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Development Trends and Prospects of Russian Automotive Industry (Overview of Passenger Car Production in Russia)

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Executive Summary

Currently, Russia's automotive sector is one of the most dynamically growing segments in terms of institutional transformation processes. Not so long ago, Russia's automotive industry was focused solely on manufacture of Russian brand cars. In the recent years, however, it became apparent that Russian cars cannot compete on a large scale with their counterparts of foreign make. Most Russian car manufacturers were forced to revisit radically their production plans and fine-tune the strategy and tactics of production. Numerous withdrawals of some top national car producers from production of Russian models and their U-turn to foreign brand cars, on the one hand, and rolling off car assembly lines by foreign automobile giants in Russia, on the other, are the crux of the transformation processes going on in the Russian automotive industry.

Government Resolution No.166 "On Introducing Changes to the RF Customs Tariff with Respect to Auto-components Imported for Industrial Assemblage" signed on March 2005 opened for foreign car manufactures new opportunities of passenger car production in Russia. The terms of industrial assembly of automobiles in Russia – close to duty-free import of auto components given the annual output is at least 25 thousand cars and the volume of auto components produced in Russia is brought to 30% of the total used auto components within 6-7 years – are actually a gateway for foreign car manufacturers to Russia.

As far as the quality goes, the Russian automotive industry is upgrading its production. Now it is increasingly associated with foreign brand cars assembled at Russian automobile plants and not with traditional Russian models. The quality of foreign brand cars manufactured in Russia is comparable to or even higher than that of their analogues produced in other emerging markets. Acknowledging obvious modernization of the Russian automotive industry, the extent of the innovation progress there is still relatively low. The reason is its orientation towards car assembly business. Therefore, outwardly growing Russian automotive industry minimizes incentives for modernization of related productions. As a result, the current reform of the Russian auto industry does not fully fit the mission set for the manufacturing sector – to ensure stable and high growth rates in the industry in the context of the fast changing economic environment.

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Introduction

The Russian automotive industry is a kind of a barometer indicating the condition of the Russian manufacturing sector and maturity of a modern consumer society. The auto industry is not only 30% of the country's mechanical engineering in money terms. It plays an important role in the economy because it is a visible part of the sophisticated auto components production system¹, accumulating the results put out by metals, chemical and other productions within the mechanical engineering sector. In this respect, accelerated development of the national automotive industry, to a significant degree, lays the groundwork for sustainable economic growth in the coming years and strengthens the Russian industry's resistance to sharp deterioration of the world economic environment.

The last five years were a period of painful restructuring for the Russian auto industry: historically focused on manufacturing of exclusively Russian-brand cars it had to admit its inability to compete on a large scale with foreign car manufactures on the Russian automobile market and was forced to revise cardinaly its production plans. The nearest outlook for the Russian automobile industry is not only continuation of the reform entailing switchover of the existing production capacities to manufacturing of foreign brand cars but also a take-off of its new development phase when new plants are built and new production capacities are launched under the aegis of world renowned car-making giants. At the same time, it will be premature to discard the potential of those Russian car manufacturers who do not contemplate to swap production of Russian models for assembly of foreign brand cars.

This paper offers an analysis of production trends in the Russian automotive industry (based on passenger car output) in the context of the Russian auto market. In our opinion, our research will allow to identify the development vector of the Russian automotive industry and

¹ According to Russian car producers, one workplace at assembly line of a car plant commands at least 10 workplaces in the respective related productions.

market and will provide the basis for their trend forecast. For the purposes of this paper, the Russian automotive industry shall be understood as a segment manufacturing passenger cars (automobiles) and the auto market is the volume of domestic sales of new automobiles manufactured in Russia and abroad and of imported second-hand foreign brand cars. The market volume is determined based on primary sales of the above cars and their further re-sale is ignored.

Structurally, this paper consists of the following sections. Sections 1 and 2 deal with analysis of the Russian automotive industry output trends and the auto market volume in 2001 – 2005, and estimates have been provided for 2006. In Section 3 we have attempted to perform price segmentation of the Russian auto market and identify the trends in sales of automobiles belonging to different price categories. Sections 4 and 5 accumulate the obtained results and compare them with the trends of the Russian automotive industry and market in 2006. Section 6 contains the analysis of trends in the Russian car assembly segment. Finally, Section 7 describes a possible development scenario of the Russian automotive industry and market for the near term.

1. Russian Automotive Industry in 2001 – 2006: Background and Reform

In the period from 2001 to 2005 the output of the Russian auto industry was growing at a slack pace and was dominated by imports of foreign brand cars, both second-hand and new, and the tendency to assemble foreign brand cars using local capacities. The main outstanding problem of the traditional Russian automotive industry focused on manufacturing of Russian models was that prices for them grew much faster than their quality.

Already in 2002 state support measures and, primarily, customs regulations were expected to halt proliferation of imported second-hand foreign brand cars to the Russian market, as they were serious rivals to the Russian automotive industry in its struggle to preserve its positions on the market. These measures were also expected to foster conditions for enhancing the quality of cars produced domestically. Customs protection was one of such measures. Since October 2002, customs duties on imports of second-hand cars aged 7+ were raised substantially: they more than doubled for individuals and zoomed three or four times for legal entities.

The next step was equalization (in July 2003) of import duties on foreign brand automobiles aged from 3 to 7 years for individuals and legal entities. In the end, import duties paid by individuals on foreign brand cars increased by \$1-2 thousand per automobile.² However,

² Additional (caused by raised customs duties) customs tariffs paid by individuals on import of foreign brand cars were at minimum \$0.2 thousand (the engine volume from 1 to 1.5 cc) and \$2.9 thousand (the engine volume from

a response of the local automotive industry to these protective measures demonstrated dead-end prospects of the Russian automotive industry clinging to the old post-soviet configurations: domestic car producers, hoisting prices for their products, were in no hurry to make a dramatic leap in quality.

Even in 2002-2003, when restrictive customs duties were brought in, the number of local brand cars manufactured and sold in the Russian market was falling: in 2004 the output of Russian models shriveled by 40 thousand cars versus 2001 and sales in Russia dropped by 66 thousand.

Table 1. Automobile Manufacturing and Sales in Russia in 2001 – 2006, in thousands of units

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006* |
|---|------|------|------|------|------|-------|
| Automobile manufacturing in Russia | 1022 | 981 | 1011 | 1110 | 1068 | 1154 |
| Russian brand cars | 1017 | 971 | 954 | 977 | 907 | 902 |
| AvtoVAZ | 768 | 703 | 700 | 718 | 721 | 755 |
| GAZ | 81 | 66 | 57 | 66 | 52 | 53 |
| Other car manufacturers | 168 | 202 | 197 | 193 | 134 | 94 |
| Foreign brand cars assembled in Russia | 5 | 10 | 57 | 133 | 161 | 252 |
| Exports of automobiles assembled in Russia | 99 | 116 | 114 | 126 | 125 | 123 |
| Sales of automobiles assembled in Russia on the domestic market | 923 | 865 | 897 | 984 | 943 | 1032 |
| Russian brand cars | 918 | 855 | 840 | 852 | 788 | 786 |
| Foreign brand cars assembled in Russia | 5 | 10 | 57 | 132 | 155 | 245 |

* Estimate based on data for 1HY of 2006; AvtoVAZ – including output plan for 2006.

Source: Russian Statistics Service, Federal Customs Service, corporate reports, ACM – Holding, Development Center.

Besides, starting from 2004 growing household incomes, appearance of reasonably-priced (about \$10-12 thousand) foreign brand cars and expanding auto credits allowing middle-income families to buy a more expensive car punctured the interest of Russian consumers in local brands. From 2004, auto credits become an important (if not decisive) factor impacting the structure of demand, as they provide opportunities to choose cars in a more expensive price range and enable to ignore the local brands, especially when the price gap between Russian models and foreign brand cars is contracting due to the ruble appreciation and growing stability of prices for foreign brands.

In all evidence, in 2005 the Russian Government was struck with a revelation that the no longer viable Russian automotive industry cannot be revitalized by any reasonable measures of state support, while foreign manufacturers were greatly interested in setting up car production in Russia. In late March 2005, Prime Minister Mikhail Fradkov signed a resolution sizably cutting

2.3 to 2.5 thousands cc). Customs clearance of most popular nameplates (the engine volume from 1.5 to 2.3 thousand cc) grew \$1.0-2.1 thousand more expensive.

customs duties on imported automobile components of foreign origin.³

In spring 2005, the Russian automotive industry was confronted with a radically new task – to use the mounting domestic demand for creation of new production facilities and manufacture the cars that will be a competitive match for their imported peers. Foreign brand cars being a joint effort of Russian and foreign producers were accepted as “home-friendly”. Actually, since spring 2005 their competition with local brand cars is removed from the agenda. Moreover, locally manufactured foreign brand cars become the key engine of modernization and production output upsurge in the Russian automotive industry.

Large-scale refusal of some local top car manufacturers to produce Russian model cars and their turnaround to foreign brand automobiles was a crucial trend in 2005. In the years to come, it is likely to navigate the reform in the industry.

The year 2005 was a turning point for a number of Russian car producers who seriously reconsidered their production strategy. Systemic restructuring of the Russian automotive industry that started in 2005 led to a slump of Russian car models output and, subsequently, to shrunk production volumes of the industry. Output of Russian automobiles in 2005 slid by 42 thousand (-3.8% versus 2004). The scale of the downswing in the output of Russian brand cars in 2005 estimated at 70 thousand units signifies rather a curtailment of local brand production by some Russian car producers rather than an output cutback.

In early 2005, Russia’s second largest automobile plant Izh-Avto gave up the production of its own IZH cars and in early 2006 stopped the production of classical VAZ-2106, preserving in production only VAZ-2104. The liberated lines were retooled for industrial assembly of Korean KIA Spectra. In 2005 production switchover halved the car output at the plant: if in 2004 the plant output was 83 thousand cars, in 2005 the output of Russian models was below 40 thousand cars, and the output of foreign brand cars averaged 3 thousand.

³ Government Resolution No.166 “On Introducing Changes to the RF Customs Tariff with Respect to Auto-components Imported for Industrial Assemblage” signed on 29 March 2005. Import duties on a number of commodities were pared to 3-5% of the customs value from the existing 12-15%. An import duty on some car components, for example, engines was removed. The import duty on car components produced also in Russia (for example, auto tires) was left at the same level. Cut downs in import duties were introduced only for car components used in industrial assembly. Car components imported for trading on the secondary market were outside the scope of the Resolution. Criteria of industrial assembly regulating the application of the above Regulation provide for annual output of at least 25 thousand cars and production cycle, including autobody welding and painting and small component assembly method (MKD).

Table 2. Automobile Production at Russia's Largest Plants, in thousands of units

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2005 growth versus 2004 |
|---------------------------------|------|------|------|------|------|-------------------------|
| Automobile production in Russia | 1022 | 981 | 1011 | 1110 | 1068 | -42 |
| Assembly of Russian brands | 1017 | 971 | 954 | 977 | 907 | -70 |
| AvtoVAZ | 768 | 703 | 700 | 718 | 721 | 4 |
| GAZ | 81 | 66 | 57 | 66 | 52 | -14 |
| Izh-Avto | 36 | 61 | 78 | 83 | 37 | -46 |
| RosLada | 40 | 40 | 27 | 18 | 22 | 4 |
| UAZ | 36 | 38 | 33 | 31 | 29 | -2 |
| Compact Car Plant ZMA | 38 | 39 | 40 | 41 | 30 | -11 |
| Other producers | 19 | 25 | 19 | 21 | 15 | -5 |
| Assembly of foreign brand cars | 5 | 10 | 57 | 133 | 161 | 28 |
| IZH-Avto | | | | 1 | 3 | 2 |
| Avtoframos (Renault) | | | 1 | 1 | 10 | 9 |
| TaGAZ | | 2 | 6 | 30 | 44 | 14 |
| Avtotor | 5 | 6 | 8 | 15 | 17 | 2 |
| Ford Vsevolzhsk (Ford) | | 2 | 16 | 30 | 36 | 6 |
| GM AvtoVAZ | | | 25 | 58 | 52 | -6 |

Source: Russian Statistics Service, corporate reports.

Gorky Automobile Plant (GAZ), which assembled only 52 thousand Volga cars in 2005 (a 16% drop y-o-y), also plans to wrap up production of this brand and is weighing the possibilities of launching the assembly of foreign brand cars. Thus, last year it was negotiating with Japanese Nissan and Toyota the production of cars and components using the plant's facilities. The plant's management believes that prospects of further automobile business development will crystallize in 2006.

In autumn 2005, the compact car plant ZMA producing OKA cars thought better of its ambitious plans to hit the annual output of 100 thousand cars. Slashing the production volume by one fourth (from 41 thousand in 2004 to 30 thousand cars in 2005) and planning the output of 10 thousand OKA cars for 2006, the plant started preparation for commercial production of SsangYong Rexton off-roadsters.

Therefore, in 2005 a number of Russia's top auto manufacturers junked the strategy of Russian car production modernization and build-up. High on the agenda for Russian car producers and market is now the search of viable auto manufacturing technologies in partnership with the world leading car manufacturers.

The first wave of growth in the output of locally produced foreign brands was observed in 2004 when TagAz (assembling Hyundai models) and Ford Vsevolzhsk Plant posted the annual output of 30 cars and GM AvtoVAZ reached the level of 58 thousand cars annually. Hence, the

share of foreign brands in the output of the Russian automotive industry widened from 0.5 – 5.7% (2001 – 2003) to 12%. Further production enhancement at these plants and the start of assembly lines at Moscow-Renault Car Plant Avtoframos and Izh-Avto in 2005 laid the groundwork for further growth in assembly of foreign brand cars in Russia to 161 thousand units (15% of the Russian auto industry output). Judging by the data for the first half year, we may expect a steep rise in output of locally produced foreign brand cars, up to 250 thousand.

In 2005 growing assembly of foreign cars failed to make up for the falling output of Russian models, as production conversion for assembly of foreign brands requires a substantial time span. However, already in 2006 the scale of growth in output of foreign brand cars under the launched projects may counterbalance (in the context of general output trend of the Russian auto industry) any reasonable contraction in Russian models production.

To assess the extent of demand for Russian and foreign brands on the Russian auto market, we analyzed the trends and the structure of the Russian automotive industry in 2001 – 2006.

2. Russian Auto Market in 2001 – 2006 Chalks Speedy Growth

We would like to remind that further in the text the Russian auto market should be understood as the volume of new automobiles sold in Russia (manufactured in Russia and abroad), and imported second-hand foreign brand cars. In gauging the volume of the Russian auto market we took into account primary sales of automobiles and their secondary sales by the owners are disregarded.

In our estimate, the volume of the Russian auto market in 2005 reached 1.8 million automobiles, expanding almost by one third versus 2001. In 2006 we expect the volume of the Russian auto market to reach 2.1 million automobiles. During the last four years the Russian auto market was expanding at a fast pace. In 2003 – 2004 the market grew by 3.1 – 8.1%, while in 2005 – 2006 it sped up by 13.2 – 16.5%, accordingly. In 2004 the volume of the Russian auto market increased by over 100 thousand cars. In 2005 sales picked up by 200 thousand cars. In 2006 we anticipate further growth of the Russian auto market nearly by 300 thousand cars.

The key driver of the Russian auto market in the recent years was accelerating import of new foreign brand cars. In 2001 about 74 thousand cars of foreign make were imported to Russia. In 2005 the imports shot up to 450 thousand. We expect that in 2006 imports of new foreign cars to Russia will approach 700 thousand. Therefore, during 5 years (2002 – 2006) imports of new foreign brand automobiles broadened tenfold.

Table 3. Russian Auto Market in 2001 – 2006, in thousands of units

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006* |
|---|------|------|------|------|------|-------|
| TOTAL: | | | | | | |
| Sales of new cars and imported second-hand foreign brands in Russia | 1349 | 1414 | 1457 | 1575 | 1782 | 2077 |
| Sales of locally-assembled cars on the domestic market | 923 | 865 | 897 | 984 | 943 | 1032 |
| Russian brand cars | 918 | 855 | 840 | 852 | 788 | 786 |
| Foreign brands assembled in Russia | 5 | 10 | 57 | 132 | 155 | 245 |
| Imports of new foreign brand cars | 74 | 102 | 160 | 274 | 452 | 694 |
| Sales of new foreign brand cars on the domestic market | 79 | 112 | 217 | 406 | 607 | 939 |
| TOTAL: | | | | | | |
| Sales of new cars in Russia | 997 | 967 | 1057 | 1258 | 1395 | 1725 |
| Imports of second-hand foreign brands** | 352 | 447 | 400 | 317 | 387 | 351 |

* Estimate based on data for 1HY of 2006; AvtoVAZ – including output plan for 2006.

** State Customs Committee of Russia, PricewaterhouseCoopers estimates, ACM - Holding

Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, European Business Association in the Russian Federation, Development Center.

Foreign brand cars assembled at Russian automobile plants are another catalyst of the Russian auto market growth. Their sales on the Russia auto market in 2001 – 2002 were small-scale (5-10 thousand cars), whereas in 2004 over 133 thousand foreign brands assembled in Russia were sold domestically. In 2005 their sales picked up to 155 thousand, and in 2006, in our estimates, they will fly to 245 thousand units.

Imported second-hand cars of foreign origin continue to make up a sizeable niche of the Russian auto market.⁴ Their domestic sales are not as dynamic as those of new foreign brands. A sharp leap in imports of second-hand foreign cars in 2002 (about 447 thousand) triggered by delays in taking a decision on raising import duties and equalization of import rules for individuals and legal entities⁵ was reversed by falling imports in 2003 – 2004.⁶ (to 400 and 317

⁴ Quantitative parameters of second-hand foreign brand car imports to Russia are less statistically accurate than the number of new cars. The reason is because official figures of the Federal Customs Service (FCS) do not include “grey” import of used cars by individuals. Up to the mid-2003, this type of entrepreneurship (customs clearance of imported cars) was extremely lucrative due to the gap between the customs duties paid by legal entities and individuals for import of foreign brands (see Note below). This import of foreign make cars was included in services provided and was shown in money and not physical measurement. In this context, assessing the quantities of second-hand foreign car imports for the period from 2001 to 2004 we relied on expert estimates of PricewaterhouseCoopers, ACM – Holding and data from official websites. Since 2004, the volume of “grey” foreign car imports dropped sharply, so the variation between the said estimates and official FCS statistics was narrowed. Since 2005, imports of second-hand foreign brand cars have been valued based on official FCS data.

⁵ In October 2002, duties on imported foreign brand passenger cars over 7 years old were pulled up: they more than doubled for individuals and soared 3-4 times for legal entities. This decision was in the pipeline for half a year, when its urgency and implications were debated. A direct side-effect of delayed decision-making was a heated demand for second-hand foreign nameplates fuelled by expected price hikes resulting from higher customs clearance costs.

thousand second-hand foreign cars). A rebound followed in 2005, driven by a new set of efforts to unify the customs procedures.⁷ Based on statistics for the first half of 2006, we may expect a drop in imports of second hand foreign cars to 351 thousand in 2006.

At the same time, the number of Russian models being sold on the Russian auto market is gradually contracting. In 2001 their sales in Russia totaled around 918 thousand cars. In 2005 – 2006 sales shrank below 800 thousand. The downward trend in sales of local brand cars was bucked only in 2004 marked by a small blip (to 852 thousand from 840 thousand in 2003). In 2005 sales of locally produced cars nosedived to 62 thousand. In 2006 we expect sales of Russian make automobiles on the Russian auto market to remain at the last year level.

In this context, qualitative characteristics of the growing Russian auto market may be summed up as follows:

1. Market shares of Russian models and foreign brand cars have changed drastically for the last five years. Out of 100 cars sold on the Russian auto market Russian models accounted for 68 in 2001, for 44 in 2002, and supposedly for 38 in 2006. Therefore, the share of foreign brand cars in the Russian market almost doubled (from 32% in 2001 to 62% in 2006).

2. The Russian auto market becomes increasingly dependent on imported automobiles. In 2001 sales of cars assembled in Russia, including foreign brands, accounted for more than two thirds of the market (68.4%). Estimates for 2006 indicate that sales of locally manufactured and imported cars stay roughly at the same level.

3. The share of imported second-hand cars in the Russian auto market is dwindling. Its movements largely depend on stability of the customs regime. The share of second-hand foreign cars in the Russian auto market widened in 2002 and 2005 as a response to the coming import duty hikes. In 2001 every fourth automobile sold on the Russian market represented an imported second-hand foreign brand car. In 2006 only every sixth car will be an imported vehicle of foreign make, according to our estimates.

⁶ In July 2003 uniform import duties on foreign brand cars from 3 to 7 years old were introduced for legal entities and individuals. So the value of customs duties paid by individuals for import of foreign brand cars increased by \$ 1-2 thousand. Higher customs duties on foreign brands paid by individuals led to reduction of “grey imports” and plunged volumes of second-hand car imports in general.

⁷ An important catalyst of growth in second-hand foreign brand car imports in 2005 was a threat of changing import regulations. While most Russian customs authorities use statistics of international catalogues to value the imported automobiles (for example, Eurotax, Superschwacke, NADA Guides), the Far East customs determined the amount of customs payments based on the value stated in the declaration up to early 2006. In September 2005 an announcement was made to introduce since January 2006 the so-called mini-catalogue for Japanese cars in the Far East, signaling transition of the Far East customs to the rules applied elsewhere in Russia. A threat that the customs charges for imported foreign brands may almost double (growth by a factor of 1.5 – 2, according to the estimates of the customs authorities) stoked up imports of second-hand cars via a steep rise in their supplies to the Far East region.

4. The share of imported new foreign brands in the Russian auto market is expanding. In 2001 – 2002 sales of new foreign brand cars accounted for 6-7% of the Russian auto market. In 2005 their share broadened to 25%, and, according to our estimates, it may grow further to 33% in 2006.

5. The share of Russian car models sagged shockingly. In 2001 Russian car models made up 68% of the Russian auto market. In 2005 their share was pared to 44% and in 2006 we expect its further contraction to 38%. At the same time, the market share of foreign brand cars assembled in Russia is growing rapidly. In 2001 – 2002 their sales accounted for less than 1% of the Russian auto market. In 2005 they increased to 9% and in 2006 we expect to grow further to 12%.

Table 4. Structure of Russian Auto Market in 2001 – 2006.

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006* |
|--|-------|-------|-------|-------|-------|-------|
| in thousands of units | | | | | | |
| Total auto market | 1 349 | 1 414 | 1 457 | 1 575 | 1 782 | 2 077 |
| Russian automobiles, excluding foreign brands | 918 | 855 | 840 | 852 | 788 | 786 |
| Foreign brand cars assembled in Russia | 5 | 10 | 57 | 132 | 155 | 245 |
| Import of new foreign brand cars | 74 | 102 | 160 | 274 | 452 | 694 |
| Import of second-hand foreign brand cars** | 352 | 447 | 400 | 317 | 387 | 351 |
| Structure of Russian Auto Market, % | | | | | | |
| Russian automobiles, excluding foreign brands | 68 | 60 | 58 | 54 | 44 | 38 |
| Foreign brand cars assembled in Russia | 0 | 1 | 4 | 8 | 9 | 12 |
| Import of new foreign brand cars | 6 | 7 | 11 | 17 | 25 | 33 |
| Import of second-hand foreign brand cars** | 26 | 32 | 27 | 20 | 22 | 17 |
| Correlation in sales of new and second –hand cars, % | | | | | | |
| New | 74 | 68 | 73 | 80 | 78 | 83 |
| Second-hand | 26 | 32 | 27 | 20 | 22 | 17 |
| Correlation in sales of locally produced and imported cars, % | | | | | | |
| Locally-produced | 68 | 61 | 62 | 62 | 53 | 50 |
| Imported | 32 | 39 | 38 | 38 | 47 | 50 |
| Correlation in sales of Russian car models and foreign brands, % | | | | | | |
| Russian automobiles, excluding foreign brands | 68 | 60 | 58 | 54 | 44 | 38 |
| Foreign brand cars | 32 | 40 | 42 | 46 | 56 | 62 |

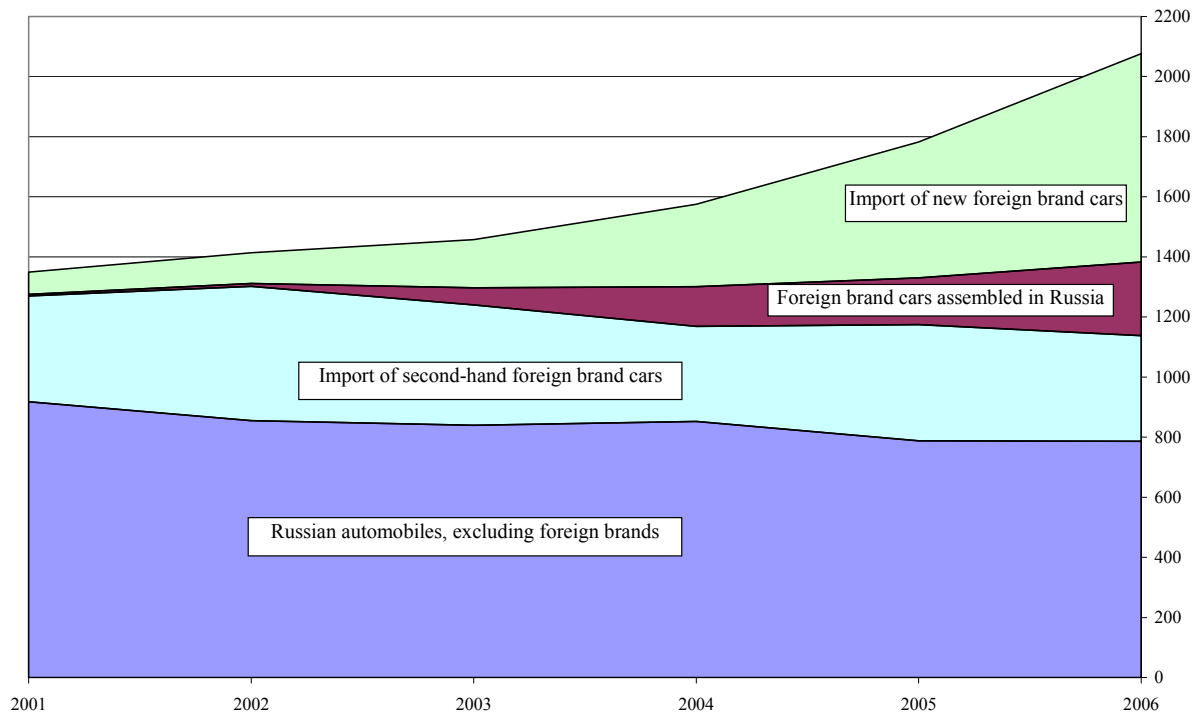
* Estimate based on data for 1HY of 2006.

**Data of State Customs Committee of Russia, PricewaterhouseCoopers estimates, ACM – Holding estimates

Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, European Business Association in the Russian Federation, Development Center.

As concluding remarks, we may say that the Russian auto market is gearing up. Its structure is “rejuvenated” thanks to gradual contraction of second-hand foreign cars and upgraded through accelerating sales of new foreign brand cars.

Diagram 1. Trends and Structure of Russian Auto Market in 2001 – 2006, in thousands of units



* Estimate based on data for 1HY of 2006.

Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, European Business Association in the Russian Federation.

Customs innovations aiming to rein in the imports of second-hand foreign brand cars to Russia cannot be viewed as highly effective and absolutely positive: delays in decision-making on the already announced measures set off a fantastic upsurge in demand for second-hand cars and postponed awareness by the Russian auto industry of its inability to compete with foreign car manufacturers. At the same time, substantial growth in duties on second-hand foreign brand cars imported by individuals put a cap on imports of cheap second-hand foreign cars aged over 7 years and helped contain growth in imports of less used cars. For some time this move bolstered competitive advantages of Russian car models, for which slightly used foreign brand cars were direct rivals, and drove a wedge between prices for Russian and foreign brand cars. In 2003 – 2004 the Russian auto industry was offered a chance to conduct a reform in a fairly beneficial environment, but it never made use of it. Spiraling prices for Russian-make cars, growing much faster than their consumer qualities in tandem with expanding auto credits accelerated in 2004 brought closer the time of price competition between Russian car models and new foreign brand cars.

Prior to 2005 the key competitors of Russian car models were second-hand foreign brand cars. Since 2005 Russian car models were challenged by a rival of a quite different weight category – a new foreign brand car of higher quality than Russian models, more expensive and available to the Russian consumer via auto loans. A possibility to finance a car purchase via auto loans that appeared in 2004 boosts the number of potential buyers of foreign brand cars, as easily obtainable credits and reasonable monthly installments comparing to the total car price often tip the scale in favor of a higher quality and more pricey automobile than the one the Russian buyer could afford without auto credits.

Sales of Russian car models on the Russian auto market are shrinking. From the perspective of new configurations rapidly taking shape in the industry since spring 2005, foreign brands assembled in Russia are gaining more ground. Their production is growing fast, but in 2005 their output still failed to make up for restructuring-driven contraction in the auto industry's output, or to meet the demand for foreign brand cars on the Russian auto market. Overshooting imports of new foreign brands expanding their share in the Russian auto market indicate that demand of Russian consumers for high-quality and reasonably more expensive cars (versus Russian models) is not satisfied in full.

The next section of this paper is focused on the analysis of foreign brand cars' presence on the Russian market depending on their price category. We will also try to answer the question about the real capacity of the market segment where Russian car models competed first with second-hand foreign brand cars and now with new foreign brands as well.

3. Price Segments of Russian Auto Market in 2001 – 2005: Classification and Analysis

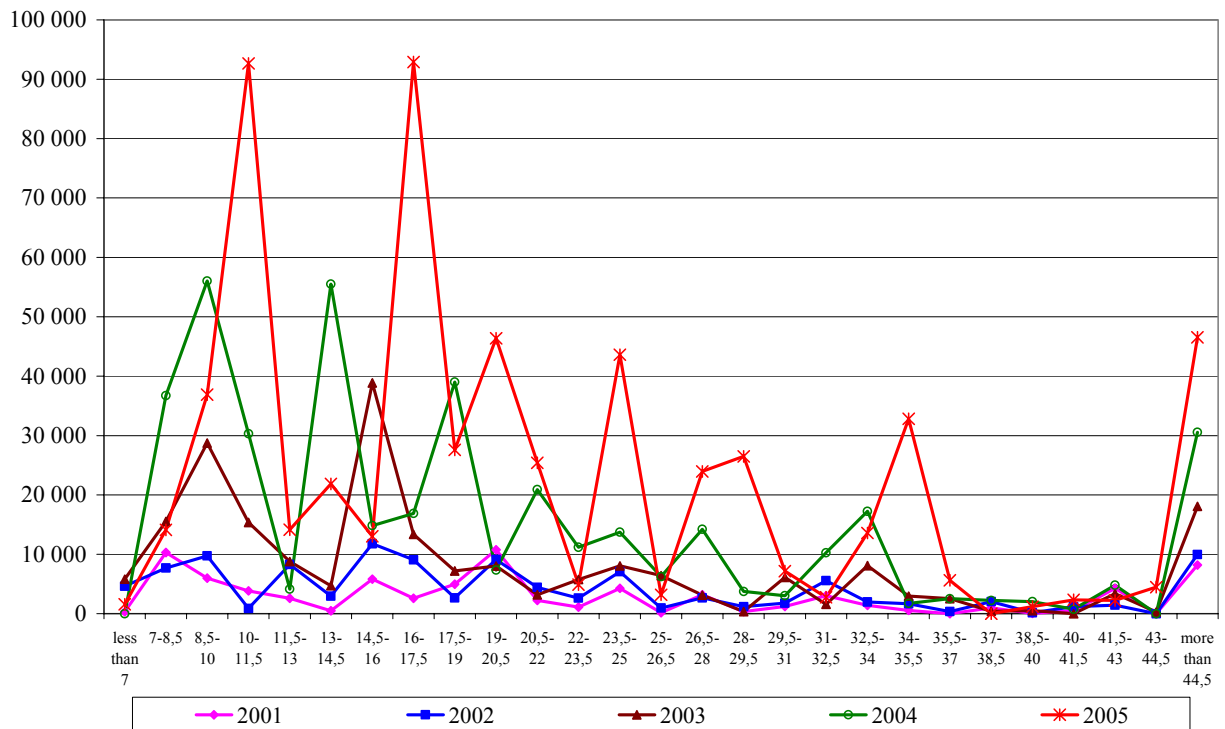
We analyzed domestic sales of new foreign brand cars depending on their selling prices. To obtain the average selling price of new foreign brand cars we used the data published by Price-N firm⁸ working with Scientific Auto Motor Research Institute.

The car modifications most widely present in the Russian market were identified by each foreign car manufacturer. The entire sample of new automobiles covered from 96% (2001) to 97% (2005) of all new foreign brand cars sold in Russia. According to statistics for March, June, September and December of the respective year, the average price was calculated for each car modification, reflecting for each month the average cost of a respective model of different

⁸ Price-N was founded in 1993. Its predecessor was Pricing Laboratory (Price Department, subsequently) established more than 50 years ago with Scientific Auto-Motor Research Institute. This structural division investigated the pricing problems and effectiveness of utilization of the automotive industry products and accumulated vast experience in processing and analysis of data flows from the ex-Soviet plants. In 1993 the Price Department team transformed into Price-N. Its core activity has been to store up information on car prices, labor to output ratios, car and car components of domestic and foreign origin.

modifications. To derive the average selling price, we took the average statistics for March, June and September of a respective year. December indicators were disregarded, as various winter rebate campaigns for new cars manufactured in the elapsing year and diverse new year bonus sales could distort actual distribution of automobiles by price category. In 2001 – 2005 foreign brand cars sold in Russia as follows, depending on their selling price, are shown in Diagram 2.

Diagram 2. Sales of New Foreign Brand Cars in Russia Depending on their Price in thousands of \$, units



Sources: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, Price-N, European Business Association in the Russian Federation, Development Center.

In principle, the price structure of new foreign brand car sales on the Russian market looks as follows. The curves showing the number of cars sold in a certain price segment have two highest points that move insignificantly during the reviewed period. Next follows a price range marked by gradually falling sales and after the bottom is hit we see a mild upturn. For further analysis, the volume of new foreign brand car sales on the Russian auto market was divided into the following segments.

The first sales maximum is generated by cars within a price range from \$9 to 11.5 thousand (depending on the year). Foreign brand cars sold at a price not exceeding the one in which the first sales maximum is delivered are further referred to as Competitors – these cars are in direct competition with Russian models, as they are approximately within a similar price niche.

The second sales maximum is generated by cars within a price range from \$ 15 to 18 thousand. Foreign brand cars sold at prices varying from \$ 9-11.5 thousand to \$15-18 thousand are further referred to as Alternative. We will show below, that in different periods they may be viewed as an alternative to more expensive automobiles given auto credits become less available, or to less expensive automobiles given auto credits are widely accessible.

Foreign cars with a price range from \$ 15-18 thousand to \$ 26–29 thousand (depending on the year) are further referred to as Middle-class. These are fairly pricey cars bought by consumers with higher and more stable incomes.

Finally, foreign cars priced at \$ 26-29 thousand are further referred to as Representation class.

A more detailed coverage of price ranges and the number of the sold foreign brand cars of the above categories is presented in Table 5 below.

Table 5. Foreign Brand Car Price Niches and Respective Sales

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|-------------|-----------|-----------|-------------|-------------|
| Price Nice, in thousands of \$ | | | | | |
| Foreign brand cars - Competitors | within 10.2 | within 10 | within 9 | within 10.1 | within 11.5 |
| Alternative | 10.2 - 16 | 10 - 16.7 | 9 - 16.5 | 10.1 – 15.2 | 11.5 - 18 |
| Middle-class | 16 - 26 | 16.7 - 26 | 16.5 - 26 | 15.2 - 28.5 | 18 - 29 |
| Representation class | above 26 | above 26 | above 26 | above 28.5 | above 29 |
| Car Sales by Price Niche, in thousands of units | | | | | |
| Foreign brand cars - Competitors | 20 | 22 | 50 | 101 | 145 |
| Alternative | 9 | 33 | 80 | 92 | 149 |
| Middle-class | 26 | 26 | 39 | 136 | 195 |
| Representation class | 24 | 31 | 49 | 77 | 119 |
| Total | 79 | 112 | 217 | 406 | 607 |

Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, Price-N, European Business Association in the Russian Federation, Development Center

Sales of Representation class cars on the Russian auto market were growing evenly in the period from 2002 to 2005, increasing by half of the volume sales each year and approaching 119 thousand cars in 2005 (versus 24 thousand cars in 2001).

Sales of foreign brand cars of the Middle class category topped out in the period starting from the second half of 2003 to 2005. In 2001 – 2002 sales of cars in this category in Russia totaled 26 thousand. In 2003 their sales surged to 39 thousand and in 2004 – 2005 these cars were the unbeaten leaders of the Russian auto market: their annual sales soared to 136 and 195 thousand cars, respectively. The upswing in sales of these cars in the Russian auto market time-matched with the onset and fast proliferation of consumer lending in Russia indicates that Russian consumers with relatively high incomes demonstrated a mounting interest in high

quality and fairly expensive cars and prompts a conclusion that expanding opportunities of obtaining auto credits (especially by this category of borrowers considered sufficiently safe by the banks) significantly impacted the growth of this segment sales on the Russian auto market.

The same factors, probably, were behind the movements in sales of the Alternative-category automobiles. In 2002 – 2003 sales of these cars sky-rocketed (from 9 thousand cars in 2001 to 80 thousand in 2003) and then braked sharply. In all evidence, foreign brand automobiles of this price niche were in high demand among high-income Russians in 2002 – 2003, when it was not so easy to obtain a car loan and select a car of a more expensive price niche. In 2004 sales of these cars touched bottom but already in 2005 sales volumes grew more than by half. Assumingly, propped up by growing household incomes and wide- spreading consumer lending, the automobiles of this category have been an alternative to foreign brand cars- Competitors since 2005.

Sales of foreign brand cars- Competitors should be analyzed in the context of total sales of new brands in this category, sales of Russian models and imported second-hand cars,⁹ as all these automobiles stay within one price niche. The structure of this market segment referred to as Economy-class vehicles is shown below.

Table 6. Economy-Class Vehicles of Russian Auto Market: Sales of Russian Car Models, Imported Second-Hand and New Foreign Brand Cars - Competitors

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|--|-------|-------|-------|-------|-------|
| Total Russian auto market, in thousands of units | 1 349 | 1 414 | 1 457 | 1 575 | 1 782 |
| Economy-class vehicles of Russian auto market, , in thousands of units | 1 290 | 1 324 | 1 290 | 1 270 | 1 320 |
| Russian car models | 918 | 855 | 840 | 852 | 788 |
| Second hand foreign brand cars | 352 | 447 | 400 | 317 | 387 |
| New foreign brand cars - Competitors | 20 | 22 | 50 | 101 | 145 |
| Economy-class vehicles of Russian auto market, % of market volume | 96 | 94 | 88 | 81 | 74 |
| Russian car models | 68 | 60 | 58 | 54 | 44 |
| Second hand foreign brand cars | 26 | 32 | 27 | 20 | 22 |
| New foreign brand cars - Competitors | 1 | 2 | 3 | 6 | 8 |

Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, Price-N, European Business Association in the Russian Federation, Development Center

⁹ For the purposes of this paper we refer all imported second hand brands to the price category under the price range of new foreign brand cars – Competitors and Alternatives. This is, doubtless, a rough assumption, but since official statistics reflecting imports of second-hand foreign brands and sound estimates of the price niches and quantities in which such cars sell on the Russian auto market are not available, either additional estimates have to be made on the basis of the existing expert estimates (which would lead to uncontrollable computational errors), or the above assumption has to be accepted. In this paper we followed the latter method.

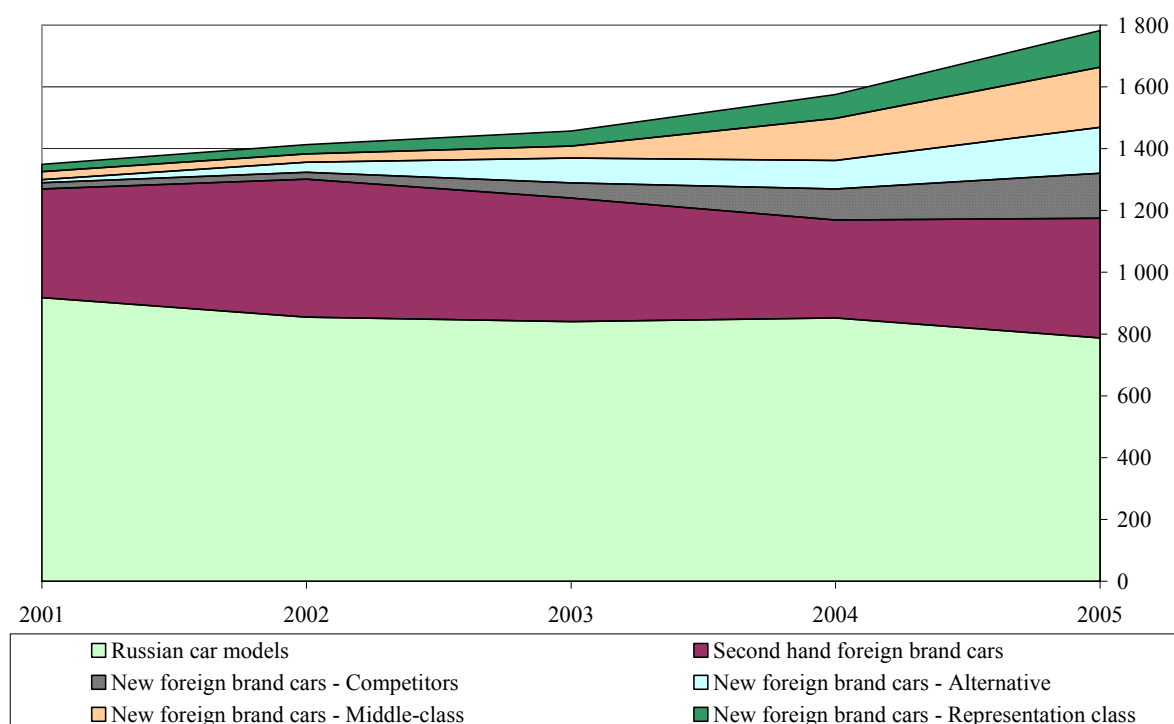
The capacity of the Economy-class vehicles segment during 2001-2005 was rather stable with annual sales posting about 1.3 million cars. Stability of this segment capacity trimmed its share in the Russian auto market: in 2001 the economy-class segment accounted for 96% of the Russian auto market, while in 2005 its share slimmed to 74%. In our estimates, it will shrink further to 65% in 2006.

It is important, that despite stable capacity of the Economy-class vehicles segment of the Russian auto market, the number of new non-expensive foreign brand cars sold in Russia (foreign brand Competitors) is resolutely picking up unlike Russian models and imported used cars. In 2003 – 2005, sales of new foreign brand cars surged by a factor of 1.5 or doubled on an annual basis, with the only exception in 2002 when spurring demand for imported used cars substantially impacted sales of Russian models and new inexpensive foreign brand cars. Therefore, new foreign brand cars – Competitors are successfully seizing new ground on the Russian auto market, ousting Russian car models and imported used cars. Despite the fact the price of a new foreign brand car-Competitor is higher than that of Russian-make cars, its sales are driven up by growing incomes of Russian households and consumer lending expansion leveling off this price gap and propelling the price to a new maximum at which a potential buyer of a Russian car is ready to re-think its plans and buy a more expensive and higher quality automobile without radical revision of its budget.

4. 2001 – 2005: Key Results and Conclusions

Analysis of the price structure of the Russian auto market allows to get a better understanding of its actual segmentation in the last five years and forms the basis for forecasting the structure of the Russian auto market in the new term. In price terms, the Russian auto market in 2001 – 2005 is shown in Diagram 3 below:

Diagram 3. Structure of Russian Auto Market in 2001 – 2005, in thousands of units



Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, Price-N, European Business Association in the Russian Federation, Development Center.

In our estimates, during the last five years sales of Economy-class vehicles (Russian car models, imported second-hand foreign brand cars and new inexpensive foreign brands) were fairly stable and total about 1.3 million. Sales of Russian-make cars demonstrate a clear downtrend (from 918 thousand in 2001 to 788 thousand in 2005). The number of imported second-hand cars sold in Russia varies widely (from 317 to 447 thousand). The only steadfast growth segment is inexpensive foreign brand cars: their sales ballooned sevenfold (from 20 thousand in 2001 to 145 thousand in 2005). Besides, a gradual upturn in demand for new automobiles is a significant trend (Russian models and inexpensive foreign brands). After the bottom-low results in 2002, when demand for economy-class vehicles was oriented towards imported second-hand foreign cars (the underlying reasons were set forth earlier in the text), sales of new cars of Russian make and of new foreign brand cars – Competitors grew noticeably (to 953 thousand in 2004 from 877 thousand in 2002). In our opinion, sales of these cars in 2005 were pulled down by production restructuring at Russian enterprises and not by subsiding demand for this category of vehicles.

As sales of economy-class vehicles in 2001 – 2005 were rather stable, we may assume that in the reviewed period the Russian auto market grew largely on the back of sales of more expensive cars in Alternative, Middle-class and Representation class categories. Growth in total sales of these automobiles from 59 thousand in 2001 to 462 thousand in 2005 drove the

expansion of the Russian auto market in 2002 – 2005. It is notable that during these five years sales of cars in each category increased evenly, or, quite understandably, marched in step with the Russian auto market.

Sales of new Representation class foreign brands are rising steadily. Their sales in Russia surged by half of their annual volume each year to demonstrate a fivefold growth in 2002 – 2005.

At first glance, Alternative class foreign brand cars are the growth leaders of the Russian auto market: during four years their sales in Russia zoomed by a factor of 16 (from 9 thousand in 2001 to 149 thousand in 2005). At the same time, sales of these automobiles peaked in 2002 – 2003 rising tenfold, to slow down considerably in 2004 – 2005. In 2004 – 2005 sales of new foreign brand cars of Alternative class rose by a factor of 1.9, sales of Representation class foreign brand cars grew by a factor of 2.4 and those of Middle-class cars – by a factor of 5.

In 2004 – 2005 maximum highs were posted by new foreign brand cars of Middle –class category: this price niche delivered highest car sales. In 2005 sales of these cars exceeded 195 thousand (versus 39 thousand in 2003).

The changed course of the Russian auto market from unrivalled leadership of new foreign brand cars of Alternative class to a sharply strengthened role Middle-class automobiles, as well as the need to identify growth trends of the Russian auto market in the near term make us turn to a question to what extent the structure of sales on the Russian auto market is determined by demand and to what extent – by supply. For the unbalanced market, and the Russian auto market had all the makings of it during the last five years, this is a crucial question. We believe that the actual trends transpired on the Russian auto market in 2006, revealing a heap of problems piled up by the Russian auto market and industry, give an exhaustive answer to this question.

5. 2006 – New Trends or Disillusionment?

In 2006 the Russian auto market saw not only an upturn in sales volumes (in our estimates, in 2006 the Russian auto market will expand by about 300 thousand automobiles). Now potential buyers have to wait for a longer time to acquire the ordered car, and primarily, a foreign brand automobile. There has always been a waiting list for foreign brand cars, but longer queues in car shops to buy a new foreign brand automobile in 2006 in the context of robustly growing sales looks really shocking. Except Representation-class cars (see classification above), the time of waiting for new foreign brand cars in the above indicated price niches lengthened sizeably.¹⁰ We

¹⁰ In the Competitors' price range, one of the cheapest Daewoo Matiz and Daewoo Nexia are deficit cars - they are available only in expensive luxury modifications. However, regular deliveries of Uzbek Daewoo prevent escalation of deficit of cheaper modifications. At the same the crunch of Hyundai Getz is mounting, especially, its basic model with automatic gear box. Today, Russian quotas on these cars are filled up for months to come. Renault Logan also joined the deficit car league – it is next to impossible to buy this car in cheap modification for the price standing

may say, therefore, that the structure of the Russian auto market in price terms becomes increasingly dependent on the structure of new foreign brand cars supply, rather than on the structure of demand for them.

We may tentatively assume that 2006 will be marked by a sudden and steep rise in demand of the Russian population for automobiles within moderate and more expensive price categories. Such a violent growth in demand cannot be put down only to rising household incomes and on-going growth in auto credits. It is probable, that soaring demand on the Russian auto market in 2006 was also nurtured by a rapid rise in real estate prices.

According to the Russian Public Opinion Research Centre, the share of well-off Russians remained unchanged at the level of 1% in 2006, despite growing household disposable incomes. But the share of people ready to buy durable goods broadened from 8% to 13%. Skyscraping prices for real estate,¹¹ hampering the opportunities to improve housing conditions in a reasonable time, induce the well-to-do Russians to search for other ways of improving their lifestyle. Apparently, the purchase of a good car is one of such ways. Car sales managers also note that some of their clients were driven by this particular reason.

In 2005 the most popular expert forecast of growth in foreign brand car sales in 2006 ranged within 30-35%. However, according to statistics of the first half of 2006, sales rode up by 55% with growing unsatisfied demand as a backdrop.

It is clear, that it is hardly possible to meet such a sudden and speedy upswing in demand through imports of foreign brand cars, as negotiating the increase in orders for supply of automobiles manufactured outside of Russia calls for some time. It will be a futile task to expect that, all or most foreign car producers will satisfy the increased supply orders without prior arrangements. Besides, transportation restrictions also pose a problem: the existing fleet of car careers, according to the auto market experts, should be at least doubled in volume, but this problem cannot be fixed at one stroke. Now the growing deficit of foreign brand cars brought about an increase in the cost of carriage by a factor of 1.5.

In a nutshell, *the first lesson of 2006* to be grasped by the Russian automotive industry and the Russian auto market is as follows. Imports of foreign brand cars cannot fully and in a time efficient manner meet the demand of the Russian auto market. It is not quite elastic with respect

close to basic. Chevrolet car lineup, including Aveo (Competitors segment) and Lacetti (Alternative segment), is also in deficit; the waiting time for these cars is three to four months. The queue for Ford Focus (Alternative segment) lengthened from six to nine months. In mid-summer auto dealers noted that Focus produced in 2006 was sold up and the waiting list was compiled for 2007. Supply of popular nameplates in the Middle-class price range (under our classification) is not sufficient either: the waiting lists are from three to nine months, or the Russian quotas on these cars are already filled up and dealers, at best, accept orders for the next year. According to Business Car, Toyota's largest auto dealer in Russia, the queue for Toyota Camry (Middle-class car under our classification) extended from two months (late winter 2006) to six months (summer 2006). The record-long waiting time (nine months) is registered by buyers of Honda Civic.

¹¹ In Moscow real estate prices jumped by 30% in the first six months of 2006.

to the changing demand structure and still less elastic with regard to its movements. Talking about the Russian auto market outlook, the experience gained in 2006 is another signal that production of high quality cars with a wide price range should be set up in Russia.

Why is the Russian auto market confronted with mounting deficit and what are the barriers to large-scale manufacturing of foreign brand cars in Russia? In our opinion, low import duties dent the interest of foreign car manufacturers in setting up commercial production of foreign brand automobiles in Russia. According to the experts of the Russian automotive industry, the existing duties at the level of 25% make it more profitable for a foreign car producer to export new cars to Russia, than to manufacture them locally. According to the estimates of some foreign car manufacturers, the assembly of foreign brands in Russia is more economically rewarding. A possible gap in profits caused by selecting imports and not local production as a mode of presence on the Russian auto market is not decisive for foreign car manufacturers, and can be treated as a token price for non-existent investment risks. Another effective way of protecting the national auto industry and market should be looked for in China. In setting up national automobile production the customs duties on automobiles in China were pulled up to 200% and only in early 1990s they were pared off to 80—100%. After China's accession to the WTO, its duties stand at 35%. After 2010, when the Chinese automotive industry entrenches its position on the domestic market, customs duties will be cut down further to 15-20%. This policy did the trick: in 2004 China was the world's fourth-largest car manufacturer.

It is undeniable, that with the currently low customs duties on car imports in Russia, signing of Resolution No.166 in March 2005¹² was an exhaustive answer to the question “What automotive industry does Russia need?” Considering the trends in the Russian auto market, foreign car manufacturers would come to Russia anyway: if the components duties are repealed and despite raised import duties on foreign brand cars. The difference in scenarios depends on the scale of production to be set up, the volume of investments into the Russian automotive industry, the time when these projects are launched by foreign car producers and the prices for foreign brand cars assembled in Russia.

If the goal was to create the well-balanced automotive industry in the country churning out sufficient numbers to supply the market with high quality and upgraded cars of different price categories, the existing regulatory framework is very conducive to its materialization. The Russian auto market is too open for imports of foreign cars and the terms of deploying assembly

¹² Government Resolution No.166 “On Introducing Changes to the RF Customs Tariff with Respect to Auto-components Imported for Industrial Assemblage” signed on 29 March 2005 opened for foreign automakers new prospects of car production in Russia. The terms of industrial assembly of automobiles in Russia – close to duty-free import of auto components given the annual output is at least 25 thousand cars and the volume of auto components produced in Russia is brought to 30% of the total auto components used within 6-7 years – are actually a gateway for foreign car manufacturers to Russia.

lines requiring the import of car parts and components for assembly are more than lenient. The planned output, which allows foreign car makers to ship car components for assembly in Russia, is about 25 thousand units a year, which is hardly a sizeable volume in terms of the Russian auto market and the output of large foreign car producers. Hence, the legislation regulating foreign car maker's entry and operations on the Russian auto market is not a very efficient stimulus for them to set up full-fledged local production (in terms of output, car lineup, developing production links with Russian car components producers) in Russia and does not really contribute to building up local production units within foreign car holdings' structures.

Another serious lesson taught in 2006 was the emergence of technological problems (which were never considered as a real threat before) challenging Russian car plants engaged in assembly of foreign cars. The oldest in this business Taganrog Automobile Plant (TaGaz) assembles Hyundai Accent sedans (since May 2001), business-class Hyundai Sonata (since 2004), and Hyundai Porter light trucks (since June 2005). Technological equipment and production capacities of the plant enable to put out simultaneously up to 6 different car models with the total volume up to 120 thousand units annually. At the same time, since October 2005 a three-week assembly line stoppage, occurred due to delays in the delivery of car components from Korea in connection with the local strike, thwarted the output of Hyundai Accent and Hyundai planned at 50 thousand. The actual output totaled 43.6 thousand units. According to statistics of the second half of 2006, the remaining dearth of components for passenger cars cut their output by 470 units (2.2%).

The snags encountered by TaGaz, viewed as a showcase example of successful car assembly business in Russia, are likely to dent the optimistic outlook of Russian car plants which opted to assemble foreign brand vehicles instead of producing Russian models. Nearly absolute dependence on the components imports that are not always stable and guaranteed, even when both Russian and foreign car makers are motivated to perform well, gives rise to risks which are largely borne by Russian car plants, and to a far less degree by their foreign partners.

Finally, *a third important lesson of 2006* was unquestioned improvement of the Russian car giant AvtoVaz's position on the domestic market. According to the seven-month statistics, the output of passenger cars rose by 9% to 429.5 thousand units in 2006. AvtoVaz's sales volumes on the domestic market also picked up – domestic sales of cars manufactured by the plant reached 377 thousand (up by 6.1% vs. January – July 2005).

In 2005 when almost all Russian car plants opted to cease production of Russian car models, their output shrank by 70 thousand units. Meanwhile, during the nine months from November 2005 marked by radical management reshuffle to July 2006 AvtoVAZ increased its output by 49 thousand cars, or 65 thousand on an annualized basis. It is true, in 2006 Russian

models that quit the market as a result of production transition to foreign brands are now being successfully replaced on the Russian auto market by VAZ vehicles, despite the growing output of foreign brand cars. It appears that the Russian auto industry segment gravitating towards production of local models still has plenty of room for further modernization and growth, and the potential of this segment should not be underestimated.

No doubt, in 2006 AvtoVaz sales were buoyed up by a string of developments on the Russian auto market – “self-liquidation” of competitors (production re-orientation of plants manufacturing Russian car models), streamlining of AvtoVAZ sales (simplification of the auto dealer structure which followed after the change in the plant management) and the emerged deficit for foreign brand cars – Competitors. However, all these factors were evidently a happy complement to the traditional loyalty of Russian consumers to the AvtoVAZ products and expanding car loans provided to finance the purchase of the automobiles produced by the plant. So after 2005, when the fate of Russian cars seemed to be decided by adopted Resolution No. 166 and subsequent production switchover to assembly of foreign brand cars by some Russian car makers, the year 2006 proved that this particular segment is more stable than it looked before. In 2006, the traditional Russian auto industry focused on production of Russian car models represented by the auto giant AvtoVAZ unexpectedly got another chance – either to modernize the existing production, or to sign an agreement on cooperation with foreign car makers on more advantageous terms to be granted owing to the increasing value of competing production as seen by foreign car producers. It is difficult to say how much time the plant has at its disposal to make the choice. In all likelihood, this period won't be long. By now the prices for AvtoVAZ automobiles have caught up with those for inexpensive new foreign brands.¹³ So, the position of the Russian car giant on the market may be influenced by stepped-up production of locally assembled foreign brands, mounting imports of foreign brand cars, and forced price hikes for self-produced automobiles.

Therefore, after 2005, which, seemingly, showed vividly that in the near term the Russian auto market and industry associate their development with the dominating presence of foreign brand cars, the current year revealed all the bottlenecks of this stance and demonstrated the untapped resources of traditional Russian car makers oriented at production of Russian car models.

¹³ For example, Kalina sedan costing from \$ 9280 is even more expensive than Renault Logan with the price from \$ 9250, and the tenth model with the price from \$ 9060 outpaced Daewoo Nexia costing from \$8800.

6. Foreign Car Makers in Russia

According to the data by end-August 2006, international car corporations Hyundai, Ford, General Motors, Renault, Kia, Volkswagen, Nissan and Toyota are already involved in car manufacturing in Russia or are at different stages of car plant construction.

Table 7. International Car Corporations in Russia

| Car maker | Russian plant producing foreign brand cars | Location | Start of commercial production | Output in 2005, thousands of units | Planned capacity, thousands of units |
|----------------|--|------------------|--------------------------------|------------------------------------|--------------------------------------|
| Hyundai | TaGaz | Taganrog | 2001 | 43.6 | 75 |
| Ford | new plant under construction | Vsevolzhsk | 2002 | 35.8 | 150 |
| General Motors | AvtoVAZ | Moscow | 2002 | 51.8 | 102 |
| | Avtotor | Kaliningrad | 2005 | 2.1 | 15 |
| | new plant under construction | Saint-Petersburg | 2008 | | 25 |
| Renault | Moskvich | Moscow | 2005 | 10.0 | 80 |
| Kia | Izh-Avto | Izhevsk | 2005 | 3.0 | 70 |
| Cherry | Avtotor | Kaliningrad | 2006 | | 17 |
| Volkswagen | new plant under construction | Kaluga | 2007 | | 115 |
| Nissan | new plant under construction | Saint-Petersburg | 2009 | | 50 |
| Toyota | new plant under construction | Saint-Petersburg | ? | | 20 |

Source: Car plants' press-releases, media sources, Development Center

Hyundai, General Motors and Ford were the trailblazers of car assembly in Russia. They kicked off commercial production of foreign brand cars on the Russian market as far back as 2001 – 2002. In 2006, Volkswagen, Nissan and Toyota joined in, but they are at the beginning of building new plants in Russia. Besides, according to MEDT, the Ministry is now negotiating the terms of agreements on industrial assembly with another dozen of foreign car corporations. .

In the recent past, most foreign car manufacturers partially used the production capacities of local auto plants that had formerly specialized in making Russian car models. By 2006, however, the reserves of production capacities were all actually exhausted giving foreign car manufacturers another argument in favor of setting up new car plants in Russia. Despite the set up assembly of foreign brand cars in the production facilities of Kaliningrad Avtotor (since 2005) with planned output at 15 thousand cars a year, General Motors starts the construction of a new car plant with minimal annual output at 25 thousand units. The Chinese Cherry plans to set up new production facilities with annual capacity up to 150 thousand units.

It is important that in 2006 the majority of foreign car makers already engaged in automobile production in Russia announced their intention to increase their production capacities. Renault's Russia-based Avtoframos plans to increase its initial capacity of 60 thousand units to 80 thousand in 2007. Similarly, ZAO Ford Motor Company plans to increase its capacity to 150 thousand automobiles per year. Since 2005, Izh-Avto assembling KIA Spectra

(initial planned capacity of 45 thousand per year) plans to step up production to 70 thousand automobiles per year.

Expanding volumes are matched with expanding car lineup offering automobiles of different price categories. This is a positive development allowing the supply to move more flexibly in response to changing demand and bringing more stability to production volumes. Among foreign car makers who started construction of auto plants in Russia, only Toyota plans the assembly of Camry which is pretty expensive for Russian buyers. At the same time, other foreign car manufacturers plan to put out cars of different price ranges. Special focus will be placed on production of moderately-priced automobiles up to \$10 thousand.

According to the planned production capacity already voiced by late August 2006, the existing, expanded and newly created capacities will enable to manufacture about 700 thousand foreign brand cars per year in (2005: 161 thousand). Moreover, this is not a final target and production volumes are likely to increase further as contracts are signed with new foreign car producers contemplating car production in Russia. Given the scale of the car business new European and Chinese car makers' project to achieve in Russia, the output of foreign brands produced in Russia may account for half the production volumes of the total Russian auto industry's production volume.

In our estimates, based on the information published in press releases of Russian car plants and Russian divisions of foreign car corporations, the volume of actual investments currently channeled to set up assembly of foreign brands in Russia makes up about \$ 1.5 billion. Considering the already announced construction plans and projections to enhance production capacity of the operating car plants, the volume of investments in the coming years may go over \$1.3 billion.¹⁴ Therefore, achieving the output of 700 thousand units per year will require about \$2.8 billion of investment.

At the same time, the experience of building the up-to-date automotive industry in China demonstrates a totally different correlation of investments and production volumes.¹⁵ In the period from 1999 to 2003, investments in car production in China reached \$ 20 billion to achieve

¹⁴ There are different estimates of investments to car assembly business in Russia. According to MEDT estimates based on the already signed contracts with foreign car manufacturers and pending agreements, the level of investments is put at \$2 billion. Moreover, our estimates include the investments of Toyota in the amount of \$250 million (to assure output of 20 thousand cars per year). It is assumed that this number may leap to \$ 1 billion triggering a respective rise in output. A scenario that Renault will turn out up to 120 thousand cars per year is also possible, but that will require additional investment infusions. This way or another, the estimates of investments into the assembly business should be lined up with planned capacities and we did so in the suggested projections.

¹⁵ China grew into one of the world leading car producers in the last ten years. In the recent past this country was counted out as a serious market player on the world auto market. According to performance indicators of 2004, China was fourth-biggest car manufacturers in the world posting highest growth and output rates. Reforming of the Chinese automotive industry in the conditions of foolproof protection from imports (car import duties varied from 100 to 200% of their value), gave a strong impetus to joint auto ventures set up with foreign car makers: they account for 70% of total car output.

the output of 2 million automobiles. Therefore, given the difference in output, to attain the same of level of car output in Russia, car production will require far less investment than in China.¹⁶

In all probability, this phenomenon may be put down to the fact that production of foreign automobiles in Russia involves a great deal of assembly works with a low level of localization unlike in China, where high import duties led to a high cost of production. The existing regulations (Resolution No. 166), requiring from foreign car corporations a 30% level¹⁷ of local production of components upon expiry of 7 years after a car plant construction as a trade-off for benefits in car components imports, and low car import duties are a weak stimulus for foreign car corporations to make additional investments in car production in Russia. With moderate production capacity (50-60 thousand car per year, according to the experts' estimates), additional costs associated with unfolding components production are much higher than lax import duties. It is possible, however, that emergence on the Russian market of foreign car makers initially focused on a large-scale output, and enhancing capacities of the already operating plants will signify growing interest of these producers in setting up production of car components in Russia. The growth in local assembly facilities in Russia will be a new landmark in the development of the Russian automotive industry entailing modernization of components, further acceleration of investments and higher growth rates in the mechanical engineering sector.¹⁸

7. 2007 – 2009 – Forecast of Trends in the Russian Auto Industry and Market

The forecast of trends in the Russian auto industry and market is based on MEDT report “Forecast of Social and Economic Development of the Russian Federation for 2007. Forecast Parameters for the Period until 2009 and Maximal Prices (Tariffs) for Products (Services) of Natural Monopolies” dated 11 August 2006.

The MEDT Forecast offers two possible scenarios of Russian economy development. Scenario 1 (inertial) projects development of the Russian economy against the background of stabilized hydrocarbon export volumes and persevering deterioration of price competitiveness of the local goods and their substitution by imported products. Scenario 2 (moderately optimistic) is oriented at relative improvement in the Russian business competitiveness and more energetic structural change through implementation of measures targeted at accelerating economic growth”.

¹⁶ Even if we match the actual and potential investments into the car assembly segment in Russia for more than ten years and those funneled into the Chinese auto industry during five years and adjust them for the difference in production volumes, the investments into Russian car plants turning out foreign nameplates 2.5 times underperform those made in China.

¹⁷ By the end of the seventh year since the started construction of a car assembly plant, 30% of components used for assembly of these cars should be manufactured in Russia and not imported (in money terms).

¹⁸ This will be true for a medium-term outlook by the time the production capacities achieve the level of 80 thousand cars per year.

MEDT forecasts of trends in automobile production are based on the following assumptions: “The output of assembly plants does not make up for stagnating production of local brand cars, exports of automobile equipment are shrinking” (Option 1) and “Increase in production of local brand cars brought by restructuring and modernization of car plants, growth in output at assembly plants, growth in exports of automobile equipment” (Option 2).

“Under Option 1, in 2009 the auto market output is forecast at 2.4-2.5 million units. Local production, in which the share of locally-assembled automobiles is expected to meet 60-65% of demand, will make up 32-35%. Expanded assembly of automobiles is not expected to make up for contracted production at local plants and car export volumes are expected to dwindle. Hence, in 2009 car output is expected to reach 1.2 million units (112.3% versus 2005). Under Option 2, restructuring and modernization of local car plants, outpacing growth of car assembly plants and implementation of projects involving creation of advanced motor transport technologies for new-generation automobiles are expected to raise substantially the car output (up to 1450 thousand in 2009; 135.6% versus 2005).”

These parameters describing the development trends of the Russian auto industry and market may be viewed as maximum forecast targets. We are more inclined to think that the average trend will prevail on the market.

According to this synthetic “trend” forecast, we may expect the Russian auto industry output to increase by one fourth in 2009 versus 2005, but this growth will be achieved exclusively through expanding local assembly of foreign brand cars. Production of foreign brand cars in Russia will exceed 450 thousand annually, increasing versus 2005 by a factor of 2.8. At the same time, the output of Russian car models is likely to be stable. As a result, Russian car models will account for 66% of the Russian auto industry output in 2009 (85% in 2005 and 99% in 2002).

In the period under review, the Russian auto market will almost double in volume. In 2009 its growth is expected to reach 2.6 million automobiles. The market will grow largely thanks to imports of new foreign car brands (their number will rise 2.5-fold versus 2005) and foreign car models assembled in Russia. Eventually, the share of Russian car models on the Russian auto market will drop to 29% in 2009 (versus 44% in 2005 and 60% in 2002).

Table 8. Development Outlook of Russian Auto Industry and Market

| | 2005 | 2006, estimate | Forecast for 2009 | | | Growth (2009 versus 2005), % |
|--|------|-------------------|-------------------|-------------|---------------|------------------------------|
| | | | Option 1 | Option 2 | Average trend | |
| Russian automotive industry, in thousands of cars | | | | | | |
| Car production in Russia | 1068 | 1154 | 1200 | 1450 | 1325 | 24 |
| Russian car models | 907 | 902 | 800 | 950 | 875 | -4 |
| Foreign brand cars assembled in Russia | 161 | 252 | 400 | 500 | 450 | 180 |
| Export of locally-assembled cars | 125 | 123 | 115 | 130 | 123 | -2 |
| Domestic sales of locally-assembled cars | 943 | 1032 | 1085 | 1320 | 1202 | 28 |
| Russian automotive industry, structure, % | | | | | | |
| Car production in Russia | 100 | 100 | 100 | 100 | 100 | |
| Russian car models | 85 | 78 | 67 | 66 | 66 | |
| Foreign brand cars assembled in Russia | 15 | 22 | 33 | 34 | 34 | |
| Export of locally-assembled cars | 12 | 11 | 10 | 9 | 9 | |
| Domestic sales of locally-assembled cars | 88 | 89 | 90 | 91 | 91 | |
| Russian auto market, in thousands of cars | | | | | | |
| Russian auto market, total | 1782 | 2077 | 2500 | 2700 | 2600 | 46 |
| Domestic sales of locally-assembled cars | 943 | 1032 | 1085 | 1320 | 1202 | 28 |
| Russian car models | 788 | 786 | 691 | 828 | 759 | -4 |
| Foreign brand cars assembled in Russia | 155 | 245 | 393 | 492 | 443 | 185 |
| Import of new foreign brand cars | 452 | 694 | 1115 | 1115 | 1115 | 147 |
| Domestic sales of new foreign brand cars in Russia | 607 | 939 | 1509 | 1608 | 1558 | 157 |
| Import of second-hand foreign brand cars | 387 | 351 | 300 | 265 | 283 | -27 |
| Domestic sales of new cars in Russia | 1395 | 1725 | 2200 | 2435 | 2318 | 66 |
| Russian auto market, structure, % | | | | | | |
| Russian auto market, total | 100 | 100 | 100 | 100 | 100 | |
| Domestic sales of locally-assembled cars | 53 | 50 | 43 | 49 | 46 | |
| Russian car models | 44 | 38 | 28 | 31 | 29 | |
| Foreign brand cars assembled in Russia | 9 | 12 | 16 | 18 | 17 | |
| Import of new foreign brand cars | 25 | 33 | 45 | 41 | 43 | |
| Domestic sales of new foreign brand cars in Russia | 34 | 45 | 60 | 60 | 60 | |
| Import of second-hand foreign brand cars | 22 | 17 | 12 | 10 | 11 | |
| Domestic sales of new cars in Russia | 78 | 83 | 88 | 90 | 89 | |

Note: We show separately the volumes of the Russian auto industry and market indicated in the Report and took into account the comments on export trends. More (Option 2) or Less (Option 1) rapid reduction of second – hand car imports is expected. New car imports are calculated on the basis of the Report under Option 1 and are universal for both scenarios. Production of locally-assembled foreign brands under Option 2 is calculated on the basis of the plans on starting off and expanding automobile production voiced by foreign automakers by the end of August 2006.

Source: Russian Statistics Service, State Customs Committee of Russia, corporate reports, ACM-Holding, Price-N, European Business Association in the Russian Federation, Development Center.

The Russian auto industry and market are growing so fast that the suggested forecast, like many other forecasts of various expert agencies, may need revisiting in the near term.

A list of foreign automakers currently operating or recently involved in construction of new plants in Russia, including Ford, Kia, Hyundai, Renault, Volkswagen, Nissan, General Motors, Toyota, continues to expand. At present MEDT is negotiating set-up of another ten assembly plants in Russia with foreign car corporations, among which are Peugeot-Citroen and Chinese companies. This may drive the output of locally-made foreign and domestic brands over the forecast numbers. Russia automakers not so far back involved in production of domestic brands are now successfully teaming up with foreign car manufacturers, and this on-going dialogue will lay the groundwork for further crossover to locally assembled foreign brands and reduction of the domestic brands output.

Besides, demand rally staged by Russian consumers in 2006, which substantially lengthened the car queues, may push foreign automakers to increase quotas on delivery of automobiles to Russia, thereby impacting the volumes of imported new cars.

Finally, tightened ecological requirements for imports of second-hand cars and mounting supply of new domestic brands and inexpensive foreign nameplates may speed up contraction of second-hand car imports.

Anyway, the period up to 2009 has all the makings for further enthusiastic growth of the Russian auto market and industry – growing household incomes and auto credits will push up domestic demand for cars and adoption of Resolution No. 166 coupled with low import duties will spur local production of foreign brands and import of new foreign nameplates.

Conclusions

We may say in conclusion that the Russian automotive sector is one of the fastest growing segments in the Russian industry. Large-scale withdrawal of Russian car giants from production of domestic brands and their switchover to foreign brands, signed agreements on set-up of assembly works with foreign leading car corporations and started construction of new production facilities, shape a new and upgraded profile of this important industry.

2005 appeared to be a countdown year for a number of Russian car makers and a period of systemic revision of production strategies. Russian Government Resolution No. 166 signed on March 2005 opened new production prospects for foreign car makers. The Russian industry is now increasingly represented by locally assembled foreign rather than domestic brands. Local production of foreign brands is growing at a fast pace. In 2005 growth in their output could not prevent “restructuring”-driven slump in the industry-wide production output. In 2006 the growth is strong enough to post record high production volumes since 2001. In 2006, however, neither rising production of foreign brand cars, nor surging imports of new foreign brands could satisfy hearty demand of Russian consumers. The current year was marked not only by an upswing in sales but also by a longer time the potential buyers have to wait to acquire the ordered car, and, primarily, the new foreign brands. So the 2006 experience was a vivid illustration of underestimated demand for passenger cars in Russia, bringing out the glaring necessity to set up production of higher quality cars within different price ranges.

According to statistics for late August 2006, international car corporations Hyundai, Ford, General Motors, Renault, Kia, Volkswagen, Nissan and Toyota are already involved in car manufacturing in Russia or are at different stages of car plant construction. Besides, according to MEDT, the Ministry is now negotiating the terms of agreements on industrial assembly with another dozen of foreign car corporations.

In the recent past, most foreign car manufacturers partially used the production capacities of local auto plants that had formerly specialized in making Russian car models. By 2006, however, the reserves of production capacities were actually exhausted and construction of new car plants turns out to be the principal, if not sole option of automobile production in Russia.

According to the plans of foreign automakers, who have the up and running car production in Russia or voiced their plans to build local car plants by the end of August 2006, about 700 thousand foreign brands (2005: 161 thousand) will be manufactured in Russia in the next ten years. The Russian automotive industry is becoming more up-to-date, acquiring international dimensions.

It is also important that foreign automakers have an opportunity to turn out and sale cars on the Russian auto market, which capacity, despite racing demand in the recent years, is regularly undervalued. The “price” for the chance to operate on the Russian auto market and set up local production is rather moderate. In our estimates, to bring the output of new locally produced foreign nameplates in Russia to 700 thousands automobiles per year (if started from scratch), about \$2.8 billion of investments will be needed to set up assembly lines. The correlation of investments and production volumes in China whose successes in building the national

automotive industry can hardly be overestimated illustrates that the Russian auto industry could have expected larger investment injections into production modernization. Only in 1999 – 2003, investments in the Chinese automotive industry made about \$ 20 billion. In 2004 about 2 million automobiles were assembled. Therefore, considering the gap in production volumes of the two countries, production of the same number of cars in Russia required far less investment.

Unlike in China, where high import duties on cars and car parts resulted in a high cost of manufacturing, production of foreign brand cars in Russia is dominated by the assembly segment with a low level of localization. This gap in investments channeled into Russian and Chinese auto industries reflects the extent of the industry modernization materialized not only in the final product but also in involvement of domestic car makers in production and at all its stages.

Acknowledging obvious modernization of the Russian automobile industry, the extent of the innovation progress there is still relatively low. The assembly production allowing practically duty free import of car components does not encourage automakers to build business links with Russian producers of components. In the next few years assembly plants in Russia will keep busy metals, chemical and other enterprises of Japan, Korea and China, ignoring their Russian peers. Therefore, outwardly growing Russian automotive industry minimizes incentives for modernization of related productions.

If the role the manufacturing industries are expected to play is that of a stabilizer assuring stability in the Russian economy in the fast changing economic environment, the bitter truth is that reforms afoot in the Russian automotive industry do not quite cope with this role. Russia will be able to free itself of oil dependence through boosting its manufacturing sector. Reforms of the Russian automotive industry, however, do not keep track of the progress in components production segment. Besides, they give rise to a new heavy dependence of the national economy on external factors – imports of car components. We are far from identifying the “oil needle” to which the Russian economy has been addicted for years with “the components needle”, although some similarities can be found. The best illustration is TagAz experiencing during ten months a deficit of components for Hyundai passenger cars and induced to cut down production volumes in the conditions of spiraling demand for this make.

Unfortunately these snags arise from the existing regulatory framework. The Russian auto market is too open to imports of foreign brand cars thanks to a low 25% import duty. The terms of industrial assembly of automobiles in Russia – close to duty-free import of auto components given the annual output is at least 25 thousand cars and the volume of auto components produced in Russia is brought to 30% within 6-7 years – are unjustifiably sparing.

The upshot is that the existing laws and regulations do not encourage foreign automakers to set up full-fledged (in terms of output and components production) production facilities in

Russia and do not help Russian subsidiaries cement their positions in the structure of foreign car corporations.

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