive than their Finnish competitors and that difference is not measured in percentage points but in times. Based on the presented above facts it is reasonable if not to expect than to suspect that if we hypothetically change the current volume of Finnish and Swedish investments in Estonia for Russian then:

1) Efficiency and productivity will be at somewhat lower level. Besides bringing lower level of GDP growth this will have also an effect on the long term utilization of resources in general and human resources in particular.

2) Corruption will not be treated by Russian investors as an unacceptable phenomenon but rather as a convenient shortcut in achieving certain goals. That will have extremely negative impact as a) corruption will allow for non-efficient allocation of resources of any kind, b) more corrupted environment will attract less FDI and c) state institutions may become ineffectual, arbitrary and disrespected and thus lose their democratic legacy. The rise and fall of Lithuanian President Rolandas Paksas in 2002–2003 could be an example.

3) Tangible presence of Russian investments in a country's economy will be certainly used as leverage in Russian foreign politics. The recent Russian economic measures against Ukraine, Georgia or Moldova could only confirm that.

That is why in the case of Finnish and Swedish investments in Estonia Estonians should paraphrase the famous Swedish pop band Abba song to "Thank you for the culture!".

The findings of this paper allow us to reach two interesting conclusions. One is that in evaluating investor's attractiveness from host country point of view much more attention should be paid to "soft" values such as business culture – the main reason being that business culture could be measured concretely in financial terms. The latter certainly deserves much more attention and further research is planned aiming to quantify the impact of foreign investor's business culture.

The second conclusion points to the fact that policy makers should take into account that Russian investments certainly have some side effects that are not limited to the direct object of the investment and may have a much bigger spill over effects that can eventually be somewhat negative and thus outweigh the financial attractiveness of the investment itself.

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Foreign direct investment developing local industries in emerging economies? – the influence of Fazer Bakeries' investment in St. Petersburg bakery market

by Elina Pelto

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1. Introduction

Foreign direct investment (FDI) has been expected to play an important role in the economic restructuring of the Eastern European transition economies. During the Soviet times, firms in planned economies were separated from the outside world. They had only very limited possibilities for knowledge exchange with foreign companies. Furthermore, as foreign trade was monopolized by the government, they faced relatively little competition even from imports. As a result, most industries in transition economies were lacking behind the technological development of the western world. Foreign direct investment is assumed to help the companies in transition countries to catch up by bringing in foreign technologies, know-how, and models of modern managerial behavior. (Yudaeva et al. 2003, 384.) On the other hand, the entrance of foreign companies in developing countries has sometimes been accused of negative effects, such as crowding out local firms, creating merely low-wage jobs and taking advantage of their powerful political and economic position in host countries (Fortanier – Kolk 2005, 2).

The external effects or so called spillover effects resulting from FDI have been widely studied, mostly in developing countries and in manufacturing sectors, using large panel data and statistical tests (see e.g. Caves 1974; Globerman 1979; Blomström 1986; Kokko 1992; Buckley et al. 2002). However, despite of the large amount of research on FDI spillovers to host economy, many aspects of the phenomenon are still poorly known. The empirical work done shows contradicting results: many studies indicate clear positive spillovers from the presence of multinational corporations (e.g. Chen 1983), while some find no spillovers (e.g. Haddad & Harrison 1993; Kinoshita 2001), and others even negative ones (e.g. Aitken & Harrison 1999; Djankov & Hoekman 2000).

More recent studies have shown that determinants, such as the absorptive capacity of the local firms, host country and host industry characteristics, home country of the foreign investor, the type of and motives for investment, the strategy of MNC etc. all may have a substantial effect on the extent and nature of spillovers. (see e.g. Enderwick 2005; Javorcik et al. 2004.) However, the role of different determinants having impact on spillover effects is still fairly unknown, and clear evidence on the external influence of FDI in different circumstances is missing. Yet, the knowledge on spillovers has a great impact on FDI policies of different countries, which in turn, influences directly the decision making in multinational enterprises.

Most writings on spillovers have looked into the matter from the point of view of the host country. However, by studying the matter starting from the viewpoint of a multinational enterprise, more information could be gathered about the mechanisms facilitating spillovers, as well as the determinants influencing to their extent. For instance, so far the role of linkages in facilitating spillovers is fairly unexplored (Kippenberg 2005, 252; Smarzynska 2002, 1; Blomström et al. 2000, 116) and the understanding on how spillovers take place in the micro level is limited (Meyer 2004, 264).

This study aims to contribute to the micro level understanding on how FDI influences the local business development in an emerging market. As spillovers can be considered to take place through relationships that can form complex business networks, the industrial network approach (see e.g Easton 1992) is believed to bring new insight into analyzing the mechanisms of spillovers. The study at hand combines the current knowledge on FDI spillover effects and the analytical tools and concepts of the industrial network approach, and examines the effects of a foreign investment on the development of St. Petersburg bakery industry.

The overall purpose of the present study is to analyze how foreign direct investment influences a local business network in a transition economy. This aim can be divided into three more specific sub-objectives:

1) *To create a framework for analyzing the impact of FDI on the local business on a network level*

2) *To describe the changes following a foreign direct investment in the local business network in a transition economy*

3) *To identify the mechanisms through which the changes are transmitted to the local companies*

The analytical framework mentioned in the first sub-objective of the study was built in two phases: a preliminary framework was created based on the existing literature on FDI's external effects and on the theoretical concepts of the industrial network approach, but the framework was further developed and modified based on an empirical case study on Finnish direct investment to Russia. Thus, the case study serves mainly the purpose of theory building through abductive reasoning characterized with a constant dialogue between theoretical concepts and empirical perceptions. The second and third sub-objectives are pursued by analyzing the empirical case.

The main contribution of the study is theoretical: the created framework can be used in other studies focusing on FDI's impact on network level. Based on the network level analysis of FDI's external effects it is possible to set new propositions for further studies on FDI spillover effects even on macro level. The study has also both managerial and policy implications. Multinational companies may have an interest in understanding their impact on local companies for two reasons: they may want to try to control the possible spillover effects to e.g. their local competitors in order to maintain their competitive advantage, and they may have an incentive to demonstrate the possible positive impact they have on the development of local businesses to local policy makers. On the other hand, understanding the FDI's impact on the local companies can help policy makers to design best policy practices to help their regions' economic development.

2. Theoretical foundations

The theoretical foundations of the thesis are based mainly in two lines of literature: FDI spillover studies and industrial network approach. These two research areas are shortly reviewed in this chapter.

FDI spillover studies

According to Blomström (1989, 4–5) economic theory offers two approaches for studying the effects of foreign direct investment on host countries: the one is based on the theory of international trade and dates back to MacDougall (1960) and the other departs from the theory of industrial organization pioneered by Hymer (1976/1960). While trade theorists have mostly been interested in the direct effects of foreign investment, those following the industrial organization approach have put more emphasis on the indirect effects – spillovers – resulting from FDI (Blomström 1989, 6–7). Since the focus here is on the impact of FDI on local companies, in the analytical framework building of this study, prior research following the industrial organization approach is more relevant. However, the approach has weaknesses especially in theoretical analysis as the empirical school has predominated in the studies of costs and benefits from FDI, and no clear theory on FDI's spillover effects exists (Blomström 1989, 7).

The word spillover is probably the most common term used for describing the indirect effects resulting from foreign direct investment. Nevertheless, also such terms as external effects, externalities and involuntary diffusion of technology are sometimes used for the same phenomenon (Blomström 1989, 6; Kokko 1992, 2). Spillovers are generally considered to bring about a significant share of the FDI's long-term influences, since FDI includes also the capitalization of technology, knowledge, skills and other intangible assets that may be transferred or diffused to the host economy. (Blomström 1989, 6; Blomström et al. 2000, 9.) "Spillovers arise from non-market transactions when resources, notably knowledge, are spread without a contractual relationship, so-called externalities" (Meyer 2004, 260).

Thus, spillovers are often understood as unintended effects that a foreign enterprise has on local businesses, as a foreign subsidiary is unable "to capture the full social product resulting from the capital, managerial skills and technological knowledge that it transplants to the host country" (Caves 1971, 24). However, the idea of spillovers being involuntarily created benefits to the local companies is not necessarily true: for example, a MNC may have an incentive to transfer knowledge and technology to its local suppliers or distributors (Smarzynska 2002, 1).

Most commonly spillovers are understood as productivity spillovers. Productivity spillovers are said to happen when an entry or presence of a multinational corporation's (MNC's) subsidiaries lead to productivity or efficiency benefits in the host country's local companies and the MNC is unable to internalize the full value of these benefits (Blomström et al. 2000, 103). As the increased productivity is usually connected to technology improvements, the terms technology spillover and productivity spillover are often used interchangeably (see for example Kokko 1992; 25). Most empirical studies on FDI spillovers have focused on productivity spillovers in developing countries and in manufacturing sectors, using large panel data and statistical tests (see e.g. Caves 1974; Globerman 1979; Blomström 1986; Kokko 1992; Buckley et al. 2002). However, the results of the empirical studies have been mixed: some studies indicate clear positive spillovers (e.g. Chen 1983), some none (e.g. Haddad & Harrison 1993) and some even negative external effects (e.g. Aitken & Harrison 1999).

In addition to the possible productivity gains resulting from the presence of a MNC, spillovers can be seen more broadly to cover all external effects on the business entities of the host country, for instance on entrepreneurial development or on market-access of local companies. FDI can influence the local entrepreneurship in two ways: on one hand, through competition effect which may prevent the entry of domestic firms or even crowd out the existing firms, and on the other hand, through positive externalities that foster the development of local industry, through e.g. business linkages, training etc. (Barrios et al. 2004; de Backen- Sleuwaegen 2003, 70–75). Also the empirical studies on FDI's effects on local entrepreneurship have come to rather ambiguous conclusions: some studies indicate negative spillovers, in other words, crowding out local entrepreneurs (e.g. Brown 2002) while in some studies such negative effects have not been found (UNCTAD 2003, 105). The differences in empirical findings may be due to the fact that different countries attract different types of foreign direct investment. Following Dunning's (1988, 54) division of main investment types, one could assume that countries attracting mostly domestic market-seeking FDI are more likely to experience crowding out because the entry of foreign affiliate results in direct competition with local firms, whereas in the case of export-oriented FDI the crowding out may be less likely. (UNCTAD 2003, 105.)

Export-oriented FDI may also bring positive externalities that enhance the export prospects of domestic firms (Buckley et al. 2002, 639). These market access spillovers may arise through many ways as the linkages with export-oriented MNC provide knowledge about product and process technologies and foreign market conditions, such as foreign preferences on product design, packaging, and quality. The knowledge gained by a local company by acting as a supplier to a MNC may help it to build its own export activities to foreign markets. Spillovers enhancing local firms' export performance may, however, come about without direct linkages. In the simplest way, this happens as local firms may learn how to succeed in foreign markets by copying multinational enterprises. (Blomström et al. 2000, 109; Buckley et al. 2002, 639.) There are considerable amount of studies showing that the presence of foreign MNCs indeed help the exports of local firms (e.g. Aitken et al. 1994, 25; Buckley et al. 2002; Varblane and Ziacik 2000, 187).

In the case of all spillovers types, the exact channels through which spillovers occur are still fairly unknown, although several possible channels have been identified in the literature. According to Caves (1971, 24), there are two sources of leakages that are especially interesting: labour training and productivity gains to local firms induced by the subsidiary's market behaviour. Quite similarly, Blomström (1990, 1) recognizes several ways how spillovers may emerge. For instance, a multinational company may increase the level of competition in host-country markets and, thus, force existing firms to become more efficient. Foreign company may also provide training of labour and management, which may then become available to the economy in general. Transfer of technology from a MNC is a third possible source of spillovers. Foreign subsidiary's advanced technology may hasten the local firms' access to a specific technology that they otherwise would not have knowledge about, or would not consider profitable to try to acquire. (Blomström 1990, 6-7.) Pure imitation and copying a MNC's technology is probably the simplest way in which spillovers may take place (Blomström et al. 2000, 104). The training of local suppliers or distributors provides yet another channel for spillovers as the MNC may train its local partners to become faster, higher in quality, and more reliable (Blomström 1990, 7). In that way, both backward and forward linkages that a MNC has with local companies may transfer spillovers. However, the role of linkages in facilitating FDI spillovers is still fairly unexplored (Smarzynska 2002, 1; Blomström et al. 2000, 116).

Industrial Network Approach

Various network perspectives have become popular in business research. One of the best known of them, especially in the Nordic countries, is the so-called IMP (Industrial Marketing and Purchasing) Group's Industrial Network Approach, by which the industrial markets are described as networks of inter-firm relationships. (Halinen et al. 1999, 779.) This approach has been used in a variety of contexts and by a large number of researchers in different disciplines. Most commonly, the network approach has been used in studies on various aspects of marketing and technological development, such as product development, market entry, competition, decision making etc., but also in other areas, such as management, purchasing, regional development, and foreign direct investments. (Axelsson 1992, 246–247.)

The network model of Håkansson and Johanson (1992, 28–29) views the business networks as structures formed by three elements: actors, activities and resources. Actor bonds, activity links and resource ties bind the companies together and create interdependencies. These interdependences are a source for both stability and change in the network. (Håkansson & Snehota 1989, 190–191.) The network approach pays special attention to the connectedness of business relationships and the borderless nature of the network in which the companies are embedded. (Håkansson & Snehota 1989, 190–191.) Each firm in the network has direct relationships with customers, suppliers, distributors, and sometimes even with competitors, and indirect relations, through those companies, with suppliers' suppliers, with customers' customers, competitors, and others (Johanson & Mattsson 1987, 35).

According to the network approach, industries can be regarded as networks of business relationships comprising a number of business actors (Johanson & Vahlne 1990, 18). The interaction between companies in the network is a fundamental aspect of development as it often results in different kinds of adaptations between the counterparts (Håkansson & Waluszewski 2002, 14). Adaptation is made in many aspects: firms may adapt to each other technically by modifying products or production processes; they may adapt logistically by adjusting stock levels or developing common delivery systems; some may adapt administratively by modifying planning or scheduling systems, or financially by handling payments in certain ways. Firm may also adapt to each other in terms of knowledge by acting together in some technical development issues. (Johanson & Mattsson 1987, 38.)

The network approach provides conceptual tools for studying dynamics in business markets in which both direct and indirect, and close and distant relationships are important for understanding change. A change in a relationship can concern actor bonds, activity links as well as resource ties between the firms. However, as the companies are embedded to a larger network context where relationships are interconnected, a change occurring in a single dyad may have different consequences on other connected relationships. (Halinen et al. 1999, 780–781; Andersson et al. 1994, 1.) Part of the change, the confined change, remains within the dyad, whereas part of the change, called connected change, affects also other relationships and actors in the network through spillover effects. However, change always emerges at the level of dyads, where it is generated, received and transmitted to other business relationships. Thus, the role of a dyad in network change is threefold as it generates change by itself but also acts as a recipient and a transmitter of it. Due to the interdependencies in a network, change may be transmitted even to indirect relationships relatively distant from the focal dyad. (Halinen et al. 1999, 781–791.)

Synthesis: A Network Perceptive on FDI's External Effects

In this thesis, the concepts and ideas of the network approach are used for studying FDI's external effects on local companies. The network approach gives a different perspective to the phenomenon and it can be argued that the common division of FDI spillovers to intra-industry (horizontal) spillovers to competitors and to inter-industry (vertical) spillovers to suppliers and customers is irrelevant from the network perspective: spillovers from the multinational company to a local supplier or distributor may spill over further to the supplier's or distributor's other customers, and thus, to the MNC's local competitors. Hence, it can be suggested that spillovers that originally may seem vertical by nature may, via network connections, create indirect horizontal spillovers to local competitors.

Spillovers can shift as MNC's local suppliers and customers may have relationships with MNC's local competitors. For instance, technology transfer or training of a local supplier that supplies also to the MNC's local competitors, are likely to benefit also the competitor via the increased quality, faster deliveries etc. In the same way, these indirect horizontal spillovers may come about via the forward linkages as MNC and local competitors use same distributors or have same customers. Thus, FDI spillovers to the local industry can be understood as a change occurring and shifting in the local business network often via the linkages that different business actors have with each other, or at least network changes can be considered as prerequisite for spillovers.

3. Methodology of the study

It is quite clear that the choice of methodological approach should depend on the nature of the phenomenon to be studied (e.g. Borch & Arthur 1995, 420). According to Yin (1989, 17) the type of research questions, extent of researchers control over behavioral events and degree of contemporary nature of events are important determinants of an appropriate research strategy. This study aims at uncovering and understanding the dynamics and change mechanisms in a business network setting and, thus, it requires a deep understanding of the phenomenon.

Stake (1995, 37–40) distinguishes understanding from explaining, although he acknowledges that explaining promotes understanding. However, these two aims are epistemologically quite different: identifying cause and effect relationships is essential in explaining, whereas "the understanding of human experience is a matter of chronologies more than of causes and effects" (Stake 1995, 39). The hermeneutic and understanding nature of the study suggests the adoption of a qualitative case-study strategy.

For studying networks, case research has often been seen as the most appropriate research strategy (e.g. Borch & Arthur 1995). For instance, Halinen and Törnroos (2005, 1286) state that case strategy is the most suitable for business network studies as "it allows the study of a contemporary phenomenon, which is difficult to separate from its context but necessary to study within it to understand the dynamics involved in the setting."

Case research that makes possible a many-sided view of a situation in its context is particularly suitable in new situation, where only little is known about the studied phenomenon (Halinen & Törnroos, 2005, 1286). Thus, for this dissertation, case study was selected as the empirical research strategy. Case study and qualitative research methods are convenient for the study at hand also because it is difficult to get reliable quantitative data on the Russian business environment (see e.g. Törnroos 1999, 100).

According to Eisenhardt (1989, 534) the case study is a research strategy that focuses on understanding the dynamics present within a single setting. This study represents an embedded single case study that aims at understanding mechanisms behind dynamics in one particular network. The case in this study is an investment of Fazer Bakeries to its St. Petersburg subsidiary Hlebny Dom, and its influence on the local bakery market. The case was selected as it was believed to serve the purpose of the research well: Firstly, the investment took place in 1997 and thus, the changes it has caused should be well present already. Secondly, there is no other foreign owned bakery in St. Petersburg which makes it easier to assess the influence on this particular investment by Fazer Bakeries. Thirdly, a foreign direct investment on food sector that is home market oriented can be assumed to be more embedded to its local network that e.g. a car manufacturing assembly factory, and thus, it was expected to have created significant changes in the local network. Fourthly, also the practical aspect of getting access had some influence on case company selection.

Yin (1989, 23) defines a case study as “an empirical inquiry that investigates a contemporary phenomenon within its real-life context when the boundaries between phenomenon and context are not clearly evident and in which multiple sources of evidence are used”. As business networks have no clear boundaries and it is impossible to study a whole industrial network (e.g. Halinen – Törnroos 2005, 1287), the empirical study is made from the focal (i.e. investor) company perspective. However, in order to get a broader view and more reliable understanding of the phenomenon other companies were included in the data collection process. The information was mostly collected by in-depth interviews within the foreign investor company, its local subsidiary, local customer companies, and local suppliers. Altogether nine thematic interviews (of which eight were personal ones and one an email interview) were carried out lasting between forty minutes and one and a half hours each. However, also written sources such as companies' annual reports, internet pages, and newspaper articles were used as sources of information.

Case studies can be used to achieve various aims: to provide description, to test theory or to generate theory (Eisenhardt 1989, 535). In this study, the objective is not only to provide a description of the influence of the foreign direct investment but to build a theoretical framework and propositions for future studies. Most often the theory development through qualitative empirical research is classified to follow either inductive or deductive reasoning (e.g. Ghauri et al. 1995, 8–9; Carson et al. 2001, 11–12). However, presenting these two as alternatives way to develop theories is not unanimously accepted and especially "pure" induction has been questioned (Grönfors 1982, 33; Niiniluoto 1983, 31–46). This study applied a third way of reasoning, namely abduction, that combines induction and deduction by theoretical thinking (see Niiniluoto 1983, 154–156). Abduction takes into account the possibility that a researcher's interest may suddenly be drawn to some things that are assumed important. A new lead may appear somewhere in empirical perceptions, theoretical literature or intiutively and guide the research further towards new theories (Grönfors 1982, 36–37). Thus, in this study the preliminary conceptual framework was constantly modified during the empirical data collection and analysis as new insights were obtained and they led to new concepts to be added in the framework.

4. Description of the case company

The case in this study is the foreign direct investment of the focal company Fazer Bakeries in St. Petersburg and the changes it has induced in the local bakery market. The focal company Fazer Bakeries is a division of Fazer Group with 40% of the Group's turnover in 2006. The other two divisions are Fazer Amica in catering business (48% of turnover) and Candyking in confectionery business (12% of turnover). Fazer Group has its origins in a family business founded in 1891 in Finland. At the moment the Group operates in a total of nine countries. (Fazer Group Annual Review 2006.)

Fazer Bakeries is one of the leading bakery companies in the Baltic region manufacturing bread and pastries in Finland, Sweden, Russia, and in all three Baltic countries. In addition, the division exports to over 20 countries. In the end of 2006, Fazer Bakeries had a total of

6829 employees of which about half worked in Russia, in St. Petersburg and Moscow bakeries. The turnover of Fazer Bakeries in 2006 was EUR 427 million, of which 48% originated from Finland and 33 % from Russia. Fazer Bakeries' operations in Russia include a majority ownership of Hlebny Dom bakery in St. Petersburg and Zvezdny bakery in Moscow. (Fazer Group Annual Review 2006.) This study concentrates in St. Petersburg market and the investment in Moscow bakery market in 2005 is left out of the analysis.

Fazer Bakeries joined in Hlebny Dom -company in 1997 when Hlebny Dom started a series of share issues. In 1998, Fazer Bakeries had acquired a majority ownership of the company through share issues, and has since then increased its ownership in the company by acquiring more shares directly from other owners. In 2002 Murinski bakery in St. Petersburg was acquired and in 2003 Vasiliostrovsky. At the moment, Fazer Bakeries owns just about 80 % of Hlebny Dom shares. (Fazer Group Annual Review 2006; interviews.)

Since Fazer's involvement in Helbny Dom, the company has developed significantly: it got a reward of the best company in St. Petersburg food sector in 1999 and in 2004 the company was given a "Russian National Olympic Medal" in Kremlin. Today, the company is the market leader in St. Petersburg with about 30 % market share and it is the leading company within the bakery industry in whole of Russia. In 2006, Hlebny Dom exceeded its targets both in terms of sales and profitability. Hlebny Dom is the only major foreign owned bakery in St. Petersburg region and a biggest western bakery in the whole of Russia. (Fazer Group Annual Review 2006; interviews.)

5. Preliminary findings of the case study

This chapter presents very briefly the preliminary findings of the case study. The chapter is mostly based on the information acquired in theme interviews.

Changes in Hlebny Dom following the Fazer Bakeries' investment

The foreign majority ownership has brought in significant changes for Hlebny Dom (HD). However, the old management, that is a minority owner of the company, has been running the company all the time, and Fazer Bakeries has not sent any expatriates to St.

Petersburg. The management of HD has been extremely committed to developing the company, and the co-operation between the company management and the foreign investor has worked remarkably well. Nevertheless, the organizational structure of HD has experienced major changes that were implemented gradually during many year: a similar system of financial management was developed as Fazer had in Finland, the system of production management was westernized, product development departments were created as those did not exist before, sales and marketing organizations were built and own logistic system was created.

Although the old management has continued to run the company, new people have been recruited since Fazer's investment. They are all Russians but have strong experience in working for western companies. In general labor mobility has been surprisingly small, as the company pays competitive salaries and with a foreign parent company standing behind, is considered a secure and reliable employer. Some managers have changed to work for other companies, and local competitors have tried and sometimes even succeeded to buy HD's managers in order to acquire knowledge on e.g. modern western organizational structure. In addition to organizational structure, the parent company's involvement has brought in major changes in product portfolio, production, and distribution of Hlebny Dom.

When Fazer Bakeries became involved in HD, the whole bakery business in St. Petersburg was undeveloped in terms of product range: bread was still manufactured following the old soviet Gosplan-standards. In practice, this meant that there were only few types of bread on the market and it was not packaged nor branded so that end customers did not know from which bakery the bread they bought came from. Fazer introduced the idea of branded bread that would stand out from other producers' products and have more value added. Hlebny Dom started to sell e.g. sliced bread in packages with its name on them. Product portfolio was extended with some similar products as Fazer had in Finland (e.g. sliced rye bread called "Krajushki" (Puikula) and blueberry pastry) and more new products were developed by HD's own product development department. Whereas the product portfolio prior to Fazer's investment was less than 30, in 2007 it was already 320.

In order to introduce packaged bread and other new type of products to the market, the production machinery of Hlebny Dom had to be modernized. New production lines that included cooling and packaging functions were bought from the west since such lines were not made in Russia. The parent company was greatly involved in the purchasing and implementation processes. Engineers from Finland visited St. Petersburg often in order to train the staff to run the machines better. The production in Hlebny Dom became more efficient, and with the new product lines, the product quality increased and products became of uniform quality – something that was new in St. Petersburg bakery market. In 2002, Hlebny Dom and Fazer bought two more bakeries in St. Petersburg, Murinsky and Vasilieostrovsky, which became part of HD. Thus, the company has now three production units in the city.

One of the major changes Fazer brought to the market was a new type of distribution system. Before, the products were distributed by HlebTrans, a joint company of many local bakeries that distributed everybody's products in wooden boxes that had to be emptied to the store shelf manually. Since the system was inefficient and the reliability of deliveries was poor, Fazer decided already 1998 to build its own distribution system for HD. The distribution system became instantly the company's major competitive advantage. It changed the competitive situation compared to other suppliers completely, as it was fast, reliable and easy to handle for the retail stores. Fazer together with a company called Arca Systems developed a new type of plastic case in which bread is delivered to stores. The cases are left in the stores full and picked up when they get empty. These new type of plastic cases are not only less expensive for stores to handle but they are also more hygienic as they can be washed. The plastic cases that Fazer introduced have since become a Russian standard as other bakeries not only in St. Petersburg but e.g. in Moscow have started to use them. In St. Petersburg all other major bakeries have now their own distribution system and the role of HlebTrans is minor.

All in all, Fazer Bakeries has brought to Hlebny Dom technical knowledge, knowledge of product development and packaging as well as marketing knowledge especially on branding strategies. Due to the changes induced by Fazer's investment to HD, the company is today a market leader in St. Petersburg. It has gained market share by offering its customers a larger product range that in the beginning faced almost no competition, as

HD was the first one to bring sliced, packaged and branded bread to the market. By modernizing its production and by buying two more production units, the company increased its capacity, and by building up its own distribution system that can better serve modern retail stores and chains, HD has managed to increase its market share up to almost 30%. One of the interviewees from Fazer Bakery summarized that “the key to success in St. Petersburg has been the rising of the hygiene level, taking the logistics to our own hands and so called ‘knowledge transfer’ from Finland to Russia concerning products, technology, sales and marketing”

Changes in Hlebny Dom’s business network in St. Petersburg bakery industry

The entrance of an international actor in St. Petersburg bakery business has induced changes not only in the subsidiary company but in the entire bakery market. At the time Fazer Bakeries made its investment in Hlebny Dom (HD), the St. Petersburg bakery market consisted of 16 larger bakeries and a few hundred small ones. Since those times, the number of major bakeries has diminished and there is a strong trend of concentration of bakery business at the moment. At the time of Fazer’s investment, HD’s market share was about 15 %. Since that time the company has bought two local bakeries and has now three production facilities and over 30 % market share. The second biggest competitor Karavai has managed to slightly increase its market share too: in 1997 when Fazer started in St. Petersburg Karavai’s share was 17% whereas now it is about 22–23%. Three other bakeries, Hleb, Zarya and Pekar, have about 6–8% market share each. The rest of the market is fragmented among a myriad of smaller bakeries. Hlebny Dom is the only major foreign owned bakery in St. Petersburg market.

A major change in HD’s business network has been the creation of its own distribution system. Hlebny Dom has won market share also because of the radical changes in St. Petersburg retail business during the past few years: retail sector in St. Petersburg has modernized itself rather rapidly and a number of retail store chains, mostly Russian but also foreign, has appeared in the market. As HD was the first one to offer large volumes packaged bread that was hygienic and easy to handle for retail stores, and could deliver the products more reliably than the competitors, it was natural that modern retail stores preferred Hlebny Dom over some smaller producers. Whereas in the late 90’s when Fazer entered the market, only 10 % of HD's sales went to retail chains, now the figure is well over 60%. Biggest customers are such retail chains as Peterochka, Kopeika, Metro, Lenta, Okay and Diksi but the company distributes to some individual customers too. Part of the HD's production is sold to Moscow but the main geographical market area for the company is the St. Petersburg region. Whereas HD's market share as a whole is about 30%, it is significantly higher among certain major retail chains.

Fazer's investment had an effect on HD's suppliers too. Especially in the machinery supplies the role of Fazer Bakeries has been significant. Although HD had invested in a modern western machinery prior to Fazer's investment, more new production lines had to be acquired from the west in order to be able to produce e.g. packed bread and new types of bread and pastry products. Since that also HD's major competitors have acquired similar production lines. Relationship with machinery suppliers changed immediately when Fazer came to picture: before suppliers considered it risky to supply to Russia and required bank guarantees and 50% prepayments. Now only 10-15% is paid in advance, no bank warranty is required and the rest is paid after the delivery and installations. Fazer's role has been significant although naturally the positive economic development of Russia has had an impact too in building trust with the suppliers.

Raw material suppliers of HD have mostly been Russian all the time. Only some more technical additional ingredients are bought from abroad. In the beginning there were some difficulties in finding good suppliers from Russia, but HD has actively developed their own suppliers by e.g. setting clear quality requirements for the supplies as well as training suppliers. At the moment, also packaging materials are bought in Russia. Whereas until quite recently HD has taken care of the raw material supplies rather independently without Fazer's involvement, now Russia is being integrated into the common sourcing strategy of the whole Fazer Group and suppliers also in Russia are more and more chosen based on large tenders.

Spillover effects to local actors from Fazer Bakeries' investment to St. Petersburg

Horizontal spillovers: In the case of Fazer's investment to St. Petersburg, the greatest spillover effects to local bakeries (horizontal spillovers) are both due to demonstration and imitation factors and increased competition. These two factors are in fact hard to distinguish as competition may lead to imitation. Also management migration to competitors can be a source of spillovers in this case, as some managers have indeed moved to work for competitors some of which have quite actively tried to buy out HD's staff. Competitors have imitated all from sales and marketing to distribution system and product innovations. New products are usually copied in about six month's time that is needed to get suitable machines to start producing similar products. Thus, the whole bread market of St. Petersburg is now characterized with branded, packaged and sliced bread that is delivered in hygienic plastic cases. Although it is difficult to say for sure how much of this development is due to the foreign entrance and how much would have happened anyway, it is at least clear that Fazer's entrance has significantly speeded up the process. The fact that product range in Moscow bread market – which is characterized with a high number of small bakeries and basically no major foreign firms – resembles the situation in St. Petersburg in a few years earlier supports the assumption that a significant part of the development in St. Petersburg is due to the foreign actor entering the market. The increased competition has had twofold consequences: some actors have started to modernize and develop their production and have become more efficient, while smaller firms have lost their market share and some have been crowded out of business.

Vertical spillovers: The strict quality requirements that Fazer set for local raw material and packaging material suppliers has been the major source of vertical spillovers from backward linkages. The systematic quality control of raw materials has led to complaints to some raw material suppliers, which have then fixed the quality problems. Fazer/HD has set higher standards than the old gosplan standards for some of the raw materials which have forced some of their local suppliers even to acquire a whole new production line in order to be able to fulfill their major client's requirements. Similarly the local packaging industry has developed significantly due to Fazer's entrance to the market.

Fazer's entrance to the market has created spillovers through forward linkages: HD's new distribution system is developed for serving the customers better, and is naturally adapted to the needs and requirements of the modern retail stores. Thus, such a system with reliable deliveries with handy plastic cases has caused efficiency benefits to retail stores, as such delivery system requires much less personnel to handle the products than the old type of system using wooden boxes.

Indirect spillovers via network connections: As the network approach suggests, change in one part of the network can shift via network connections and influence even distant network members. Similarly, the case study showed that spillover effects may shift e.g via suppliers to competitors making the division of horizontal and vertical spillovers less clear. Here, such effects are called indirect spillovers. Indirect spillovers refer to spillovers to firms with whom the foreign investor company or its subsidiary has not had any direct connections. The indirect spillovers are thus transferred by other network actors to more distant network members.

Fazer's entrance to St. Petersburg created indirect spillovers to competitors through both backward and forward linkages. As Fazer set strict quality requirements and a systematic quality control, the raw material suppliers have improved the quality of their products, which has most likely benefited also other local bakeries. Also foreign machinery suppliers from whom new machinery was acquired to Hlebny Dom can be considered as transmitters of indirect spillovers, as they have been eager to sell recipes along with the new machines to local competitors.

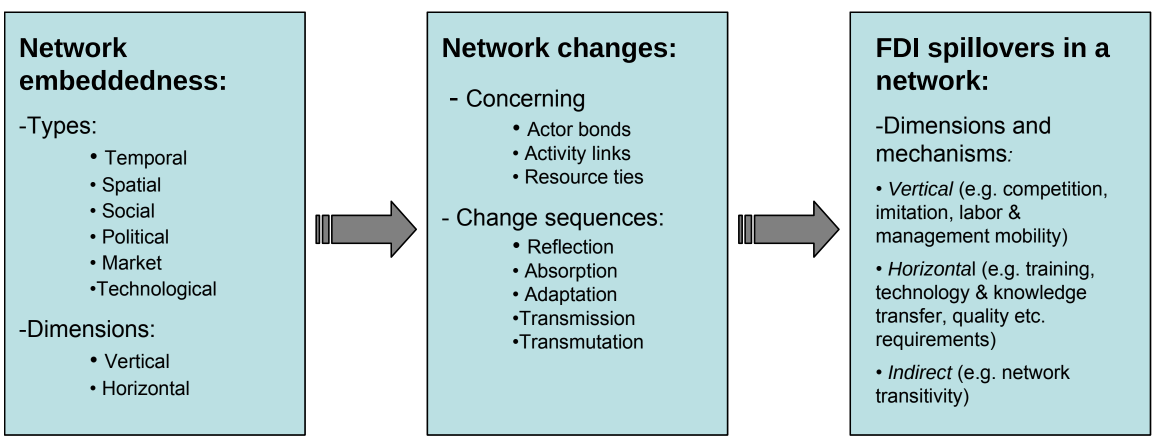
Retail chains have played a significant role in transmitting indirect spillovers through forward linkages. After Fazer/Hlebny Dom introduced their new distribution system, retail stores have started to require other bakeries to use similar distribution system with plastic cases. As retail chains have expanded to other regions, they have even sent the local bakeries to St. Petersburg to study how bread should be distributed. The plastic cases that Fazer introduced have became to a large extent a Russian standard that is used not only in St. Petersburg but also in other cities.

6. Discussion and conclusions

Fazer Bakeries' investment to Hlebny Dom in St. Petersburg has had a significant influence on the development of the local bakery industry. This is likely due to the strong local embeddedness of Hlebny Dom. Foreign investment has caused changes in the local business network which have shifted through network linkages even to other regions creating possibilities for both intra- and inter-industry spillover effects.

This study aimed at developing a theoretical framework for studying FDI's external effects on a network level. The framework is constructed as a synthesis of some central concepts and theoretical assumptions of the industrial network approach, and empirical findings of previous FDI spillover studies as well as the empirical case study conducted as a part of the this research. The conceptual framework of the study is presented in a summarized way in the following figure.

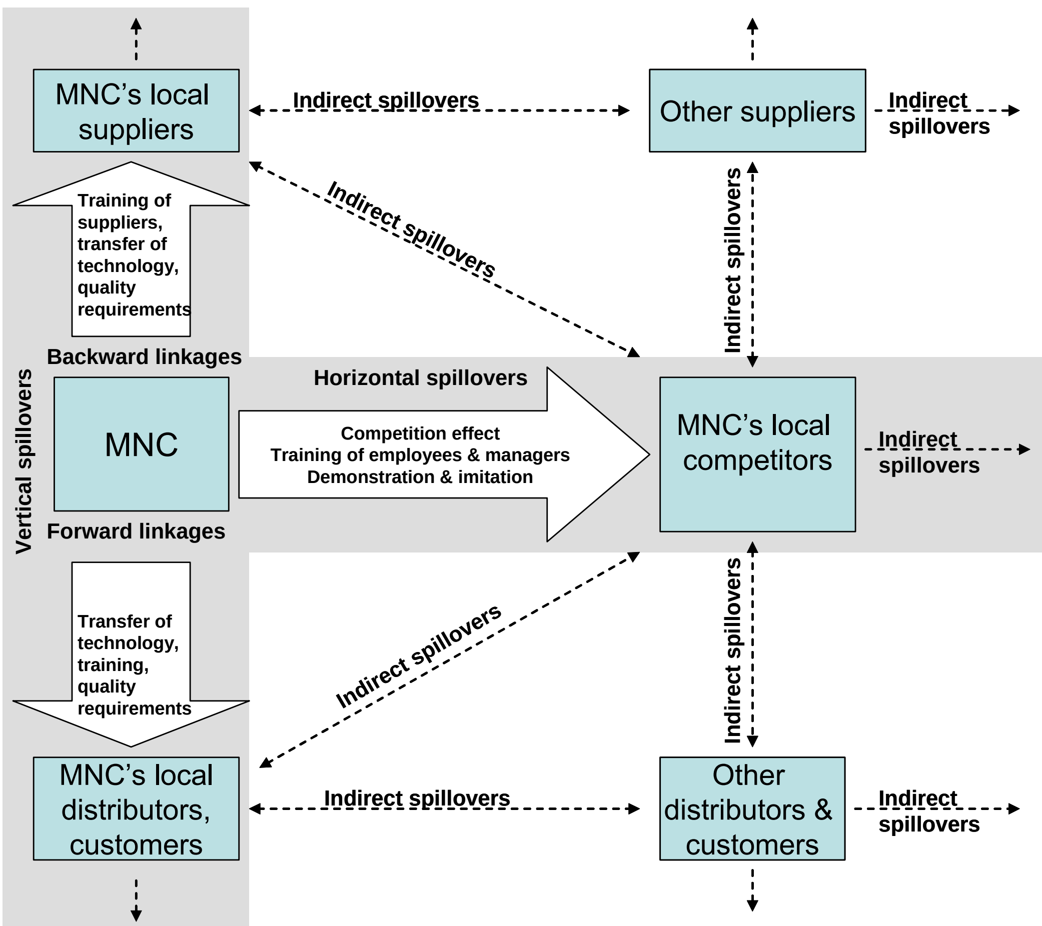
Figure 1 Summary of the conceptual framework of the study



As the Figure 1 illustrates, the framework suggests that the external effects of FDI depend on the embeddedness of the foreign investor to the local business network in the host country. It can be assumed that the stronger a foreign investor's local affiliate is embedded to local networks, the more likely it is to cause some change in them.

Secondly the network changes initiated by the FDI should be described and analyzed. Network change can be considered to be a prerequisite for FDI spillover. Thirdly, the framework concentrates in identifying the possible FDI spillover effects and the mechanisms behind them in the local business network. The following Figure 2 illustrates the possible sources and directions of FDI spillovers in a business network.

Figure 2 FDI spillover effects in a business network



Three possible sources of horizontal spillovers are mentioned in the Figure 2: firstly, the effect of competition may force local competitors to become more efficient but it may also crowd them out of business. Hence, spillover effect to local companies may be positive or negative. Secondly, training of employees and managers may create spillovers though labor mobility. The third and simplest way for horizontal spillovers to occur is probably the demonstration and imitation effect, as competitors may copy the MNC's technology and practices. (e.g. Blomström 1990, 6–7.) However, the effects of competition and imitation are difficult to separate, as imitation together with innovation is a central part of competitor dynamics bringing change to the markets (Selnes & Johnson 2004, 128).

The above figure illustrates how the horizontal spillovers can create indirect spillovers to the competitors' suppliers, distributors, customers, and even to their competitors through interdependencies in the network. For instance, MNC's local competitor may imitate MNC's behaviour and acquire new technology that improves its performance. The change in the competitor's production technology may require changes in its supplier's technology or processes. The change is thus transmitted to other network actors where it may become a source for efficiency benefits.

Similarly, the sources of vertical spillovers from the MNC to its suppliers, distributors or customers, e.g. transfer of technology, training and quality requirements (e.g. Kokko 1992, 42–47) may affect and create spillovers to other actors in different levels of the value chain. For instance, the technology transfer to MNC's local supplier may create spillover benefits to MNC's local competitors if the same company is acting as a supplier for both the MNC and its competitor. The supplier's new technology may also lead its competitors to acquire similar technology in order to remain competitive. Thus, FDI spillovers may continue to shift in three directions: through forward linkages downstream the supply chain, through backward linkages upstream the supply chain as well as horizontally to different network members' competitors.

All in all, the present study suggests that foreign companies may indeed play a significant role in speeding up the industrial development in an emerging market by setting standards, by offering training, or simply by demonstrating etc. However, the effects are not automatic but depend on the embeddedness and position of the foreign investor in the local business network. Through both backward and forward network connections change may shift to far away network members. Thus, as an implication to policy makers the study suggests that developing regions should try to attract FDI that is strongly embedded in the local market, and has both backward and forward linkages to local actors.

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Exploring the contact points of internationalisation and supply chain management in emerging markets – the case of Finnish firms in the Russian market

by Harri Lorentz

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1. Introduction

The internationalisation of national economies has been taking place in increasing degree since the prerequisites and opportunities for growth in domestic markets were substantially decreased due to *structural contradictions* revealed *in the crisis of the world economy* in the 1970s (Castells 1989). The share of manufactured goods in the international trade flows has increased significantly to replace the previous dominating position of the primary commodities. For example during the last half of the 20th century, the international trade volume of manufactures was multiplied by 42.6, while the same factor for agricultural commodities was 5.7 and for fuels and mining 8.3 (WTO 2005). The world total foreign direct investment (FDI) inflows have been steadily rising since the 1980s, and resumed growth after decline in valuation in the beginning of the millennium. Notably, the developing countries share of the global FDI inflows during 2004 was 36% (UNCTAD 2005). The aggregate statistics point to a profound reality in the global economy: *the framework of production is no longer the national territory but the entire globe* (Stalder 2006).

International production requires new forms of organisation, i.e. a change from vertically integrated hierarchies to modular and more flexible forms of organisation (e.g. Coase 1937; Williamson 1986; Stalder 2006). This organisational change and consequent mental orientation for flexibility in production and operations has been made possible and enhanced by the new information technologies (Castells 2000). The above mentioned developments have had a profound effect on logistics in the form of increased movement of products between specialised and networked firms both in national and in international level, initiating demand for knowledge and methods that address the arising issues.

Logistics and supply chain management (SCM) are areas of management science that have been receiving increasing attention in research, and to some degree in practice. SCM was introduced in the early 1980s by consultants and has since received increasing attention in the academia (Grant et al. 2006). The definition of SCM has enlarged from a logistics subsection to a wider concept of integrating and managing key business processes across the supply chain.

With the breakdown of the Soviet command economy, the integration of the CIS countries to world economy is also taking place. Many emerging markets (EM) are taking similar paths and opening and deregulating their economic systems. As was elaborated on above, this effectively means international product flows and production that involves locations with diverse institutional and infrastructural settings such as for example Russia.

Given the previously presented trends, the task of addressing the following main research question with sub-questions is undertaken: *What are the SCM related challenges and implications for internationalising firms in the emerging market setting?*

- *What is the level of supply chain collaborative integration and effects on performance in an uncertain cross-border context?*
- *How supply chain related factors are reflected in the firm's location decisions concerning the emerging markets?*
- *How can companies manage competitive demand-supply network positions in emerging markets?*

Due to the central role of the emerging market concept in the thesis, a definition is provided. The International Financial Corporation (IFC) coined the term (more specifically Emerging Financial Markets) in 1981, to describe certain countries that were included in standardised stock indices (Sakarya et al. 2007). The novel term replaced the use of the term “developing country”, as the new category of countries aimed towards liberalisation of markets. Since then the use of EM as a term to describe assets based in markets with long-term growth opportunity, has broken out of the financial market context, and become a term to reflect business opportunities in less competitive markets with increasing disposable incomes, large populations of young consumers and economic liberalisation, and essentially with such characteristics as high-growth, high-potential, and high-risk (Ibid.). Many use the term “emerging market economy” or “emerging economy” to describe countries with previously presented characteristics (Kula & Tatoglu 2003; Rahman & Bhattacharyya 2003). This research employs the term “emerging market”, and concurs with above presented definitional characteristics of the concept. A position is also taken to underline the relevance of cost-benefit analysis in terms of business operations in emerging markets: relatively high costs are usually present due to possibly underdeveloped infrastructure and market economy institutions (North 1990), while the potential capture of opportunities for serving the lucrative market define the potential benefits. Essentially the emerging markets entail certain types of constraints (often operational) for opportunity capture, in many cases different from the ones companies experience in mature markets.

As the research is set in the Finnish-Russian context, it effectively addresses some of the challenges for international business (IB) research in the Central and Eastern Europe (CEE) context identified by Meyer and Gelbuda (2006), by addressing (1) the interaction of environmental change with firms' internationalisation process (IP), and (2) the operational issues such as sourcing, to which this paper's focus on SCM is related to. Furthermore, the study relates to the analysis of *the adaptation of resources from mature market economies to transition economies and the absorptive capacity facilitating such transfer and adaptation* (Meyer & Peng 2005, 613). The process approach is seen particularly relevant for CEE research due to the change and learning processes taking place in these societies and internationalizing firms (Meyer & Gelbuda 2006).

The findings and conclusions presented in this article are based on a collection of journal articles and conference papers that will comprise the author's doctoral dissertation.

2. Theoretical foundations

The theoretical foundations of the thesis are based on the domain of supply chain management (SCM) in an international/global setting (Narasimhan & Mahapatra 2004), as well as the one of international business (IB) (Rugman & Brewer 2001). In the following the theory of supply chain management and internationalization are reviewed, as they form the theoretical foundations of the research. Further the international dimension of SCM and international manufacturing (IM) are reviewed in order to draw conclusions on the contact points of the foundational literature streams.

Supply chain management

There is a great need to understand the management of international supply chains as a whole and in specific national settings (Braithwaite & Christopher 1991; Kerr & Colborn 2006). Logistics and the SCM are emerging as the critical success factors for companies operating in the international arena, as increasing complexity rises from wider range of products, shorter product life cycles, market growth, and the number of supply/market channels. When it comes to the emerging market economies (EME), the insight provided by Braithwaite and Christopher (1991) to the management of global supply chains is quite relevant: *The ability to engineer the performance of the supply chain is a crucial requirement in the context of the increasing rate of change in markets combined with operating conditions which are broadly adverse to reducing, or even containing, cost*. The rate of change (turbulence) and the present operating conditions in EMEs certainly increases the challenges in supply chain engineering, and requires local attendance for detail in operations and service level maintenance.

Supply chain management (e.g. Houlihan 1985; Harland 1996; Lambert & Cooper 2000) is undergoing a process of identity development as is evident from the increasing demand for theoretically based conceptual development in contrast to the past focus on empirically based descriptive research (Croom et al. 2000). Burghes et al. (2006) claim the characteristics of SCM research to entail multidisciplinary approach, lack of consensus in terms of definitions, and a focus predominantly on empirical survey and case methods with positivist paradigmatic stance. Additionally, a lack of rigorous methodological discussion was detected in the discipline related case study research (Hilmola et al. 2005). While consensus on SCM definition seems to be lacking (Burghess et al. 2006), we take the view of the Council of Supply Chain Management Professionals (CSCMP), in which the role of interfirm relationships and their coordination (activity links and resource ties) is at the forefront.

"*Supply Chain Management encompasses the planning and management of all activities involved in sourcing and procurement, conversion, and all Logistics Management activities. Importantly, it also includes coordination and collaboration with channel partners, which can be suppliers, intermediaries, third-party service providers, and customers. In essence,* *Supply Chain Management integrates supply and demand management within and across companies.*”

On the other hand, phenomena around the discipline demonstrate increasing coherence, quality and impact, explicit discipline theory, and maturing application of existing theory; thus signs for an emerging discipline are becoming visible (Harland et al., 2006; Cousins et al., 2006). In attempting to introduce coherence to the emerging field of research, Giannakis and Croom (2004) introduced the “3S” –framework, which directs scholars to three areas in current SCM research, namely the *synthesis* of business network, inter-actor *synergy* in the networks, and the *synchronization* of operational processes. The current research topic may be positioned into the synthesis area, as it is concerned with supply chain oriented positioning in the network.

Internationalisation in IB research

The internationalisation process (IP) of a firm is also about gradual strengthening of a network position, specifically in a foreign market. The IP-model of Johanson and Vahlne (1977), has been particularly influential with the structured argumentation as follows: firms internationalize (i.e. establish network positions) in gradual terms by acquiring, integrating, and using knowledge of the foreign market, increasing commitment in an incremental manner (a process), due to the lack of knowledge so far acquired of the foreign market and the consequent uncertainty. The model has gone through several improvements over the years, with focus on the aspects of building and changing business network relationships that enable entry into new markets (Johanson & Vahlne 2003), and the opportunity development as the outcome of relationship commitment via learning and knowledge creation in a foreign market business network (Johanson & Vahlne 2006). Also the role of expectations as the driver of internationalisation process has been underlined by Hadjikhani and Johanson (2002).

In addition to the internationalization process models (see e.g. Buckley & Ghauri 1999) a stream of literature on internationalization of the firm has drawn on the network approach (Johanson & Mattsson 1988), into which the IP-model was converged to in the earlier cited revision by Johanson and Vahlne (2003). Along this line of thought Ghauri & Holstius

(1996) presented a model of the foreign market entry process, where the outcome of three entry phases and the matching activity on global, macro and micro levels, lead to a business network position in a foreign market. Other network oriented investigations into internationalisation include for example Ghauri et al. (2003), Johnsen and Johnsen (1999), as well as Coviello and Munro (1995).

International dimension of SCM

Diverse issues of global supply chain management (GSCM) have been on the research agenda in the past couple of years. According to Hult (2004), the aim in the focused attention towards GSCM was to strengthen the integration of the two areas of international business and supply chain management and provide direction for future research.

The contributions presented tackle issues such as global supply chain decision models (Narasimhan & Mahapatra 2004), outsourcing (Kotabe & Murray 2004), sourcing through online reverse auctions (Emiliani 2004), and market segmentation from the logistics service providers' point of view (Mentzer et al. 2004), the relationship of logistics competencies and performance (Closs & Mollenkopf 2004), institutional analysis of supply chain innovations (Bello et al. 2004); indeed a diverse collection of topics. Furthermore, Handfield and Nichols (2004) list the key issues in building a global supply base and conclude on the significance of the human element in the development of high-performance global supply chains. Flint (2004) addresses the challenges in reaping the benefits of global supply chain wide marketing efforts.

While the future research opportunities proposed by the previously mentioned authors are many of the same that are dominant SCM research issues in general, still they direct us in the identification of relevant issues in GSCM and the implementation of SCM in diverse national markets. One clear common denominator seems to be the call for research that enables the firms to deal with increased complexity and uncertainty that the global and international environment entails. Supply chains that cross borders, function in diverse operating and cultural settings, or are subjected to constraints in the institutional environment in developing and transitional markets, require a great deal of management skill, flexibility and resilience in order to generate supply chain wide cost reductions, marketing synergies, and smooth performance (Harvey & Richey 2001; Kotabe & Murray 2004; Narasimhan & Mahapatra 2004). For example, resilience and risk management seem to be emerging research topics in the current SCM literature, most relevant indeed to the overlapping area of international business and supply chain management (e.g. Christopher & Lee 2004; Giunipero & Eltantawy 2004; Christopher & Peck 2004; Jüttner 2005). Market turbulence, external shocks, narrow supply base, are factors that are amplified in importance as additional complexity in the form of diverse environments affect the supply chain.

Meixell and Gargeya (2005) provide a literature review of the decision support models for the location related design of global supply chains, and conclude that few models address required practical issues adequately, while location specific variables such as tariffs/duties, non-tariff trade barriers, currency exchange rates and corporate income tax rates are often incorporated. Canel and Das (2002) present a twenty-year perspective on global location modeling, and present a model with integrated manufacturing and marketing decision variables. By a way of an example, Bhatnagar and Sohal (2005) establish the relationship of diverse location, uncertainty and manufacturing practice related factors to the supply chain competitiveness. Such factors as labor, infrastructure, business environment, political stability, proximity to markets, proximity to suppliers, key competitors' location, supply chain uncertainty as well as manufacturing practices, affected the operational measures of supply chain competitiveness. Further, Bhutta et al. (2003) propose an integrated model for location, production, distribution and investment of the multinational corporation (MNC) and consider scenarios based on varying facility configurations and foreign exchange rates and tariff levels. Fraering and Prasad (1999) identify policy measures through which authorities may increase country's attractiveness in terms of manufacturing and logistics operations. Countries with high tariffs, volatile currency, poor infrastructure, and poor setting for SCM should be approached with caution in terms of location decisions.

International manufacturing

An interesting stream of literature from our point of view can be found under the heading of international manufacturing (IM), which emerged largely during late 1980s, and at the time that international issues were found largely missing from the manufacturing strategy literature (Adam & Swamidass 1989). While not directly in connection to the supply chain management literature, although integration is beginning to become evident (Er & MacCarthy 2001), the stream is mainly concerned with managing the international factory network (Ferdows 1989), with coordination and configuration issues at the forefront (Porter 1986; Meijboom & Vos 1997). These are obviously topics of crucial interest also in the IB literature (Cray 1984), examining for example the transnational capabilities (Bartlett & Ghoshal 1988), or the conceptualisation of the MNE as an inter-organisational network of headquarters and subsidiaries with external network ties to suppliers, distributors etc. (Ghoshal & Bartlett 1990). According to Meijboom & Vos (1997), configuration in international manufacturing networks is essentially the activity of locating facilities and allocating resources in the inter-facility value chain. Coordination on the other hand is defined as the activity of linking or integrating production and distribution facilities for the achievement of firm’s strategic objectives.

Ferdows (1989; 1997) underlines the importance of having a clear strategic role for each manufacturing facility in the multinational company’s network, even though the operational complexity may force managers to focus on the tactical level. The role of the factory should depend on the level of technical sophistication of activities undertaken at the site, and on the primary strategic reason for the site. Generally, production facilities may potentially grow into the role of a “lead” –position, in which a situation the subsidiary taps into local knowledge and expertise, creates new innovations in terms of products and process, and has direct and deep cooperative relationships with its suppliers and customers. Effectively, the lead factories stimulate innovation in the company and provide access to technologies from its external network of relationships. The path taken to the leading flagship position may vary according to the primary strategic raison d'être of the production subsidiary. Different strategic roles are elaborated on in the following.

According to Ferdows (1989) Outpost –factories are only a theoretical possibility, as the establishment of production facilities for the main reason of collecting information and acquiring local technologies has not been validated by empirical evidence. Instead other methods may be used, such as R&D facility establishments of entering into strategic alliances with existing manufacturers at the site.

In low-cost input factor environment, factories may take the Off-shore –role and essentially serve as feeders to a home plant with a more sophisticated technical activity portfolio. Managing these types of facilities is attempted with minimal allocation of managerial resources, as no real-engineering work in terms of products and processes goes on. Managerial decision authority is limited to following up on the day-to-day order fulfilment and keeping the shipments to other factories in the network as simple as possible. Source –factories however have a more substantial role in taking advantage of the low-cost production input factors. They essentially play a key role in producing specific components, and thus employ more managers and technical specialists in addition to having more managerial decision making autonomy in all internal supply chain decisions, such as procurement, production and distribution (Ferdows 1989).

Factories rigged for serving the markets in close proximity may take the role of Server –factories, with the main focus on serving specific national or regional markets. As in the Off-shore case, managerial talents and investments are maintained at a low level, with the main purpose of running production and distribution operations smoothly. Contributor –factories take the market serving role to a higher level, by serving for example as testing ground for new process technology and as first launchers of new products. They are expected to make higher than pure financial level contribution to the multinational in the form of for example market, product and process know-how (Ferdows 1989).

The evolution of factories in terms of their role and contribution is also addressed by Ferdows (1989). Factories are seen to usually start from Off-shore or Server roles and may remain so depending on the level of centralisation in the multinational company. It is important to note that in the case of no advancement in terms of technical activities mainly in connection with innovation and knowledge sharing, the contribution of these factories to the whole company is expected to be low and thus suboptimal. Taken further, stagnation and falling behind may be imminent outcomes, having negative implications to performance. In order to facilitate the knowledge sharing and higher than financial contribution, communication technologies and management information systems are seen as key-elements, however, only if implemented in proper scale and focus.

Other notable contributions in the international manufacturing stream are for example the work of Oliff et al. (1989), with the expansion of the Farmer-Richman model (1964), where external constraints for management in national environments, such as educational, sociological, political-legal, and economic, affect the management of international manufacturing operations along the critical elements of manufacturing configuration decisions (including strategic forecasts, logistics, process technology and equipment choice, production technology, process and product assignment, vertical span of manufacturing process) and manufacturing coordination decisions. The latter can be broken down to policies for manufacturing support activities and policies for technology support activities. The key implication of Oliff et al. (1989) is a framework for the analysis of adaptations to management processes required in the development and management of international factory networks.

Dubois et al. (1993) present a framework for identification of major internal and external factors affecting firm’s international manufacturing configuration (IMC) decisions, which range in the level of market orientation from home country focus to regional and even global focus. The findings in this study indicated that firm’s competitive priorities or emphasis put on manufacturing performance priorities (efficiency/cost, dependability, quality, flexibility), as well as such key variables as market orientation, experience, and product characteristics largely determine the firm’s IMC strategy. Importantly, this study integrates the relevant body of IB-literature (Vernon 1966; Doz et al. 1981; Dunning 1977) and the manufacturing strategy literature (Hill 1985; Miller & Vollman 1985; Skinner 1985; Voss 1992).

Meijboom and Vos (1997) examine the coordination and configuration balancing activity in international manufacturing decisions, offering interesting managerial implications. For example plants located in low-cost locations should also be treated as important sources for learning and gaining market knowledge that in turn facilitate for example the customization of product to local preferences. Additionally, a more broad consideration (e.g. on the network level) of location factors should be considered, and the case of suppliers ability to provide adequate deliveries in terms quality, quantity and timeliness is mentioned as an example. Poor suppliers can easily off-set the cost advantages found in an archetype low-cost country as manufacturing location.

The time dimension in locations decisions is also worth of analysis according to Meijboom and Vos (1997). With the passing of time, the values of key location factors are likely to change and thus understanding the relationships of these variables to the manufacturing facility's performance is crucial. Relevant monitoring measures should be taken that targets at least the most crucial variables. The paper well integrates both IB and IM literature, indicating an increasing dialogue between the two streams of literature.

As a last contribution in the context of IM, we examine the work of Colotla et al. (2003), who set out to explore the interplay and interdependencies of factory and network capabilities. Their rationale for the research is the trends contributing to the complexity that affects the management of increasingly dispersed manufacturing networks, due to the higher level of competition and volatility in operating environments. Capability-operational performance relationship is established, and the importance of examining managerial factory and network level capability decisions in unison is highlighted.

Contact points between IB and SCM

One of the aims of the research is to identify possible contact points or lack of them between these two management theory streams, and as a result provide a rationale for this research, that effectively aims to describe and explain the effects of supply chain management on internationalisation and the management of supply chain in international / emerging market context.

After reviewing the theoretical bodies of international supply chain management and international manufacturing, a conclusion can be presented that the latter is well integrated to the IB streams of research that deal with multinational corporations and their configuration and coordination issues. Clear contact points with internationalisation theory are however missing. The independence of streams is much more pronounced in the case of supply chain management, where global and international issues are discussed with hardly any references to relevant work in the IB stream. To strengthen the conclusion, a more structured and comprehensive literature review should be undertaken in the future, targeting systematically major journals, with volumes published during the past 20 years or so. The author is of the opinion that the integration of the streams would serve the interest of both paradigms well, as the number of international operations increases.

This research may be considered as an initiator for such integration. The relevant approach in future research, based on the international business-specific argumentation of Meyer and Gelbuda (2006), could be the interaction of environmental change process in foreign markets, with internationalising firms' supply chain processes, addressing, for example, such issues as sourcing, distribution, and network design. Furthermore, the issue of adapting a firm's SCM-specific resources from mature markets to transitional emerging markets (Meyer & Peng 2005) would be another beneficial research approach.

3. Findings and conclusions

This section compiles the main insights and conclusions of the research, and attempts to draw some compound conclusions with discussion, consequently giving some preliminary results of the forthcoming thesis.

In terms of the first sub-question (*What is the level of supply chain collaborative integration and effects on performance in an uncertain cross-border context?*), the main conclusions are as follows. Generally it seems that supply chain integration in certain cross-border contexts may be quite low, and even below the aggregate cross-European results (Bagchi et al. 2005), where comprehensive integration is more a rhetoric than actual practice. The achieved results from supply chain integration in a cross-border setting are modest, leading towards a conclusion on the existence of certain cross-border variables that moderate the levels of supply chain integration and the achieved changes in performance. According to the presented results, it seems that long history and experience in cross-border supply chain operations do not guarantee success in supply chain integration efforts. However, those companies with large export volumes, implying frequency and leveraged resources in operations, seemed to be better able to integrate for successful outcomes (Lorentz 2007).

The generally positive effects of supply chain integration to performance were confirmed. However, the explanatory power of the presented models was quite modest. It must be underlined that in many areas “no change” results from integration were common and even negative effects were reported. One such example is the case of product development, where integration may affect some performance variables (such as inventory turns and stock outs) negatively, most probably due to increased product introductions and variety. The cross-border context seems to very challenging for actualising supply chain management (Ibid.).

Despite generally bleak picture of cross-border SCM, interesting insight was generated on in which areas the integration may be the most effective. Supply chain design is one of the areas where companies should clearly collaborate, accentuating the important role of streamlining the logistical flows in an uncertain cross-border context. Specific areas for joint-planning should thus include facility location, mode of transport, carrier selection, and general flow management related decisions. Looking back to the description that was provided of the Finnish-Russian border, the relevance of such planning activities seems highly logical. Additionally collaborative integration in such areas as production, distribution and inventory management, produced positive performance change effects on quality and inventory turn rate (Ibid.).

Further in terms of the second sub-question (*How supply chain related factors are reflected in the firm’s location decisions concerning the emerging markets?*), the conclusions were as follows. The significant weight of the supply chain related factors in the location decision, underscores the total supply-demand network wide functionality oriented thinking in food industry: are we able to secure the supply of raw materials, and can we attain significant enough a market share in order to compete in our business and as a supply chain. Additionally, consumption and distribution potential factors weigh significantly in the decision, as their combined weight reaches 13.3%. Also SCM readiness and know-how – factor’s weight of 9.3% portrays the emphasis that food industry experts place on supply chain collaboration and IT diffusion in the supply-demand networks. The factors with less significance convey the firms’ perceived abilities to make an impact with the investment or create external effects in the local economy and business networks. Labour can be educated and trained to support the activities of the company, infrastructure can be developed in cooperation with regional authorities, ecological risks can be managed with adequate quality inspection regime in place, and legal/financial risks can be managed with local experts and social networks (Lorentz 2008).

The main postulation of Lorentz (2008) is that supply chain considerations are a major factor in the food industry location decisions, due to the need to utilize local sourcing, distribution and service systems in the economy. Consequently the development of industries, services and know-how in the target market is crucial to the entry and business development decisions of foreign firms. This finding is in line with the IP-model (Johanson & Vahlne 1977), as it can be proposed that as conditions for the ability to implement functional supply chains develop favourably (an environmental process), and related uncertainty can be reduced, knowledge of these conditions permeates the company, and market commitments in the form of facility establishment take place (company's internationalisation process). The downstream, upstream and related service sectors in the supply chain can thereby serve as constraints to the business expansion process. This research thus addresses the need to understand company's internationalisation process's relation to other development processes in the economy and business networks (Johanson & Vahlne 1990), specifically from the supply chain management perspective.

In terms of the third sub-question (*How can companies manage competitive demand-supply network positions in emerging markets?*), two articles address this issue, with the first (Lorentz et al. 2007) serving as introduction to the operational constraint thinking, while the second (Lorentz & Ghauri 2007) elaborates constraints further and focuses on the processes of overcoming the constraints.

According to Lorentz et al. (2007), two case studies show that distribution structures in CEEC are still complicated, and contain overlapping phases; this is caused by simultaneous existence of traditional (indirect) and modern (direct) retail structures. In order to achieve large enough sales volumes, both channels must currently be utilized in carefully balanced manner, while the modern key accounts and supply chain partnerships offer prospects for improved distribution operations. It is also interesting to note that as complexity and uncertainty is higher in emerging CEEC markets, location of factories and warehouses become a significant issue affecting supply chain operations. The toy manufacturer established its base in the Czech Republic with clear logistical advantages for manufacturing and distribution, and confectionary manufacturer correspondingly established operational base in St. Petersburg, with highly developed modern retail industry and good logistics connections to Moscow and other CIS markets. In conclusion the article argues that the distribution system evolution does reflect upon the company decision making in terms of supply chain management, as well as facility location planning (Lorentz et al. 2007).

The research findings support the general theory of supply chain management as well: in the confectionary manufacturer’s case, simpler and shorter supply chain resulted in lower amount of variation in demand with more easily manageable forecasting and operations (e.g. Ackere et al. 1993; Lee et al. 1997). However, changes of demand variation were less obvious in toy manufacturer’s case; demand was very spiky, and seasonal. Still, the management argued that somewhat lower variation in demand in the case of key accounts facilitated better forecast accuracy, and consequently improved supply chain performance considerably. Thus, we could rightly argue that delivery lot sizing and shortage gaming (Lee et al. 1997) are the primary causes of spiky demand development, and greater uncertainty in the toy manufacturer’s case. In conclusion, the modern and more direct channels of distribution seem to offer operational benefits to manufacturing companies (and therefore the efficiency of the retail chains), such as lower demand variation, better forecasts and general performance, especially in the case of functional products where actual demand patterns can be made more visible through collaboration in the sphere of information sharing. It is therefore proposed that the opportunities for supply chain partnership development should be reviewed and potentially developed with the appropriate support measures and investments. Cost-benefit analysis would lay the foundation for correct levels and components in partnership development.

Lorentz and Ghauri (2007) present a seven-dimensional model describing the demand-supply (D-S) network opportunity development process, postulating that the D-S network positioning process has its starting point in the perception of opportunities in foreign markets for the development and optimization of supply chains that aim at improved customer service. The positioning process is subject to several constraints that cause supply chain uncertainty. In terms of constraints, it appears that in addition to the business environment (e.g. insufficient logistics infrastructure capacity), the D-S network structure and incumbent capability do indeed present constraints for competitive supply chain operations establishment. These constraints may turn out to be a major causes for low visibility, planning inability, investment delays, relatively high logistics costs, and increased inventories; all symptoms of supply chain or D-S network uncertainty as elaborated on in the previous literature (e.g. Geary et al. 2002; van der Vorst & Beulens 2003).

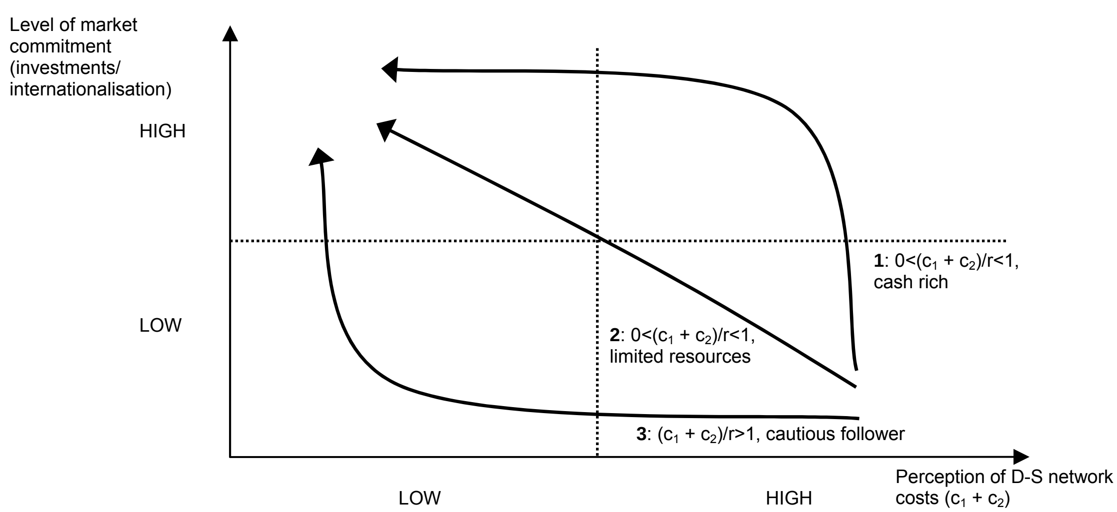
Although the level of success due to D-S network positioning may vary, it is to be expected that in general relationship development and collaborative integration initiatives produce positive results in terms of performance change, in line with the previous supply chain integration-performance results presented in the literature (Rosenzweig et al. 2003; Cousins & Menguc 2005). However, exceptions may exist, which could be inferred as temporary performance area specific set-backs that balance out as the overall performance is examined in the long-term. Especially, the structural changes that take place in D-S network require reactions that may cause difficulties in some tactical areas. It is to be expected that the results emphasize the importance of market learning, also in the group top management level, in order to purposefully develop the opportunities that may be elusive for perception and blocked from view by popular views on market risk or share holder pressure for rationalisation.

Overall, the presented model should encapsulate the properties of the D-S network opportunity development processes in emerging market environments reasonably well. Quite interesting is to consider the feedback loop from constraints to D-S network uncertainty and onwards to opportunity perception. In extreme case, it may be that high constraints and the inability to penetrate them, could affect opportunity perception so negatively as to maybe prevent internationalisation process or business expansion (Ibid).

In general it seems that achieving supply chain integration in an emerging market context may be especially challenging, be it in the saturated-emerging market cross-border context, or in a local emerging market supply chain context. In many cases the operational challenge may simply boil down to establishing a functional supply chain, with proper suppliers and reasonable level of control in the downstream side. In industries where operations are based on localized supply chains or smooth cross-border penetration of logistical flows, the supply chain related factors become relevant in facility location decision making and network design in general. Based on the findings of this research, it is perhaps reasonable to conclude that the emerging market context impacts supply chain planning and management in three main levels, namely (1) infrastructure, (2) networks and (3) institutions, which can all lack in comparison to the respective elements found in the company's home market. Therefore the analysis should concern these development gaps, and how to deal with the consequent constraints for establishing and managing competitive supply chains.

Having summed up and discussed the findings of this research, and aiming now to potentially point out further research opportunities in combining the SCM and IB theories, a hypothetical representation of the relationships between the perceived costs of developing the D-S network (c1), the perceived current costs of D-S network uncertainty (c2) and the perceived benefits (r) of capturing an opportunity through D-S network development process (resulting in enhanced competitive position, via supply chain performance improvement and first mover advantages) is presented. Costs are largely determined by the constraints, as presented in Articles 4 and 5. The perceived cost-benefit ratio would determine the paths and actions taken by the company in developing its D-S network position. The concept is illustrated in Figure 1.

Figure 1 Expansion paths of companies with heavy supply chain dependency



We may assume that companies (in the same industry) start with somewhat similar perception of supply chain costs (c1 + c2) and opportunities (future potential revenues, r) in an emerging market, but begin to diverge in these dimensions as they accumulate knowledge of the market. Additionally, the availability of cash for D-S network development (rich – limited resources) may be significantly different in companies. If the cost-benefit ratio ((c1 + c2)/r), is less than one (c1, c2, r>0), company may initiate investments, internationalisation and effectively supply network development processes. The case 1 path (Figure 3) implies rapid introduction of full scale operations, of which a good example is the Coca-Cola Company having established vast and costly distribution networks for its products in Russia in a very early stage of the market development, resulting in huge investment outlays. The case 2 indicates a situation with cost-benefit ratio also below 1, but with limited resources in the company. The companies in Article 5 case-study provide a case in point, as they internationalised in a relatively early stage, but with a reduced form operations and supply chain: for example by delaying the introduction of full-scale local production and serving the market via export operations and later limiting local presence to a sales subsidiary, enabling the firm to gather market knowledge, consequently enabling controlled timing of commitments (e.g. Johanson & Vahlne 1977). Lastly the case 3 indicates the "cautious follower" situation where perceived costs exceed the benefits, and investments are delayed until the costs come down, due to for example structural changes in the retail sector, lower supply chain risks, and agricultural development enhancing supply conditions. These development paths will have to be validated by further research.

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PART 4 – CONCLUDING REMARKS ON THE NEW ROLE OF RUSSIAN ENTERPRISES

Future role of Russian enterprises as actors in the international business arena

by Valtteri Kaartemo

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1. Strategic role of Russian enterprises

As Anna Korppoo states in her article: “corporate ownership introduces strategic thinking”. However, strategic thinking has on the other hand introduced state ownership in Russia, which has hindered the needed structural reforms and availability of capital in many sectors of the economy. This has had wide-spread effects on the economy as a whole and on regional, sectoral and operational level. This publication has made an important contribution on understanding the new role of Russian enterprises, its strategic sectors, recentralisation of power and outward expansion. All these macroeconomic trends have transformed the microeconomic environment in Russia. In general, the increasing role of state ownership is considered as a step back, as it has led to less efficiency and slower growth. As Liuhto states: “A sufficient amount of control leads optimally to stability, predictability and economic growth. However, an over-controlled economy leads to immobility and accumulating societal tension.”

Typology by Zashev et al. on internationalising Russian companies has identified a few roles which characterise their level of conformity to the state’s foreign policy and transparency of their operations. However, Russian enterprises may have simultaneously several different and partially contradicting roles. As Karppi states: “in its transnational affairs an enterprise may be simultaneously a global player, an oil company, a Russian entity, a defender of national interests, an instrument in domestic politics or a hub for a cluster of domestic and international partners”.

In Korppoo’s article it is shown how a sector’s development may be hindered by not having the “strategic” status. As pulp and paper industry has never had such a status in Russia (or in Soviet Union) there have been very limited amount of new capital stock available, and as a result the sector has severed from limited modernisation. Currently, Russia tries to improve its pulp and paper sector by raising customs for its timber exports, and thus to attract foreign investments for more value-adding production. However, as stated by Jussi Pesonen, the CEO of Finnish paper giant UPM, “Investments in Russia require functionality in raw material and energy supplies. It includes also functionality of the infrastructure and the society.”[72] This is very much in line with the view of Lorentz on

[72] For reference, see Maaseudun tulevaisuus on November 19, 2007.

supply chain management in Russia, and the decision-making in terms of internationalisation and production facility investments, which can be understood through a cost-benefit -oriented managerial reasoning. Uncertainty and development gaps in terms of infrastructure, networks and market economy institutions cause relatively high supply chain establishment and operation costs, while the benefits in the ratio are determined by the perceived opportunities that may be captured in the market with the supply chain.

Pelto's article gives another example of a non-strategic sector, namely local bakery market, and shows what the impact of corporate ownership and foreign capital may have on micro-economic transformation and modernisation. By spoiling its investment environment, Russia fails in attracting the needed foreign capital, which seems to be a catalyst for modernisation and productivity. More competitive industries could then attract more foreign investments leading to further positive spillovers. Further competition again brings out the survival of the fittest, as the one's who cannot modernise their production will be crowded out of business. There were examples of the realisation of such threat in the pulp and paper sector as several Russian companies listed 'staying in the market' as a driver of modernisation. The introduction of competition - which is part of the very much needed structural reform - was considered as positive instead of artificial respiration for companies unable or unwilling to carry out modernisation. Lack of capital and market signals are main driver and barrier to modernisation, which still requires a structural reform to take place. In the article by Pelto, it is shown how foreign investment has also led to the development of supply chain management, and thus the benefits can be seen throughout the value chain.

In the article by Kärnä, it is noted how the transition process of the Russian mining industry has led to oligarchic ownership, which are more open to riskier investments not only in Russia but internationally. The transition has also led to a situation that individual mines have lost their autonomy, and the mining conglomerates have taken the role of earlier Soviet branch ministries. Similarly, vertical integration has returned to Russian mining industry, as many companies want to produce the processed product, not the raw material.

As during the Soviet era, the state remains as an important actor in the mining industry. The increasing role of the state has also been predicted to bring along development, which drives out domestic and foreign investors. It is also estimated that if the Putin regime will stay in power after the forthcoming elections, foreign companies will have only limited possibilities to become major players in Russian mining industry.

2. Russia on the verge of knowledge-based society

Strategic industries may have positive impact on regional development, for instance when both enterprises and towns will be developed according to agreed principles. There are cases where local mines are made to pay off the social programmes which the region could not afford to. The regional administrations are also causing barriers to productivity growth as local governors are keen to avoid increasing unemployment rates.

In Korppoo's study it has been noted that the implementation of energy saving policies have largely failed due to institutional and financial problems. However, as a result of recentralisation, regions power in decision-making has to some extent diminished. The EU-level support has to be guaranteed at the federal level, in order to be efficient.

The Russian Ministry for Economic Development of Trade and Development[73] has published scenarios for 2020, explicitly embracing the innovation scenario, as a source of long term economic growth for the federation. In the light of the recent development it seems like Russia is far away of becoming a knowledge-based economy. According to Karppi, "the prerequisites for development of a knowledge-based economy will be particularly reflected as a mechanism to redesign and rejuvenate the Russian economy".

Is Russia able to create its innovation path is another question. Economic geographers have suggested that for a region (or a country) the following are needed to escape from a lock-in situation: indigenous emergence of a new technological paradigm; diversity among agents, technologies, institutions, social networks; importation of new industries and technologies from elsewhere, transition and upgrading. Bearing these in minds it may look a rather difficult task for Russia to escape from the current lock-in situation, where the economy is heavily reliant on high oil price. High prices on global markets for Russian energy and raw materials has led it to introduce "strategically sensitive industries", "patriots" and "closed world logic", which all hinder Russia's possibility to take advantage of transnational possibilities. In addition, it is widely accepted that top-down approaches do

[73] For reference, see Russian Ministry of Economic Development and Trade (2007): Konzepzija dolgosrotsnogo sozialno-ekonomitseskogo pasvitija rossijskoj federazii.

not often lead to success in a long-run, and the state ownership makes predictability and planning difficult, also for privately-run operators. Instead, long term success comes from changes in factors of production via investments, which suggests increasing role for companies and investments particularly in human capital. In this matter, strategic thinking is emphasised as long as it is company-led process resulting in cost-effective investment decisions.

The questions on path-dependence and semi-periphery are also relevant in Russia's case – particularly the question, whether Russia and Russian enterprises will be in the global core in the future. Russia has earlier showed its potential with technology centres and it still has potential. However, currently the economy is going at an opposite direction relative to Europe, which emphasises openness and decentralisation. In case, the conventional energy sources are becoming less important with the upcoming alternative energy sources, Russia is in the urgent need to become less dependent on its energy exports and develop other assets.

It is interesting to note that whereas the Russian internationalisers are coming from the strategic sectors, they can be regarded as investing in the strategic sector of the recipient country. This causes a lot of political tension. The motives for Russia are not only to use soft power on its neighbouring countries but also to secure both supply systems and distribution of strategic raw materials.

In relation to what is stated above, the recent development in Russia suggests diminishing role of the country in the global core in the long-run. In the mid-term, the energy demand and supply may however increase Russia's role in the global economy, its bargaining power against countries without sufficient domestic energy supplies, and thus also improve its possibility to perform better in the future. This however needs changes in the policy-making in the future. Whereas, it is considered that decentralisation, deregulation, liberalisation, support for growth of business, open financial markets and competition, greater flexibility of labour market, emphasis on individual needs, open networking and public-private partnerships lead towards economy's path towards core. In reality, the development in Russia has proved quite the opposite. For instance, Yukos internationally recognised as being one of the most efficient, market-driven and transparent Russian companies fell to the verge of bankruptcy in less than one year under pressure from the Russian government, as stated by Zashev.

Similar political tension is also valid in Russia, where the democracy in background tries to keep down social costs of higher energy costs, for instance. As for the time being, the only way to modernise pulp and paper sector is seen through government financing, it is also interesting to think what kind of effect this would have on the sector in general, as it could on the other hand distract foreign investors in the fear of increasing role of the state.

However if Russia thinks about its future until the year 2020 – the question could be placed whether it is in the global core by being modern knowledge-intensive economy. Could better results for the economy and society come from service-intensive economy? In this case we would need more knowledge how Russia could become one. On the other hand, only time tells whether the energy and raw material-led internationalisation, recentralisation of power and renationalisation of strategic industries bring out the best result for the economy and the society as a whole. In 2007, judgments are too early to be done.

APPENDIX

A list of publications published during the Academy of Finland-funded project “New role of Russian enterprises as actors in the international business arena”

Hilletofth, P. – Lorentz, H. – Savolainen, V.-V. – Hilmola, O.-P. – Ivanova, O. (2007) Using Eurasian Landbridges in Logistics Operations – Building Knowledge through Case Studies, World Review of Intermodal Transportation Research, Vol. 1, No. 2, 183-201.

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