Prospects for Foreign Investment in Russian Forest Industries

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ABSTRACT

Global demand for wood fiber has already led to tremendous harvesting of eastern Siberia’s forest resource. And with timber demand far exceeding supply projections for some of Asia’s most rapidly growing economies, Siberia will continue to play an increasing role in the global timber supply situation. There are foreign investment opportunities in Siberia in the processing of paper and packaging, construction materials, and non-timber products. This paper will highlight investment opportunities and pitfalls for foreign investors, detail the investment climate in Russia, and present opportunities for foreign investors interested in Siberian forest development.

Overall Russian Economy Overview

Over the past ten years the Russian economy has undergone a fundamental change. This change centers on a transition that has attempted to move Russia from a centrally planned economic system to one that attempts to adapt to a liberal market oriented economy. The process has undoubtedly seen its share of success, but this success has been uneven at best.

Nearly all of the current-day economic problems can be traced to the inherited weakness from the old Soviet-style planned economic system. Under Soviet rule, the economy was a hyper-militarized institution focused on heavy industry with little support of consumer goods industries. The Soviet-style planned economy did not foster (or necessitate) the development of an economic infrastructure capable of supporting a modern liberalized economy. This type of economic system was ill suited to rapidly react to the changing dynamic of the economic environment from an industrial-based system to a post-industrial, information age economy. Further, the exit of the State as a managing force in the economy and industrial development in 1992 and the simultaneous liberalization of prices and foreign trade compounded Russia’s economic problems and left Russia without clear direction for economic growth. This has led to capital flight and the unchecked expansion of corrupt influences in the economy, growth of complex and burdensome bureaucracy – at both local and federal levels – and fueled the development of barter and exchange-based economic system. These factors, in collaboration with political and financial instability, and an unclear interpretation of the law, have distorted the transparency of the Russian economic system and all eliminated foreign investor confidence.

Nonetheless, over the past ten years some significant results have been achieved in this transformation process of Russian economy, including:

- 75 percent of the state owned companies have been privatized
- Legislation was developed and implemented for regulating various spheres of economic activities. This legislation is not perfect. It does not have transparency, in some cases it is normative and descriptive, and lacks necessary mechanisms for implementation. Despite these inefficiencies, the legislation necessary for supporting market economy infrastructure was developed and enforced. It provides the base for the future enhancement.
- Stock exchange and securities market were established. Most of Russian enterprises survive in the crisis economic conditions rather than function. It makes portfolio investments very risky and unattractive. Nowadays, the main players at the stock exchange are so called “blue chips” – companies of oil and gas complex. However the results of the daily trade and financial indicators are available to anyone interested through the media and press reports. More and more people become familiar with the functions of the stock exchange, its functions and possibilities of participating and investing money. As soon as the economic situation improves, the securities market will develop and enhance its operations and their volume as well as number of participants.
- A new generation of energetic and well-educated business leaders has appeared. They learned how to manage a business without support and supervision from the State, how to be competitive and to participate at the market transactions. These leaders greatly support the liberal reforms and ensure further integration of Russia with the West.
- New technologies fundamental to western economic structures (i.e., information technology) were introduced and adopted.
- Banking system was created. Illiquidity of the majority of enterprises does not
create conditions for the development of the banking sector. Its future establishment is greatly dependent on the overall condition of the country’s economy, especially of the industrial sector.

The change in Russian political and economical systems was dramatic. It is not possible to make a conclusion about the success or failure of the reforms. However, it could be stated that the significant leap forward was made, but there is still a long way to go.

Established democratic rule in Russia and its transformation to the free market economy brings tremendous opportunities for foreign investors. Russia has vast natural resources, fast growing domestic and neighboring international markets for wide range of goods, and a highly educated and inexpensive labor force. The majority of industries in Russia mainly deal with obtaining natural resources for export rather than processing them and creating goods with added value for export as well as for domestic consumption. This approach exacerbates the existing situation in the economy even more. The development of value added industries and their domination in the economy represents one of the key elements that could significantly benefit to the Russian economy and establishing economic growth.

The natural resource that Russia is especially proud of is its vast and beautiful forests. Besides the source of fiber, forests always served the Russian people as source of food, shelter and spiritual inspiration. However, the Russian forest sector is very important both in a national and global context. Size and effect on global climate change, biodiversity and unique wildlife habitats determine its extremely high value. According to the study done by the World Bank, Russian forests represent 22 percent of the world’s forest resources. Their carbon storage capacity equals to 15 percent of the estimated global terrestrial capacity and 75 percent of total boreal forest capacity. Production is 21 percent of the world’s estimated standing timber volume and 10 percent of its timber production (World Bank, 1997). The contribution made by Russian forests in very important for the global environment and forest product supply. That is why it is necessary to establish sustainable development of the undisturbed resource and avoid the mistakes that were made in the Far East and European part of Russia as well as in the other parts of the world.

The former Soviet Union forest sector management practices were oriented on the ecosystem and landscape management approach, which are key elements of sustainable development. Nevertheless, loss of centralized control and the lack of a sound economy made the forest sector very poorly managed and economically insufficient.

**Current Situation in the Forest Industries**

Russian forest industries represent five percent of total industrial output of Russian economy (Nilsson, 1997). This output consists of timber and non-timber products. Timber products: construction materials (26.2 percent), packaging (24.7 percent), pulp and paper (24.0 percent), furniture making (20.9 percent) (Backman, 1998). Russian people traditionally consumed non-timber products in large volumes. These products are berries, mushrooms, resin, bark, stumps, twigs, hay, medical herbs, honey, nuts, and fur. For example, over 2000 species of higher plants with medicinal properties are growing in Russian forests. Some 600 of them could currently be used by the pharmaceutical industry, but only 200 of them are used today. The purchase of medical raw material for commercial organizations by the Russian Federal Forest Service during the 1980s was some 2500 tons. Another fact about the wild fruit and berry, for the period 1982-1990, the commercially accessible yearly resource of fruit and berries was estimated to be 580,000 tons. The corresponding commercial harvest was 55,000 tons and the harvest by private households was 125,000 tons per year (Nilsson, 1997).

Russian forest industries are very important at the international level. Russia is one of the major suppliers of wood products in international markets. Timber export is one of the major sources of the country’s hard currency income after exports of oil and gas.

Industrial development and specialization of Eastern and Western regions of Russia vary greatly. Western regions are characterized by the better development of the processing industries, while in Eastern regions and Far East raw materials are collected but not processed. These regional differences determine the export specialization of the regions. Forest enterprises located at the Western part of Russia export mainly processed timber to European countries. Japan, South Korea and U.S. import mainly logs from the eastern regions of Russia.

Forest industries were not an excluded from the market reforms. As soon as the State was not making overall plans for the country’s economy, each forest enterprise had to make decisions itself about raw material supply, types of goods to be produced, potential consumers and prices. These were absolutely new problems and most managers did not have any experience in solving them in a market-oriented economy. As a result, most companies became unprofitable and were surviving just because of the state subsidies, which quite often were used inappropriately. The majority of industries were stagnating and the volume of overall industrial production and consumption drastically decreased.

Since 1989, the production of forest products has fallen steadily, in many cases up to 40
percent, as economic activity in Russia declined. Until the collapse of the Soviet Union, the forest resources of Russia accounted for 10 percent of the world’s industrial roundwood harvest. Russia produced 15 percent of the world’s lumber output, but only 4 percent of the global paper and paperboard output and 7 percent of the pulp output. Russia accounted for a significant share of the international trade of industrial roundwood (27 percent), and lumber (17 percent), as well as a smaller share of traded pulp (7 percent) and paper and paperboard (4 percent). Only two years after the demise of the Soviet Union in 1991 Russia accounted for only 9 percent of the global industrial harvest, 9 percent of the world’s lumber production, 3 percent of its pulp production and 2 percent of its paper and paperboard production. Russia’s share of the international trade in forest products also declined (Backman, 1998).

The situation seems to be improving during last and this year. In 1999 the Russian economy experienced a significant upturn. 1999’s economic growth can be attributed to two factors: the rise in oil prices on the international market and the devaluation of the rouble in 1998. The increase in oil prices handed Russia a currency windfall (65 percent of the nation’s hard currency revenue comes from the sale of oil), while the devaluation of the rouble priced most imports out of market for Russian consumers, thus fueling Russian industrial output. As a result, the production of boards has increased by 25 percent, pulp – 27 percent, paper – 20 percent, carton – 35.7 percent (Expert, 2000). High prices for imported goods were also favorable; they allowed substitution of domestic goods for foreign ones, thus providing investment sources for Russian forest enterprises. In this respect the demand for domestically produced furniture, packaging materials, and paper products has increased. According to the report of the Minister of Finance, the year of 1999 was the first of positive financial results after the three last years of debt. Improvement in the forest industries is also indicated by the decreasing number of non-profitable enterprises from 68 percent in 1998 to 51 percent in 1999. Besides, the volume of investments in the forest industries has increased two times, and 82 percent of the investments were from the enterprises’ own funds (Expert, 2000). These are very promising and encouraging trends, but the long-term fundamental restructuring of Russia’s forest industry should be done in order to overcome many difficulties.

One of the main problems that create many consequences is lack of investments in forest industries. Even under the central planning of the former Soviet Union the forest industry had low priority. The priority of capital investments was given to the logging rather than the pulp and paper or the wood industries. The centralized capital investments in forest industries declined from 80 percent in 1980 to 5 percent in 1995. (World Bank, 1997). Few private investors do any long-term investments in forest industries development at present due to the high level of risk and economic uncertainty. The collapse of domestic markets exacerbates the financial situation of the forest enterprises. Besides, the Russian forest sector consists of small-scale manufacturing and harvesting organizations. In the new economy these small enterprises have a very weak financial basis to withstand all the changes and challenges of the market economy. They do not have sufficient funds for development and upgrading their level of technologies and equipment.

The capital enables Russian wood industries to produce competitive and marketable products and capitalize incomes for future development. Only 12 percent of forest products manufactured in 1986 met world standards, while 57 percent met domestic standards (Backman, 1998). Since 1986, nothing was done to improve the situation and the majority of forest products manufactured in Russia are not marketable internationally or even domestically. For example, the export market will be closed to the majority of local pulp and paper combines that are unable to replace outdated equipment. In addition, pulp whitening technology that uses chlorine, and is practiced in Russia, has received criticism from environmental organizations. It is expected that the import of paper and cardboard made from such pulp will be forbidden in all European countries by 2003.

The old manufacturing equipment is especially noticeable in the plywood, reconstituted panel, and the paper industries, where the average age of the equipment varies from 17 to 24 years. Seventy percent of the manufacturing equipment in the plywood sector is older than 10 years, with 50 percent older than 20 years. The situation is the same in the other forest industries (Backman, 1998).

The lack of modern equipment and the absence of real financial stimulus for the workers lead to the inefficient utilization of available capacities and resources. The capacity utilization in the industry is between 35 and 55 percent with high volumes of harvesting and processing waste. It is necessary to provide investments for the new equipment and technologies, because it is difficult to turn the situation in the positive direction with such levels of utilization rates. Logging enterprises experience all of these difficulties and this further worsens the quality and volume of output. It creates a deficit of fiber for the processing enterprises and complicates the situation even more. Besides, since 1975 the Russian forest sector has not experienced any real sophistication in its environmental protection. Improvement of the economy and industry will increase the economic stability but reduce the quality of the environment, which is crucial in a global scale.
The current problem of Russian forest industries is access to vast resources but an inability to utilize them effectively due to the lack of financial funds and good management practices. That is why the participation of the foreign investors is very important.

**Forest resources**

There are two major groups of timber species in Russian forests: coniferous (508 million ha, or 72 percent from the total stocked area), and deciduous (130 million ha, 20 percent).

Predominant coniferous species are pine (15 percent of total stocked forest land), spruce (11 percent), true fir (2 percent), larch (38 percent), cedar (5 percent). Predominant deciduous species are birch (14 percent of total stocked forest land), aspen (3 percent), and oak (1 percent) (Federal Forest Service of Russia).

The other unique feature of Russian forests is their age. These forests are among the last old growth forests in the world, which have not been disturbed by modern human and industrial activities. Mature and overmaturity stands are situated mainly in Asian part of Russia and are prevailing.

The forest sector resources provide 540 m³ of allowable annual cut with the annual growth of some 1 billion m³ (Backman, 1998). However, this volume is not realizable by the forest industry at the present due to uses of the forest that conflict with timber extraction, the absence of transportation network, inappropriate harvesting technology and low capacities of forest enterprises.

**Possibilities for Foreign Investors**

These enormous timber resources and changes in the Russian economy provide excellent opportunities for the foreign investors. Growing world population and its increasing demands as well as overexploitation and extinction of forests at many parts of the world determine the high value and demand for forest products worldwide. In this situation Russian may become world’s major supplier of fiber and forest products in the nearby future.

The economic growth of Russian economy has already resulted in the increase of the forest industry output (see above). The domestic demand on forest products is forecasted to have a strong increase in a few next years. It is also possible that there will be a strong increase in demand over time for lumber and panels in Kazakhstan and Central Asian republics. These republics will stimulate the development of market for the forest sectors located in East and West Siberia.

Domestic demand requires almost two-thirds of the fiber supply produced in Russia and up to 75-80 percent of the output of various manufactured products; export markets can be expected to play an increasing role. Eastern Russian enterprises (the Far East) will concentrate on markets in the Pacific Rim including Japan and South Korea. Recovering markets in China collapsed in the early 1990s, but are forecasted to increase the volumes of forest products trade. Besides, the Russian and Chinese governments are working together to establish bilateral cooperation and trade between the two countries.

The development of European republics of the former USSR will also result in fiber shortages within two decades (Nilsson, 1997). A forest sector located in European Russia would be well positioned to have those regions as market opportunities in addition to the traditional European market.

Russian forest industry will expand its share at the domestic and international markets providing excellent opportunities for investors at the markets of equipment for timber-harvesting, wood-working, fire-detection and transportation. However, before achieving any results they would have to overcome significant barriers.
The Major Problems for Foreign Investors

The problems that foreign investors will deal with are the following:

- Low prices of forest products. Prices for forest products remain low due to the low level of wages and bankrupt status of major consumers. High tariffs on power supply and transportation represent the biggest part of the production cost. This makes marketing tools difficult to implement.
- Ineffective taxation system. The Russian Tax system is very complicated and not supportive for business development. It is not rare that all profits are paid as taxes and nothing is left for reinvestment.
- Unstable political policy and frequent changes in the government, which create high risk and uncertainty.
- Small size of enterprises. It makes them more flexible in the changing market, but it is more difficult for enterprises of this size to find necessary funds for growth.
- Unclear property rights. There is no official regulation that would clear forest property rights as well as establish rights of private owners and the State. In 1996, there were 3348 forest industry enterprises; and by January 1996, 3194 had been privatized (World Bank, 1997). However, the State has about 20 or 30 percent of their shares and this still enables it to influence key decisions.
- Lack of transparency in the legislation.
- Illiquidity of Russian companies and non-payment by customers. Majority of transactions between Russian enterprises is barter exchange. About 1/5 of all customers are unable to pay for goods or provide alternative goods in exchange. As a result of a policy that does not devote enough time for careful choosing of customers, a company could get bankrupt very quickly.
- Infrastructure deficiencies. The forest logging and fiber processing enterprises have a remote location from transportation networks and markets. The banking system has very limited number of operations. There is lack of high-tech equipment. At the same time, unstable power supply disrupts equipment.
- Lack of reliable data on resources, ownership, markets, prices, products and customers. More over, available data is often in a format that is difficult to understand and use for foreign specialists.
- Unfamiliarity with United States’ products. Forest logging and processing equipment comes mainly from European countries, while there are very few American models and people do not know about them. It makes their promotion very expensive and time consuming
- Crime and corruption at each level of administration. In many cases, more than 50 percent of a company’s gross profit margin could be paid out in bribes, local tariffs or kickbacks.
- A multilevel bureaucracy inherited from the old Soviet system, slows business and obtaining even one signature may require several weeks or even months.
- Cultural and language barriers.
- Different business practices. For Russian people, personal relationships with partners are very important, while for American businessmen it is not always so. Different attitude about time and negotiation styles could make parties disagree on very unimportant matters and prevent from dealing with each other forever.

It may seem that it is impossible to be successful in making business in Russia. It is true, that the risk of investments is very high, especially when political and economical situations are changing so frequently as in Russia today. However, in order to insure stable position in the markets, foreign forest companies should think about the potential of Russian enterprises, the volume of growing global demand on forest products, and the utility of expansion in the Russian industries.

How to Invest in Russia and Be Successful

Despite the difficulties of investing, there are some factors that make investing in Russia more attractive:

- Abundance of product niches in the Russian markets. It will be necessary to introduce the technologies with low cost for their development. This could prolong the life cycle of the products that are already unpopular in the West.
- Great support from the regional and federal authorities, which provide tax relief and some privileges.
- Highly educated and low cost labor.
- Unique geographic position, which allows to cooperate with Eastern and Western countries.

These advantages do not solve the existing problems and do not make the current level of risk lower. The following strategies for the long-term investments in the Russian forest industry could be recommended.

1. Low risk investment. The fact that it is too early to make any direct investments into Russian industries right now should be admitted. However this possibility should be included into the plan of a long-term development of the company and its markets. Any possibilities to become familiar with the Russian forest industries should be used, including learning about Russian culture and business practices and keeping up with the current events are recommended.

2. Medium risk investment. Nowadays there is an excellent opportunity to establish a market of
second-hand forest equipment. Russian companies will be able to pay its price and get acquainted with the modern technologies. Besides, these enterprises could serve as demonstration stations for other Russian forest enterprises, because for Russian people, direct marketing is the most effective means of new product promotion. This approach will provide the base for the future expansion when situation in Russia stabilizes. This strategy will provide a competitive advantage at the time when the Russian market will have low investment risk, enormous opportunities and high number of businesses desiring to utilize them.

3. High risk investment. Another good way to start a business in Russia is to create the joint ventures with Russian businessmen. Joint ventures are very popular in Russia, because there is a code of joint ventures that states the legal framework for those enterprises and make it more predictable. When creating joint ventures, the Russian side provides a building, labor, equipment and deals with the bureaucracy; the American side provides investments and managerial personnel.

In any situation when dealing with Russian enterprises in order to ensure themselves and to protect from uncertainty and challenges of the unknown country, foreign investors should involve agencies, which are available through the American embassy in Russia and many other government and non-government organizations, both American and Russian.

References:
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