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Introduction

This dissertation research project examines three processes that profoundly reshaped the post-Soviet economic space: 1) the stagnation of post-Soviet enterprises and the emergence of industry-led financial-industrial groups; 2) the emergence of private banking sector and the development of bank-led financial-industrial groups and the 3) restructuring of the oil and gas sector and the emergence of the raw-material financial industrial groups (known by their Russian acronym—FPGs—finantsovo-promyshlenye grupy).

Alike the majority of post-Soviet enterprises, most industry-led FPGs stagnated in the course of the reforms. The bank-led and the raw-material FPGs grew into Russia's largest oligopolies until 1998 when the majority of the bank-led FPGs collapsed as a result of the 1998 financial crisis. The raw-material FPGs recovered from the crisis and continue to dominate Russia's economic landscape. The dissertation examines the development of the three different types of FPGs and their respective industries since the beginning of the reforms up to the 1998 financial collapse with the objective of showing how their internal developmental capacities in interaction with specific state policies shaped their unique developmental trajectories.

The dissertation seeks to explain how specific state policies shaped the construction and development of the three groups of FPGs together with their internal capacities for adaptation and market restructuring. It shows the interplay between the presence or absence of internal resources available to the three groups of FPGs and external resources provided by the state, and the effect of such interplay on stagnation, development and collapse of these FPGs. The dissertation explores variables and processes that contributed to the adoption of specific reform policies by the Russian state and examines how these policies changed the availability of resources for post-Soviet enterprises, banks and raw-material companies and for the FPGs that emerged within these sectors. These variables include the dominant reform ideology, the nature of domestic political coalitions and incentives and pressures of foreign financial institutions and governments. The dissertation explains how these variables interacted to promote the adoption of specific reform policies which were adverse to supporting post-Soviet industries and industry-led FPGs but directly and indirectly promoted the boom of the banking sector and the growth of bank-led and raw-material FPGs. The research explores variables such as structures, histories, and internal resources of enterprises, banks and raw-material companies to show the relative dependency of these organizations and their FPGs on the provision of state resources and means of political support.

The dissertation begins by outlining the formation and adoption of reforms policies by the Gorbachev and the Yeltsin governments and shows how these policies affected the post-Soviet industrial enterprises and industry-led FPGs. It argues that the dominant laissez-faire ideology, pressures and incentives of the WB and the IMF and the ruling state coalition foreclosed options for the state to support the restructuring of post-Soviet industries and industry led FPGs. In combination with the lack of internal resources of these organizations and the nature of the domestic financial sector, these policies resulted in an overall stagnation of post-Soviet industries and industry-led FPGs. This in turn led to the weakening of the resource base of the Russian state and its increasing dependence on large domestic banks and IMF loans. The story of the post-Soviet enterprises and the industry-led FPGs is thus a story of failure of state policies and failure of constructive adaptation of post-Soviet enterprises to the environment created by these policies, with dire consequences for the Russian state, economy and society.

The story of banks and bank-led FPGs is a story of boom and bust. It shows that the initial policies of the Russian state provided resources for the banking sector and led to an inflation-driven boom of Russian banks. The state developed a close, interdependent relationship with a few large Moscow banks that emerged in the course of the banking boom. It traded state financial and political resources for financial and political support of these banks which also became the founders of bank-led FPGs. However, this collaboration between the state and the banks was divorced from the rest of the economy and based on unsustainable financial loops and transfers of capital between the state, the banks and foreign lenders, culminating in the 1998 financial collapse that all but whipped out the new Russian banking sector. The research explores the banks' dependence on the state and the effects of the decline of the state resource base on these banks and their FPGs. The decline is shown to be the result of the ongoing crisis of the industrial sector and the sudden withdrawal of foreign capital which was another important external resource for both the bank-led FPGs and the Russian state.

The resource-poor industry-led FPGs never gained access to state support or to foreign or domestic capital. The bank-led groups enjoyed such access temporarily but were unable to maintain it. The raw-material FPGs had close linkages to the Russian state but did not depend on them for their survival. Rather, they depended on linkages to foreign markets. These linkages, created on the basis of their internal resources and supportive state policies, helped them to survive in spite of the decline of the Russian state and the domestic economy and to weather the 1998 collapse of Russia's banking sector. Some of them developed into large, multi-national raw-material FPGs that loom high above the remnants of the post-Soviet economy and the banking system and exercise a considerable power over the state. Their survival is not surprising although it testifies not about the success of state economic policies but rather about the world's need for energy and raw materials.

The dissertation presents an important result for sociological accounts of capitalist development in Russia. It provides strong evidence against the view that a liberal, market-oriented set of policies will necessarily result in the emergence of a broadly-based, balanced economy and circumstances for the maintenance of a broad middle class. Instead, it points towards the limitations of 'reforms' being driven by policies that prevented the majority of economic organizations from adapting to the new economic environment leading to a broad and deep economic decline that weakened the state and promoted its dependence on unsustainable financial flows and domestic and foreign capital.

The research contributes to several literatures that study change in organizations and their economic and political environments. It focuses on the study of system-level institutional change that involves a major shift in ideology, in state and legal institutions and in economic policies, showing their effect on changes of economic organizations and their environment. It seeks to supplement existing research on institutional and organizational change which does not pay adequate attention to organizational environments and their political construction and focuses primarily on internal characteristics of organizations. The dissertation draws out the relationship between internal characteristics of organization and environmental parameters and processes. The focal point of the research is to broaden the concept by of a firm or economic organization by focusing on the space of engagement of organizations and environmental institutions such as the state and markets. This space is shown to consist of key sets of relationships and resource flows and includes organizational clusters such as FPGs and relationships within these clusters as well as relationships of organizations and organizational clusters to other organizations and institutions such as the state and domestic and international markets.

The Rise and Fall of Financial-Industrial Groups: The Genesis of Russian Capitalism
Chapter 3: Industry-led FPGs

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3. Industry-led FPGs

3.1 Variables and Dynamics

The objective of this chapter is to capture the profile of industry-led FPGs and distinguish them from the bank-led and the raw-material groups. The chapter provides a typology of industry-led FPGs, explains the motivations for their formation and their internal structural ties. Secondly, the research examines the political and economic environment of industry-led FPGs and identifies reasons why these FPGs were not very successful in adapting to the new environment and becoming profitable, market-based conglomerates. The research identifies three groups of variables that help to explain the failure of market restructuring and adaptation of industry-led FPGs: their structural, historical foundations including the lack of internal resources and capacities for market adaptation; state policies towards industry-led FPGs and the banking sector; and the relationship between Russian banks and industry-led FPGs. The dissertation explores these groups of variables and explains their interaction and effects on the development of industry-led FPGs.

The *historical, structural characteristics and resources* of different industry-led FPGs, most specifically the sectoral affiliation of their member enterprises, directly shaped their capacities for restructuring and market adaptation. The industry-led FPGs were formed by post-Soviet enterprises from a variety of sectors: light industry, construction, military production, automobiles, textiles, etc. All of these enterprises were constructed during the Soviet period and were deeply affected by the breakdown of central planning and the withdrawal of the state from investment, distribution and planning of their production. In order to compete with foreign imports through cutting production costs and increasing quality, these enterprises invariably required extensive technological and organizational restructuring. For that they needed resources which most of them could not generate internally. The formation of industry-led FPGs was an attempt of post-Soviet enterprises to mediate the lack of internal resources by pooling resources together with other organizations, obtaining support from the state and forming linkages to the financial sector. Industry-led FPGs hoped to participate in state investment programs, to establish linkages to banks, to attract investors and to strengthen their internal organization and rationalize resource flows among member enterprises. As the research explains, industry-led FPGs were in general unable to accomplish their objective of attracting external resources and improving the conditions of member organizations.

The difficulties of FPGs to generate external resources can be explained by *the direction of state economic policies*. State policy-making was shaped by laissez faire doctrine embraced by the leading governmental coalition and advised by foreign governments and financial institutions. As explained in chapter 2, the economic policies of the Yeltsin government were directed towards privatization and economic liberalization and the government was not focused on supporting the restructuring processes of the privatized post-Soviet industries or industry-led FPGs. The resulting state policies towards FPGs prevented the flow of external, state resources into industry-led FPGs.

Neither did state policies promote the development of linkages between industry-led FPGs and the banking sector. The *absence of linkages between large banks and industry-led FPGs* was yet another factor that blocked the flow of external resources for restructuring and raised the importance of internal resources. The banking sector was developing separate from the industrial sector and the new, private banks that could provide investment for the industry-led FPGs and post-Soviet industries were instead generating revenues through the inflow of cheap state credits

and currency speculations¹. The member banks of industry-led FPGs were in general small, undercapitalized, and demonstrated low investment activity into FPGs. The absence of domestic investment into FPGs was combined with a low level of foreign investment. Foreign investment into Russia was unsubstantial and oriented towards raw-material producers and the growing financial sector as opposed to post-Soviet industries and industry-led FPGs. The investment into FPGs declined even further after the collapse of the banking sector in 1998. Consequently, the majority of industry-led FPGs continued to suffer from the lack of internal resources, connections to domestic or foreign investors, and means of state support. This resulted in their stagnation in the course of the reforms which in turn deeply affected the resource base of the Russian state² and its capacity to support bank-led FPGs.

3.2 Officially Registered and Industry-Led FPGs

As indicated in previous chapters, some FPGs registered with the state while others remained “de facto” as opposed to “de jure” FPGs³ and did not pursue official registration. With one or two exceptions, the registered FPGs were industry-led. The bank-led and raw-material groups were as a rule non-registered, “de facto” FPGs. The industry-led FPGs tried to register to formalize their linkages to the state and become eligible for state support that was promised to registered FPGs in the FPG legislation. The bank-led and the raw-material FPGs had personalistic ties to various governmental groupings and internal financial resources that made them less swayed by promises of formal state support. With the exception of the Oneksimbank conglomerate which registered with the state on the basis of special presidential decree, the bank-led and raw-material FPGs did not find it necessary to undergo formal registration, especially after it became clear that the state will not act upon its promises of support.

The issue of registered and non-registered FPGs is important for the comparison of the different groups and data collection on industry-led FPGs. While it is easy to identify bank-led and raw-material FPGs due to their limited number, size and status (there were no more than a dozen organizations in each of the two categories and all of them counted among the largest and most powerful Russian businesses), it is difficult to categorize industry-led FPGs which were numerous and very diverse. In order to access information on industry-led FPGs that captures some of their main characteristics, I focus on the sub-group of registered industry-led FPGs.

The data and information on the registered FPGs I collected in Russia is used in this chapter. The data includes primarily statistics collected by governmental agencies and research institutes. It is supported by information I obtained through interviewing governmental officials, researchers, journalists and bankers who were directly involved with industry-led FPGs. Although

¹ The banks were not prepared and willing to undertake long-term investment into post-Soviet industries, including industry-led FPGs, for reasons that will be explained in the chapter on Russian banks.

² The revenue base of the budget fell from 160 million rubles in 1990 to an equivalent in constant prices to just 93 billion rubles in 1998. The increasing indebtedness of the Russian state was directly related to the decline of the economy and Russian enterprises. The lifting of many foreign trade barriers that accompanied trade liberalization, growing prices of inputs, high interest rates and production costs placed limits on the ability of Russian enterprises to adapt to the emerging market regime. The enterprises had no investment for restructuring and could not compete with imports. As a result their revenues were falling and their debt was increasing. Falling company profits meant that the enterprises were paying less and less tax which translated into a decrease of revenues for the government. In early 1993 the gross volume of tax non-payments equaled 0.4% of Russia's GDP. On July 1 1998 this figure already amounted to more than 19% of GDP. In late 1996 only 16.5% of all Russian enterprises and organizations were paying their taxes on time and in full, while 33.8% were not paying at all. In the first six months of 1998, just a few weeks before the Russian government had publicly announced that it could no longer continue to pay off its debts, the state managed to collect less than half of the planned tax levels (Tikhomirov, 2000:67).

³ This distinction is commonly used in Russian literature on FPGs.

the data offers the best available information on the group of industry-led FPGs, it is limited in the following way. First, it does not provide data on those industry-led FPGs that did not register with the state. This may not be a substantial drawback given the research objective of providing general information about the group of industry-led FPGs for comparative purposes. Moreover, according to most researchers and business analysts, the group of non-registered, industry-led FPGs is numerous but not necessarily different from the registered group. Dementev and other FPG researchers assert that it may be unproductive trying to separate registered, industry-led FPGs from other forms of integrated, industry-led, FPG-like organizations because the registration of the industry-led FPGs was mostly formal, motivated by the hope of receiving governmental assistance on the part of the FPG members (V.Dementev, 2000). In reality the registered FPGs include a variety of integrated business groups that were united on the basis of diverse interests and used diverse mechanisms of coordination, decision-making and economic cooperation. These characteristics apply to unregistered agglomerations as well (V.Lenskii, A.Cvetkov, 1999:96). The difference between the registered and unregistered industry-led FPGs is relatively unimportant especially in the view of the striking differences between industry-led FPGs, registered or non-registered, and the bank-led and raw-material FPGs the research seeks to outline. None of the industry-led FPGs, whether it would be a registered FPG or a non-registered conglomerate, reached economic power or political status comparable to the bank-led and raw-material FPGs.

The second limitation stems from the fact that one of the bank-led FPGs (the “Interross” group) did register a portion of its industrial holding with the state and some of the general statistics available on the registered FPGs include information on the Interross group. I try to eliminate this distortion by using data that exclude this bank-led holding⁴. In spite of these limitations, the information available in this chapter offers a portrait of the industry-led FPGs that clearly depicts their distinction from the bank-led and the raw-material groups in terms of the evaluative criteria used in the dissertation.

The registered FPGs surveyed in this chapter started to form in 1993 after the government decided to assert control over the agglomerative processes occurring within the economy by passing a law on FPGs. According to the official definition that is part of the law, “A financial-industrial group is an aggregate of legal actors including leading and daughter companies which fully or partially combined their material and non-material assets on the basis of a contract about the formation of a financial-industrial group for the purpose of technological or economic integration that is to serve the realization of investment and other projects and programs directed towards the increase of competitiveness or expansion of markets for production or services, increase in production efficiency and the creation of jobs. It is obligatory that a FPG includes organizations that operate in the sphere of production of goods or services, and also banks and other credit institutions.” (V.Lenskii, A.Cvetkov, 1999:100; V. Dementev, 2000:99).

In 1993 there was only one FPG which included 20 industrial enterprises and one credit-financial institution. In 1994 there were seven groups (150 enterprises and 14 financial institutions). In 1995 there were 27 groups (274 enterprises and 51 financial institutions), in 1996 - 46 (710 - 95) and in 1997 - 72 (1121 - 154). By May 1998 there were 85 FPGs (V. Dementev, 2000:99) and in September 1999 there were 87 (A.Voitenko, 1999:22). The 87 official, registered FPGs included over 1200 industrial enterprises and around 100 financial institutions (most of them small and medium banks)⁵.

⁴ The “Interross” group will analyzed in detail in the chapter on bank-led FPGs.

⁵ The decline in the number of FPG banks is an outcome of the 1998 financial crisis.

Year	1993	1994	1995	1996	1997	1998	1999
# of FPGs	1	7	27	46	72	85	87
# of banks in FPGs	1	14	51	95	154	162	100
# of enterprises in FPGs	20	150	274	710	1121	1178	1200

Around 5 million people worked for FPGs. The smallest FPG had 5 000 workers and the largest had over 300 000. According to (V.Dementev, 2000:114) out of 200 largest Russian (i.e. post-Soviet) enterprises, 50 became members of official FPGs.

The acceleration in the formation of registered FPGs between 1995 and 1997 is related to the adoption of laws on FPGs in 1995 and 1996 that included a provision for governmental support for registered FPGs (V.Lenskii, A.Cvetkov, 1999:100). Enterprises that were interested in some form of integration or had already formed non-registered associations or conglomerates hoped that their registration as FPGs will increase their qualification for receiving governmental assistance. As the research shows, their need for governmental support was motivated by their low internal sources of financing and lacking or weak ties to large Russian banks. Once it became clear that the government is unlikely to provide any assistance to registered FPGs some of these FPGs showed a lack of interest in maintaining their official FPG status and failed to re-register in accordance with the law on FPGs⁶.

3.3 Path-Dependent Organizational Structure as a Foundation for Industry-led FPGs

The development of FPGs was based upon pre-existing structural, technological and territorial linkages among member enterprises. With the exception of six FPGs that were formed by federal and regional governments (#2, V.Lenskii, A.Cvetkov, 1999 , 83), the majority of FPGs developed through the initiative of groups of industrial enterprises that had historical ties with one another—whether sectoral, technological, regional or production or market-based. The enterprises joined into FPGs on the basis of these ties and some common developmental objective stemming from their shared problems and conditions.⁷

For example, a number of FPGs were formed on the basis of territorial ties. 60% of registered, industry-led FPGs were regional and included enterprises within a single region. 25% of registered FPGs were interregional and included enterprises from multiple regions. 15% of registered FPGs were transnational and included enterprises located in various states of the former Soviet Union (A.Voitenko, 1999:22). Regional FPGs were often formed in a collaboration with local governments and were expected to serve regional development, while transnational FPGs were expected to strengthen economic cooperation among the former Soviet republics.

Territorial Ties	Regional FPGs	Interregional FPGs	Transnational FPGs
% of registered FPGs	60%	25%	15%

In terms of structural and technological ties, sectoral affiliation was an important foundation for the development of FPGs. Sectoral division of registered FPGs was the following:

⁶ Groups that did not undergo re-registration include FPGs "Sokol," "Dragotcenosti Urala," "Ruschim," "Obedinenaia Promyshlennostroitelnaia Compania," "Magnitogorskaia Stal," "Sviatogor," "Primorie" and others (#2, V.Lenskii, A.Cvetkov, 1999 , 100).

⁷ That distinguished them from bank-led FPGs that were formed on the basis of property ties—the consolidation of shares of enterprises through loans-for-shares auctions, investment contests and acquisitions, and were motivated by ambitions to expand economically and to gain political power.

chemical industry—8 FPGs, metallurgy—6 FPGs, electronics—6 FPGs, avia construction—4 FPGs, construction—3 FPGs, automobile industry—3 FPGs, defense industry—5 FPGs, light industry—4 FPGs... (V. Dementev, 1998:8).

Sector	chemical industry	metallurgy	electronics	avia construction	construction	automobile industry	defense industry	light industry
# of registered FPGs (1998)	8	6	6	4	3	3	5	4

Some authors also divide FPGs according to the direction of their ties into vertical and horizontal FPGs and conglomerates. According to V.Lenskii and A.Cvetkov (1999:100), 36% of registered, industry-led FPGs were vertically integrated groups, 60% were horizontal groups and 4% were conglomerates: large, diversified groups governed by a single, central organization—a bank or an industrial company—and integrated through a combination of horizontal and vertical linkages.

3.3.1 Sectoral FPGs

The majority (around 70%) of registered, industry-led FPGs were created on sectoral basis, often through the initiative of leading enterprises within a specific sector (A.Voitenko, 1999:26). In 1989 the sectoral distribution of FPGs was the following:

Sector	Machine building	Chemicals and petro-chemicals	Agriculture	Metallurgy	Building and Construction
% of registered FPGs	15%	11%	14%	12%	8%

Some of the sectoral FPGs counted among the largest organizations in their sectors. For example, the "Volzsko-Kamskaia" FPG produced around 10% of the production of the automobile industry, the "Ruschim" FPG represented around 4% of the production of the chemical industry and the "Nosta-Truby-Gas" FPG produced around 6% of ferrous metallurgy. About 30% of FPGs, such as "Soiuzagroprom" and "Titul," were multi-sectoral and included enterprises from three to four sectors (A.Voitenko, 1999:26).

In many cases, the central position within an industrial FPG has been occupied by the founding enterprise: a large industrial producer that often became the leading organization in the group. For example, a major automobile producer "Nizhegorodskie Avtomobili" formed the "Nizhegorodskie Avtomobili" FPG, the "Magnitogorskii Metallurgicheskii Kombinat" formed the "Magnitogorskaia Stal" FPG, and two major automakers "VAZ" and "KamAZ" formed the "Volzhsko-Kamskaia" FPG (V.Lenskii, A.Cvetkov, 1999:83). These large enterprises tried to strengthen and coordinate upstream and downstream linkages with their suppliers and buyers and facilitated their agglomeration into FPGs.

As an example of a sectoral FPG, the "Magnitogorskaia Stal" FPG unites 18 enterprises and organizations that employ over 260 000 workers. These enterprises are linked together through a technological chain—the mining of iron ore, metallurgy, processing of scrap iron and production of cars and technical equipment. The founding enterprise, Magnitogorskii Metallurgicheskii Kombinat (MMK) contributed 65.13% of the basic capital of the FPG central company. The main technological linkages include the deliveries of iron ore, iron ore concentrates and equipment from the group members to the MMK and also cooperative ties between the

MMK and the buyers of its production (V.Lenskii, A.Cvetkov, 1999:87).

Another metallurgical FPG is the "Obedineniia Gorno-Metallurgicheskaia Kompania." It was created by some of Russia's largest metallurgical enterprises: AO "Novolipetskii Metalurgicheski Kombinat," AO "Cheliabinskii Metalurgicheski Zavod" and "Magnitogorski Kalibrovchny Zavod." The FPG is formed on the basis of vertical linkages that start with mining and initial processing of coal and ore and encompass the production of steel, its transportation and sale. The group benefits from the mining enterprises being close to the metallurgical plants and also from a geographically advantageous position of the group's port.

The automobile industry is another sector that features large FPGs. As most other sectors, it has suffered from a lack of investment, turnover capital (oborotnye sredstva) and falling production and demand. The "Nizhegorodskie Avtomobili" producer has tried to overcome some of these difficulties by forming the "Nizhegorodskie Avtomobili" FPG, which is one of the largest and well-known industry-led FPG. The group consists of 31 organizations and 22 of these are enterprises closely connected to AO "GAZ" which is the leading enterprise of the group.

The FPG is engaged in the coordination of investment, production and price policy and it managed to increase production by approximately 5% (each year) in 1995, 1996 and 1997. According to V.Lenskii and A.Cvetkov, (1999:151), this was possible through the establishment of long-term cooperation between the producers and the buyers of parts and equipment. Both producers and buyers tried to develop a price policy that would help them to prevent increases in the price of materials and parts and thus lower the price of final production. This helped to stabilize the prices of passenger cars in 1996 and 1997. The FPG also has developed dealership networks in over 200 cities of the RSFSR. However, the group continues to experience difficulties with selling its production similar to other automakers.

The "Nizhegorodskie Avtomobili" FPG is both sectoral and transnational and includes enterprises from non-Russian countries—Ukraine, Belorussia, Kyrgyzstan and Latvia. For example, AO "RAF" in Latvia produces assembly parts for AO "GAZ" located in Nizhni Novgorod, Russia, and obtains from it chassis and finished and assembly parts. The Ukraine members of the FPG (PO "Belocerkovshina" and "Chernigovskii Zavod") deliver to the head enterprise of the FPG (the AO "GAZ") tires and cardan shafts. And AO "Kyrgyzskii Avtosborovchny Zavod" of Kyrgyzstan delivers the FPG cooling radiators and obtains chassis in exchange. (V.Lenskii, A.Cvetkov, 1999:169). According to V.Lenskii and A.Cvetkov, (1999:152), the FPG could possibly control a large share of the Russian automobile market through creating a horizontal conglomerate with other enterprises that produce parts and other means of transportation.

The "Prompribor" is another example of a sectoral FPG. It includes some of the largest Russian producers of equipment for controlling and regulating technological processes and for recording energy usage. It was formed around a developmental program "The design of a new generation of machinery for recording and control of energy usage and the development of its production." This program was developed in 1994 but the government was unable to provide sufficient financing for its realization. According to V.Lenskii and A.Cvetkov, (1999:157:169) the "Prompribor" FPG and other FPGs in machine-building and other severely depressed industrial sectors do not have many chances to overcome the sector-wide economic decline.

According to O.Velicko, (1999:173), it is conceivable that the FPGs formed on the basis of large, vertically integrated production-technological complexes in sectors that have some solvable demand and export potential such as FPGs in the petro-chemical industry and metallurgy may evolve into holdings. Some other FPGs created on the basis of long-term cooperative ties among enterprises and formed around a base enterprise (such as "Nizhegorodskie Avtomobili") may evolve into highly integrated concerns. Those FPGs that include enterprises from a single sector with a low level of profitability which does not allow for internal financing and that do not

include large Russian banks will have difficulties to survive (O.Velicko, 1999:175).

Vertical FPGs

According to A.Voitenko, (1999:25), around 36% of registered FPGs were vertically organized on the basis of technological-production linkages. Many of the vertical groups were formed to preserve historical technological or business ties of enterprises engaged in various stages of production of a specific product. These FPGs united enterprises that produced a specific raw material with enterprises engaged in processing of this material and using it to produce and sell a specific product. 44% of the vertically integrated groups were formed around such technological-production and distribution chains. Some of these groups were formed with the vision to control the production and distribution cycle from a single center such as a large production-technological complex or a FPG central company.

An example of a vertical FPG, the "Nosta-Trugy-Gas" FPG includes producers and consumers of steel and pipes. The formation of this FPG was motivated by an effort to unite the productive and financial capacities of these enterprises to produce pipes of increased durability and resistance to low temperatures which would be comparable in quality to their foreign analogues and would satisfy the needs of the domestic energy sector.

Another example is the "Obedinenaia Gorno-Metalurgicheskaia Kompania" FPG which is both a sectoral and a vertical FPG. It is formed around cooperative ties among coal-mining enterprises, steel and iron ore producers, transporters and distributors. The group includes raw-material producers (OAO "Centralnaia Obogatitelnaia Fabrika "Kuzbasskaia" and OAO "Bakalaiskoe Rudoupravlenie") involved in mining and initial processing of coal and other raw materials that are used to produce iron ore and steel. These partially processed products are delivered to processing enterprises (OAO "Novolipetskii Metalurgicheskii Kombinat," OAO "Cheliabinskii Metallurgicheskii Kombinat" and OAO "Magnitogorskii Kalibrovochnyi Zavod") where the production of steel and other finished metals takes place. Then these finished products are transported through the FPG transporting enterprises (OAO "Nachodkinskii Morskoi Torgovyi Port"). The FPG also includes a medium-sized commercial bank ("Bank Sodeistvia Privatizatsii") and a commercial enterprise (AOZT (closed joint stock company) "Lait-M").

Similar to sectoral FPGs, some vertical FPGs were more centralized and formed around a single, relatively large industrial enterprise which determined the strategy and economic policy for other group members. According to V.Lenskii and A.Cvetkov (1999:103), 56% of the vertical FPGs were created around a central company. The centrally controlled vertical FPGs included the FPG "Nizhegorodskie Avtomobili," FPG "Tulskii Promyslenik," FPG "Morskaia Tekhnika," FPG "Neftiximprom" and FPG "Kontur" (V.Lenskii, A.Cvetkov, 1999:92). The FPG "Tulskii Promyslenik" for example represents a diversified group that is led by AO "Tulacermet." Practically all industrial enterprises—members of the FPG—either deliver their production to "Tulacermet" or receive from it raw materials and other resources. At the same time "Tulacermet" functions as a shareholding center and controls enterprises such as "Iubskomet" and the bank "Tulskii Promyslenik." The FPG unites enterprises from different sectors (production, trade, transport, services and financial institutions) that are grouped into a concern (V.Lenskii, A.Cvetkov, 1999:92).

Horizontal FPGs

Another example are horizontal FPGs that combine several enterprises that produce diverse types of production or the same product for a specific market. These FPGs resemble associations or cartels and are interested in controlling prices, dividing markets and agreeing on a volume of production. The majority (60%) of all registered, industry-led FPGs were horizontal, regional groups focused on maintaining control over regional market and on stabilizing prices

(V.Lenskii, A.Cvetkov, 1999:102).

FPGs "Zhilishe" and "Soiuzagromprom" are examples of this type of organization. The "Zhilishe" FPG was formed by the government to organize production and sales of building materials to contractors. It includes a variety of producers of building materials, insulations, polymers, linoleum, wall-papers, paints, cables and other materials. However, the group activities have not been organized due to the lack of investment programs. These programs were supposed to be directed towards organizing the production of new materials, building of houses, replacement of old technologies and development and installation of energy-saving technologies. However, as in the case of many registered FPGs, it was unclear how these activities are to be funded. The government and the banks failed to provide funds for these programs (V.Lenskii, A.Cvetkov, 1999:102).

Regional FPGs

Based on spatial linkages among their members, the registered, industry-led FPGs were regional, multi-regional or transnational. 15% of registered, industry-led FPGs were transnational groups, 25% were interregional and 60% were regional groups (A.Voitenko, 1999:22). Regional FPGs include for example FPGs "Edinstvo," "Viatka-Les-Invest," "Uralskie Zavody," "Vostochno-Sibirskaiia Kompania," "Sibir" and others. These FPGs are diversified agglomerations of enterprises that reflect the production specificity of their region and include financial institutions located on the territory. Enterprises of the agro-industrial sector, for example, engaged in the formation of primarily regional FPGs. These groups include the FPG "Edinstvo" in the Perm region, FPG "Soiuzagromprom" in the Voronez region, FPGs "Doninvest" and "Don" in the Rostov region, FPG "Kamenskaia Agrompromyslennaia Financovaia Grupa" in the Penza region and others.

As an example of a regional FPG, the "Uralskie Zavody" FPG includes two dozen enterprises of various forms of ownership and types of production. The group controls about one third of the industrial potential of the Udmurtia Republic which is one of the more highly developed industrial regions in Russia. The largest enterprises of the group are defense enterprises AO "Aksion," AO "Izhevskii Elektromekhanicheskii Zavod," governmental enterprise "Izhstal," and AO "Bumash." The production of the Uralskie Zavody FPG declined by 3% between 1994-1997 due to the lack of solvable demand and financing. The FPG managed to create some linkages to foreign markets and establish collaboration with Siemens, Alkates-Sel and Phillips.

The "Sibir" FPG is another regional FPG that includes large enterprises in the Novosibirsk region including AOOT (limited liability enterprise) "Zapado-Sibirskii Metalurgicheskii Kombinat," "Novosibirskii Elektrovakuumnyi Zavod", AOOT "Sibirskii Zavod Elektrotermicheskovo Oborudovania" and AOOT "Novosibirskii Metallurgicheskii Zavod." These enterprises cooperate to produce a variety of consumer goods for the market and intermediary products for consumption within the group. The "Sibir" FPG managed to increase its production by 12% as a result of exports of metals. In 1997 the FPG was exporting goods for 38.4 million dollars compare to 1 million dollars in 1994.

The regional FPG "Vostochno-Sibirskaiia" reflects the technological specificity of the Irkutsk region. The region uses hydroenergy to produce raw material and semi-processed products. 80% of GDP of the region is now produced in such sectors as TEK (tepelo-elektricheskii kompleks: heat and energy sector), chemical and petro-chemical industry, ferrous metallurgy and mining industry. The members of the "Vostochno-Sibirskaiia" FPG represent these industries and include AO "Angarskaia Neftekhimicheskaiia Kompania," AO "Irkutskenergo," AO "Vostsibugol" and others. The FPG had experienced difficulties with financing and sales of its production. While it managed to increase its production by 2% in 1994, between 1996-1997 its production decreased by 12%.

The increase in the volume of production in 1994-1995, for the first time since 1990, had to do with a high export potential of non-ferrous metals, and fuel and petro-chemical products together with relatively low energy prices. The world market conditions were favorable for export and so was the governmental exchange policy. These conditions allowed for regional exports to reach 2.5 billion dollars in 1995. In 1996 the favorable conditions for the regional exporters diminished which led to the decline in the leading regional sectors and the "Vostochno-Sibirskaiia Company" FPG (V.Lenskii, A.Cvetkov, 1999:103).

The formation of regional FPGs was actively supported by local governments that were seeing FPGs as a mechanism that could help them to manage regional economies and strengthen their relationship with the center. The local administrations associated the formation of FPGs with the implementation of large regional restructuring programs, with the restructuring of technologically interdependent enterprises, with efforts to maintain employment levels and to solve regional ecological problems (V.Lenskii, A.Cvetkov, 1999:104). Another motivation for FPG formation was the effort of regional autocratic leaders to gain control and ownership of viable local industries through ownership of shares of the FPG central company. For example, the Soviet of Ministers of the Udmurtskaia Republic owns 19.9% of shares of the FPG "Uralskie Zavody." The shares are managed by the Republican Property Fund (V.Lenskii, A.Cvetkov, 1999:104). In exchange, the regional FPGs are able to lobby local administrations to provide guarantees for a variety of investment projects for "their" FPGs and to lower the FPGs' taxes.

Regional governments of the Sverdlovsk, Orlovsk, Orenburg and other regions have been trying to create a favorable environment for their FPGs. Their rationale has been that if these FPGs develop into strong businesses they will contribute resources to local budgets. However, according to V.Lenskii, A.Cvetkov (1999:170) the formation of regional "pocket" FPGs may not be beneficial for those industries that would benefit from forming linkages beyond the boundaries of their regions.

V.Lenskii and A.Cvetkov, (1999:154), further argue that the support regional governments can provide to 'their' FPGs is limited and can hardly compensate for the lack of support of industry-led FPGs by the federal government⁸. Moreover, the regional FPGs lack linkages to strong financial institutions that could invest in them. With the exception of the FPG "Sibir," which includes a relatively large Moscow-based commercial bank "Promradtechbank," the other FPGs do not include large banks and lack financial resources. Some of the FPGs have tried to solve the problem by forming their own regional banks and insurance companies. These efforts were in general not very successful.

3.3 Differences in Motivation and Power among Registered, Industry-led FPGs: Internal Resources and External Demands

The development of industry-led FPGs reflects the historical territorial, technological and relational ties and power relations among post-Soviet enterprises and the transformation of such ties into a new organizational form which was expected to facilitate their adaptation to the new environment. The registered, industry-led FPGs differed not only in their structural foundations, but also in their developmental objectives and their expected adaptation prospects and capacities. The research shows that the relative economic and political position of different enterprises, which corresponded to the differences in their internal resources and capacities, affected their needs and expectations regarding the formation of FPGs. In other words, the economic and political position of FPG members and founders shaped their developmental objectives regarding FPG formation

⁸ The relationship between the federal government and the industry-led FPGs will be explored at the end of this chapter.

and affected the developmental objectives and strategies of their FPGs. The research of the three groups of FPGs compares their resources, capacities and their relative economic and political position, showing how it shaped their developmental strategies and objectives. The following sections explore how such differences in economic and political power shaped strategies and developmental objectives of FPG within the group of industry-led FPGs.

According to V.Dementev, (2000:122), enterprises had different expectations regarding the benefits of forming or joining an industry-led FPG based on their relative market and political power. The "stronger" enterprises that had greater internal resources expected that they would expand their influence within the boundaries of the FPG while the "weaker" enterprises hoped that they will benefit from the integration without becoming daughter or dependent companies. These motivational differences were studied through a survey of directors of 160 enterprises in three regions conducted by "The Interdepartmental Analytical Center" as a part of a project called "Regional Research on the Formation of the Private Sector." The survey was ordered by the "Institute of Strategic Analysis and Development of Entrepreneurship" and funded by the World Bank.

According to the survey results, the motivations for forming registered or non-registered FPGs or other agglomerations differed depending on the economic position of the enterprise. The stronger enterprises were interested in a) gaining control over enterprises and financial-credit institutions with whom they already had established prospective business ties, b) increasing the rating of their conglomerate in the eyes of the investors and c) increasing the interaction with governmental organs to prove their capability to carry out priority programs of regional and federal governments. Some directors were not interested in formally registering as FPGs. They did not want to be limited by the FPG registration requirements and were not swayed by the promises of governmental assistance, hoping to rely on their own resources (Y.Vinslav, 1996:20).

The weaker enterprises were focused on a) obtaining governmental assistance for internal restructuring in the forms provided for in the law on FPGs, b) developing effective partnership ties with commercial banks and obtaining resources under favorable conditions to increase liquidity and to finance technical restructuring of the production process, c) finding additional opportunities to consolidate small internal financial resources of the group members to invest into projects of common interest (Y.Vinslav, 1996:18:19).

A number of researchers noted that most of the industry-led FPGs consisted of relatively weak enterprises that were focused on survival as opposed to strategic, long-term development. According to V.Lenskii and A.Cvetkov, (1999:102) the majority of industry-led FPGs were "soft," "cooperative" groups formed to enhance the survival chances of member enterprises under the uncertain market conditions and to "stand together" and wait for governmental support provided for in the FPG legislation (V.Lenskii, A.Cvetkov, 1999:102). The FPG structure was expected to help the member enterprises to "survive difficult times," to strengthen their intra-group ties and to improve their economic position by pooling resources. The FPG structure was also expected to protect the enterprises from outsiders (i.e. buyers of enterprise shares) who were perceived as a threat to the integrity of member enterprises through layoffs of the workforce and replacement of the management. The enterprises also hoped that the FPG structure will make it easier to face competition and to assert a collective pressure on the government to keep competition at bay through import tariffs and other restrictions of foreign goods and services⁹. As noted by several researchers, (V.Lenskii and A.Cvetkov, (1999:164; V.Dementev, 2000; Y.Pappe, 2000) the main

⁹ In many cases industry-led FPGs were created as means to protect domestic producers against foreign imports. Such FPGs included for example the "Aramidy i Technologii" FPG that was created to confront the expansion of Dupon. Another FPG "Mezgosmetiz" was created to compete with the Belgian "Bekaert" company that was increasing imports of metal cable to the SNG markets. FPGs in the food and textile sectors were also formed to protect domestic markets against imports (V.Dementev, 2000:114).

motivation for survival oriented enterprises to form FPGs was to gain governmental support as provided for in the FPG legislation and bring in investment on subsidized terms to increase liquidity and to finance technological restructuring.

The results of the survey research suggest that the economic position of FPG-founding enterprises affected the developmental aspirations of FPGs. Organizations that had a stronger economic position within the post-Soviet economic environment had higher aspirations and goals for their FPGs and were interested in using FPGs as a mean to gain an active control over their environment. The weaker enterprises were making uncertain survival attempts, hoping that a collaboration within a FPG will help them to weather the hostile forces within the environment and that the registration of the FPG will help them to gain governmental support and a connection to financial institutions. These differences in FPG-forming objectives within the group of industry-led FPGs will become considerably more pronounced in the process of comparing this group with the bank-led and raw-material FPGs groups¹⁰. The chapters on these FPGs provide data that shows that the political and economic situatedness of these groups in post-Soviet Russia allowed them to assert certain external political and economic demands and follow specific developmental strategies that were off limits to the industry-led groups.

3.4 Weak Internal Structure of registered, industry-led FPGs

The relatively weak, uncertain and unstable economic position of the majority of post-Soviet enterprises engaged in the formation of registered, industry-led FPGs was reflected not only in their survivalist motivations but also in the weakness of the internal organization of their FPGs. While the bank-led and the raw-material FPGs were primarily holdings, often tightly controlled by a powerful bank or a holding company that followed a specific developmental strategy and controlled shares of FPG member organizations, the most popular form of integration of registered, industry-led FPGs was a "soft," association-like structure directed towards the development of some form of cooperative organizational ties (V.Lenskii, A.Cvetkov, 1999:105:97).

This form was characteristic of 95% of all registered, industry-led FPGs while only 5% of these FPGs were organized in the form of strong multidivisional companies, holdings and concerns. The "soft," "cooperative" form was considered to be the fastest and the cheapest way of testing the possibilities of cooperative activities. FPGs of this type include the FPGs "Russkii Textil," "Rossiiskii Aviatcionyi Konsorcium," "Soiuzagromprom" and many others.

The weak internal organization of industry-led FPGs was a result of internal and external constraints. The internal constraint included lack of financial resources and also protectionism of enterprise managers while the external constraints involved the lack of external financial resources and state support. The formation of cooperative FPGs has been popular because privatized enterprises were generally controlled by insiders who did not want to give up control over their enterprises. Secondly, even the strongest of the FPG-forming enterprises lacked financial resources needed to buy up shares of other enterprises and to form a holding company or

¹⁰ The focus of the dissertation research is to explore the differences in environmental linkages, resources, structure and motivation for FPG formation among the industry-led, bank-led and raw-material FPGs, showing that the relative economic and political position of the FPG-founding organizations in combination with state policies affected their motivation for integration, their expectations about the benefits of the integration, and the FPGs' capacity to form linkages to their environment. The economically and politically stronger banks and raw-material enterprises and their FPGs were motivated to expand their existing linkages to markets, financial institutions, prospective industries and the state. They expected that the integration into FPGs will give them more political weight and economic control. The industry-led FPGs and their member enterprises, which were comparatively weaker than the bank-led and the raw-material groups, had lower expectations, ambitions and capacity to form effective external linkages. They hoped that pooling their resources will help them to survive in the uncertain environment. They also hoped that the FPG structure will allow them to create beneficial relationship with the state and with financial institutions.

a strong central company. Thirdly, the legal procedure governing the formation of holdings was complex and restrictive and, unlike the bank-led and the raw-material FPGs, the industry-led FPGs did not have the political leverage to win an exemption from these legal restrictions or to simply ignore them. Finally, the banks of industry-led FPGs were in general unwilling to commit resources to FPG central companies. For these reasons the soft, cooperative FPG form has been the most convenient and popular among FPG-forming enterprises (V.Lenskii, A.Cvetkov, 1999:102).

The weak structure and direction of many industry-led FPGs was reflected in the weakness of FPG central companies. Most registered, industry-led FPGs were formed by their members jointly creating a central company that became an independent legal entity (A.Voitenko, 1999:22). This has been a requirement of the FPG legislation. In some cases all FPG member enterprises contributed the same amount of investment into the central company and were expected to have the same degree of influence over its activity. In other cases the contributions to the basic capital of the central company differed for different members and reflected the division of power within the group. For example, in the case of the "Sviatogor" FPG the contribution of AO "Uraltrak" to the basic capital of the central company was 65.1%, and in the case of the "Nizhegorodskie Avtomobili" FPG AO "GAZ" owned 27.6% shares of the central company and 30 and more percent of four of the FPG members (V.Dementev, 2000:123). Other FPGs were organized as trusts in which the head enterprise managed the shares of other group members.

The central companies of many registered, industry-led FPGs manifested the financial and organizational weakness of these groups and the uncertainty about the integrative project on the part of member organizations. According to V.Dementev, (2000:123), more often than not, the central company of the registered, industry-led FPGs was formed to satisfy the requirements of the Law on FPGs and had a nominal status. In some cases it was controlled by the main enterprise of the group that was at the center of the FPG and had more control over the FPG than the other member organizations. The hopes that the deficit of resources of registered FPGs will be compensated by governmental subsidies and then the central company will have an important role in managing and dividing these resources—as provided for within the Law on FPGs—proved to be unfounded. The state did not come through with a support for industry-led FPGs and central companies of industry-led FPGs remained in general undercapitalized and organizationally weak.

The lack of internal financial resources of FPG member enterprises prevented them from creating strong central companies. V.Dementev, (2000:124) claims that the low level of governing capacity of the FPG central company is related to the low amount of its basic capital. In most cases, the amount of basic capital of the central company was relatively small—less than \$500 000 based on the July 1999 exchange rate. The leaders here included "Sibagromash" (179665 thousand rubles), FPG "Vostochno-Sibirskaiia Grupa" (91800 thousand rubles), "Aerofin" FPG (49502 thousand rubles) and "Magnitogorskaia Stal" FPG (47600 thousand rubles) (V.Dementev, 2000:124). In many cases the group members lacked financial resources and gave the central companies property actives (productive infrastructure, supplies of raw material or finished production) instead. The central companies did not have financial resources to buy shares of the group members or enterprises that operated in related sectors (A.Voitenko, 1999:24). According to A.Voitenko, (1999:24), the share of basic capital of the central company in the overall sum of the basic capital of other group members was small and did not reach beyond 5% on average¹¹.

The banks that joined industry-led FPGs or were created by them did not provide the

¹¹ For example, in the "Avantgard" group it was 0.03%, in "Nosta-Truby-Gaz" it was 0.03%, in "Soiuzagroprom" --1.01%, in "Nizhegorodskie Avtomobili"--1.65%, in "Dalnii Vostok"--3.38% and in "Tiazhenenergomash"--4.44%. Exceptions were groups "Doninvest"--17.5%, "Gormash-Invest"--19.22% and "Titul"--21% (A.Voitenko, 1999:24).

necessary financing for FPG central companies. According to the data available, the participation of banks in the basic capital of the central company was very low for most registered FPGs. In the “soft,” “cooperative” groups, banks owned only a small percentage of shares of the central company. In the case of "Sviatogor" it was less than 1%, in the case of "Nizhegorodskie Avtomobili" it was 8.87%, and "Don" 4.6%. Registered FPGs in which banks held a large portion of shares of the central company (for example FPG "Interchimprom"--34%) were exceptional (A.Voitenko, 1999:26). This situation is reflective of the fact that financial institutes played only a minor role in cooperative FPGs or were "pocket banks," created by the central company (V.Lenskii, A.Cvetkov, 1999:102).

A further reflection of a weak internal organization of the registered FPGs was a weak and often unclear relationship between the central company and the FPG members. According to O.Velicko, (1999:166-167), the relationships among individual group members and among group members and the central company--whether organizational, financial or material—were often very ineffectual and considerably confused. 5% of registered, industry-led FPGs did not have any capital ties among their members and 62% of the groups had unstable or unclear capital ties. This could lead to the breakdown of the FPG as an organizational structure or to its disintegration in case group members focused on their own interests as opposed to the group interest (O.Velicko, 1999:166).

O.Velicko (1999:167) claims that in most cases the central company is so weak that it does not play any strategic role in the activity of the group and all decisions are made outside of the central company by the dominating industrial or financial FPG organization. The absence of a clear decision-making center that has the authority to make decisions for the group members (through the control of the group's capital or other means) slows down the group decision-making process. In the case of conflicting interests among the group members, a weak central organization is unable to mediate the conflict or to enact or enforce the enactment of the decision adopted (O.Velicko, 1999:167).

According to V.Dementev, (2000:125), the actual role of many central companies is alike that of a "presidential club" of the Japanese groups: a place where the directors meet and discuss developmental strategies. However, as opposed to Russian FPGs, the Japanese groups are governed by many other sets of relational, institutional and property ties that do not exist in the case of the Russian FPGs. Many industry-led FPG remain internally loose, voluntary associations that depend on a good will of independent directors who are focused on maintaining their autonomy. Researchers such as A.Voitenko (1999:25) argue that the weakness of the central company with insignificant basic capital lowers its capacity to develop and enforce a single production-financial strategy of group development. According to A.Voitenko, (1999:26), due to the weakness of the central company unable to enforce specific rights and obligations, at least half of the registered FPGs lack an active governance center which has a negative influence on the functioning of these groups.

According to a research done by the **Scetnaia Palata** (Accounting Chamber), not all FPG members were enacting decisions adopted by the FPG directorate and joint meetings due to the weakness of the FPG central companies. The central companies were too weak to enforce these decisions, to coordinate the groups' activity and to stabilize the productive and financial situation of their members. The central companies were also unable to obtain necessary financial and accounting information from the group members (A. Ponomarenko, 2000:39).

The data suggest that the industry-led FPGs were unable to develop strong managerial centers that could coordinate their activities and that the FPG central companies reflected some of the weaknesses of the FPG member organizations such as the shortage of financial capital, lack of governmental support and general uncertainty regarding common strategy and developmental objectives of the groups. These characteristics clearly distinguished the industry-led FPGs from

the bank and raw-material groups that were centered around powerful banks or raw-material companies and organized into holdings on the basis of capital ties.

3.5 Assessment of Performance of Industry-led FPGs

Researchers of registered, industry-led FPGs have tried to evaluate the progress of these FPGs in accomplishing some of their key objectives such as improving economic performance, developing effective internal structures, forming linkages to financial institutions and markets and obtaining state support. The research teams working on industry-led FPGs encountered a variety of obstacles trying to evaluate the performance and behavior of the registered FPGs. One of the obstacles was the ongoing economic crisis that continued to affect the vast majority of post-Soviet industries including those that participated in FPGs. The effects of the payment crisis, investment crisis, inflation, and the breakdown of state-organized markets and allocation systems overshadowed the impact of economic integration of post-Soviet enterprises into FPGs and many of the industry-led FPGs continued to reflect the difficult economic and political position of their member organizations and non-FPG enterprises.

Another obstacle that prevented a comprehensive evaluation of FPG actives was the great diversity among the industry-led FPGs discussed in previous paragraphs. The structures and objectives of the FPGs were diverse and many of the weaker groups lacked a specific developmental strategy. This complicated the usage of standard measurement of success of registered FPGs.

Thirdly, the economic performance of each group was affected by its sectoral affiliation and changes in the economic situation of sectors represented within each FPG. These changes had a great impact on the economic situation of different FPGs¹². For example, FPGs in depressed sectors had great difficulties to create economic ties to markets and the state and also to develop effective internal organization. As noted by several researchers (Y.Vinslav, E.Guskov, 1996:21; V.Lenskii, A.Cvetkov, 1999:169) the agglomerations of enterprises in severely depressed sectors such as machine-building or light industries into FPGs did not help them to alter their economic situation. In other words, the integrated FPG structure could not compensate for larger developmental constraints—both internal and external—of the FPG member enterprises.

Perhaps the single greatest obstacle for examining the performance of industry-led FPGs was the lack of data provided by the groups. For example, out of the 72 FPGs registered by the end of 1997, only 54 FPGs offered information regarding their economic activity (V.Dementev, 2000:113). This trend continued in 1998 when almost half of the industry-led FPGs failed to provide accounts of their economic activity. V.Dementev, (2000:113) calls these groups "sleeping" as opposed to "active" and asserts that the weak central companies of these groups do not have information regarding the activity of the groups' members which prevents them not only from reporting this data but from coordinating the groups and formulating a single developmental strategy (V.Dementev, 2000:113).

According to an auditor of **Scetnaia Palata** (Accounting Chamber) V. Panskov, the Federal Law "About Financial Industrial Groups" stated that the group's yearly economic indicators have to be recorded by an independent auditor. However, the majority of FPGs did not maintain a consolidated accounting which made it impossible to audit their activity (A.

¹² The decline in production of most sectors continued through out the reform process. Between 1992-1998 the GDP decreased by 45% and the volume of industrial production decreased by 50% (Certas, 1999:109). The numbers of unprofitable enterprises in industry increased to 41% in 1998 (from 26% in 1995) and the production capacities of enterprises were being used up to 50% on average. In 1998 the volume of production in light industry (textile, clothing, footwear, etc) in constant prices was less than 18% of the 1990 level. Machine-building had declined by 63% between 1990 and 1998 (Tikhomirov, 2000).

Ponomarenko, 2000:38). The failure on the part of FPGs to provide statistics to governmental agencies was matched by the lack of governmental incentive to collect them. According to O.Velicko, (1999:159), Goskomstat, Russia's governmental statistical agency, stopped collecting statistical information on the activity of registered FPGs and not one of the registered FPGs has been audited.

In spite of the shortage of data, several groups of researchers tried to evaluate registered FPGs by comparing their performance with the performance of the rest of the economy and by comparing the performance of FPGs with different sectoral affiliations. According to V.Dementev, (2000:115), the industry-led FPGs that provided economic indicators to the registration agency showed a slightly higher performance than the overall performance of the Russian economy. For example, in comparison to 1997, in 1998 the groups decreased production by 2.9% while overall production decreased by 5.2%. Investment in basic capital funds in these FPGs increased by 4.6% while it decreased by 6.7% for the economy in general (V.Dementev 2000:115).

V.Dementev (2000:115-116) also shows that those FPGs that had a higher degree of intra-group trade (i.e. whose internal deliveries were not less than 5% of all deliveries) performed slightly better than other groups in terms of investment and the increase in the volume of production. However, these results were calculated using data provided by only a half of the registered FPGs. It is conceivable that the FPGs that had the organizational capacity to collect and report such data were "active" and had a higher performance than those which did not provide the information.

Yuri Vinslav offers an assessment of economic activity of the first 12 registered FPGs between 1995 and 1996 (Y.Vinslav, 1997:29). These FPGs increased the volume of production by 1.6% in 1996. While their overall sales increased by 5% in 1996 compared to 1995, the ratio of sales per unit of production costs fell from 1.17 to 1.05% which signifies a decrease in profitability. Several of the FPGs, including "Eksochim," "Obedinenaian Promyshlenno-Stroitelnaia Kompania", "Tulskii Promyshlenik," and Vostochno-Sibirskaiia Grupa" ended up with losses. Moreover, the ratio of credit to debit indebtedness of the groups increased from 25% in 1995 to 66.2% in 1996 (Y.Vinslav, 1997:29-30).

Information about the activity of the 28 registered FPGs in 1996 was collected by the Center of Market Conditions. Their survey had shown that the key goals of FPG member organizations continued to be: 1) improvement in financial situation (69.4% of participants); 2) increase in profits (62.9%); 3) improvement of technological and cooperative ties (54.8); and 4) development of new products (45,2%). According to the respondents, the actual realization of these goals within FPGs was unsatisfactory (Y.Vinslav, 1997:31). The research also showed that the registered FPGs increased their efforts to receive tax breaks and lobbied the government to help them to access foreign markets. Some FPG member organizations also complained about the leadership of their central companies. Overall, the majority of enterprises and organizations that entered the groups did not register any notable effects of their new status (Y.Vinslav, 1997:32).

V.Dementev (2000:107) provides an evaluation of FPG activities, comparing the objectives of the Russian government tied to the creation of FPGs and the degree of their accomplishment. In summary, he argues that while the Russian government associated the creation of FPGs with a possible reversal of the decline in investment, registered industry-led FPGs were not able to reverse the investment decline. FPGs were also unable to promote technical restructuring and most of them continued to maintain existing production technologies.

Some researchers note moderate achievements of registered FPGs. According to V.Lenskii and A.Cvetkov, (1999:150), some registered FPGs were able to achieve positive outcomes such as strengthening linkages to suppliers and improving technological linkages through the FPG organization. Some FPGs were also able to develop internal pricing system and to

overcome some of the effects of the crisis of payments and low liquidity. V.Lenskii and A.Cvetkov (1999:158) argue that some FPGs were able to 1) lower the need for turnover capital (oborotnye sredstva) of member enterprises by creating, for example, a promissory note center inside of the group. Some groups also managed to decrease input costs and production prices through internal agreements and were able to focus resources on managing non-payments among FPG member enterprises¹³.

Based on the studies of registered FPGs available, it is difficult to conclude whether the registered FPGs performed better than non-FPG enterprises and the economy in general. It seems plausible that the FPG structure had a positive effect on relationships among member enterprises in those cases where the FPG member organizations had some internal resources and developmental capacities prior to forming a FPG. However, the FPG structure was unable to compensate for difficulties experienced by enterprises in severely depressed sectors without much internal developmental potential and without external investment and supportive state policies. In other words, for the FPG structure to develop and have a positive effect, the FPG founding organizations and member enterprises needed to have some market linkages, productive and financial resources, and a strategy of common development. The availability of market linkages and internal resources was closely associated with specific sectors, with the position of these sectors within the post-Soviet, market oriented economy, and with governmental policies that affected these sectors.

The differences in the performance of registered FPGs in more or less viable sectors were noted by several researchers¹⁴. According to V.Lenskii and A.Cvetkov, (1999:157), the sectoral affiliation, production potentials and available markets of FPG founding organizations were essential determinants of the performance of the registered FPGs. The authors claim that the FPG-founding enterprises can be divided into three groups relative to the stability of their solvent buyers and internal norm of profits. The degree of such stability is related to the type of production made by these enterprises (i.e. to which sector they belonged to).

The first group consists of enterprises from the oil and chemical industries and metallurgy. These enterprises are characterized by a relatively stable demand, large norms of profits and have a high export component which allows them to attract relatively cheap credits. These FPGs are not relying on industrial enterprises only, but also on large banks which they partially control. These groups have a tendency to form holding-type FPGs that combine not only producers but also consumers of metals, for example.

The second group includes enterprises that are primarily the buyers of production of the first group. These are relatively few enterprises that produce competitive consumer goods and in some cases are monopolists on the market. They have a relatively stable demand and profits to be able to at least maintain production.

The third group, which is most widely represented within the registered, industry-led FPGs, includes enterprises of light industry, agriculture, construction, machine building and also enterprises that produce products with long cycles of production. These enterprises are characterized by a low or a complete lack of solvable demand, lack of profitability and uncompetitiveness of their production. Enterprises belonging to this group were motivated to form FPGs by their survivalist needs. They hoped that the FPG structure will help them to establish themselves on the market and to develop their market niche. They also sought to develop ties to financial-credit institutions to gain sources of credit and investment for restructuring and turnover

¹³ According to V.Lenskii and A.Cvetkov, (1999:150), FPGs did not necessarily lessen the problem of non-payments. However, the rationalization of payments and financial flows within some groups improved the payment and accounting procedures among the group members

¹⁴ This research will expand on this theme by comparing groups of FPGs in the industry, banking and raw-material production.

capital. Thirdly they were trying to accumulate their own financial resources and use them for investment into shared projects. Finally they hoped to receive governmental help for restructuring (V.Lenskii, A.Cvetkov, 1999:163). The authors argue that many FPGs within the third group cannot meet these goals and are unlikely to succeed.

Y.Vinslav and E.Guskov (1996:21) provide similar criteria for the evaluation of FPGs when analyzing the economic indicators of fifteen registered FPGs between 1994 and 1995. The authors divide the FPGs into two groups based on the differences in the indicators of their performance. They conclude that the successful FPGs in group A were created primarily by raw material producers that had an export potential. FPGs in this group were able to consolidate capital in amounts many times higher than the amount of capital available to FPGs in group B. The amount of actives and resources of commercial banks in the well-to-do FPGs was 6-7 times higher than in the group B (Y.Vinslav, E.Guskov, 1996:22). Also, FPGs in group A were able to ensure twice as high levels of outside investment compared to group B.

The "A" FPGs also had close ties to the government and participated in regional and federal programs such as the "Primorie" group which was created to service a governmental program focused on protecting inhabited areas, agricultural areas and buildings from floods in the Primorskii region. The group also participated in a number of other governmental programs (Y.Vinslav, E.Guskov, 1996:21). Ideally, FPGs in group A were able to combine internal resources and access to markets with a governmental support to increase their developmental potentials. For example the "Magnitogorskaia Stal" group was an exporter of steel and also benefited from governmental assistance: from the day of its official registration it was exempt from obligatory sale of hard currency income from the export of its production under the condition that it will channel these funds into financing its investment projects (Y.Vinslav, E.Guskov, 1996:21). FPGs in group "B" included enterprises in sectors such as machine-building. These FPGs had little internal capital and were unable to obtain investment resources or governmental support or market access.

The evaluation of economic performance of registered, industry-led FPGs suggests that internal resources and capacities of different FPGs to develop connections to especially foreign markets was a key to their economic success. Such connections had little to do with the FPG structure itself, but with the sectoral affiliation and internal capacities of member enterprises operating in the context of unresponsive investors and neglectful governmental policies. The internal weaknesses and strengths of the FPG-founding enterprises and their relative capacity to survive under the uncertain and challenging environmental conditions were reflected within the FPGs and continued to affect their internal structure, behavior and development. Economically weak post-Soviet enterprises in depressed sectors were unable to resolve their economic stagnation by agglomerating into registered FPGs. Although some FPGs might have been able to improve linkages among their member enterprises and establish common accounting and payment procedures, the weakness of the FPG central companies suggests that most of the industry-led FPGs did not have strong coordinative centers. The effects of integration largely depended on the economic strength of the FPG members and their ability to create ties to the post-Soviet economic and political context and to overcome the absence of state support and the severe scarcity of external investment.

Although it is difficult to conduct a detailed evaluation of the performance of industry-led FPGs, the data available allows for several important statements. Firstly, the lack of internal resources and capacities was a key obstacle in the successful development of registered, industry-led FPGs. As explained in the following sections, the additional obstacle was the combination of unsupportive state policies and the lack of effective linkages to the financial sector. Secondly, the industry-led FPGs never clearly rose above non-FPG post-Soviet enterprises and the rest of the economy in terms of their performance and market adaptation. Thirdly, it is easy to distinguish

this group from the bank-led and the raw-material FPGs both of which clearly surpassed the industry-led FPGs and the rest of the economy in economic power and political status.

While the majority of the registered, industry-led FPGs continued to stagnate in the course of the reforms, the founding organizations of the bank-led and raw-material FPGs and their financial-industrial holdings were consistently counted among the 50 most valuable Russian businesses since the origin of their formation up to the financial crisis of 1998¹⁵ and their political influence over the Russian state was very strong. None of the registered, industry-led FPGs was considered to be a part of the core elite group of Russian businesses. Researchers from an independent research institute “The Center of Political Technologies” who conducted a research of all three types of FPGs stated that not a single Russian enterprise that could be counted among the most successful Russian enterprises belongs to a registered FPG (Y.Pappe, 1998:3). According to their assessment, the registered groups were given a disproportional attention by the public and by certain political groupings. The groups have not worked as a mechanism that would be able to lift the Russian economy out of its crisis and neither did they threaten the development of the market system as some liberal reformers feared they may do. These groups did not have strong ties to the government at the federal level and the political and economic influence of any of these groups was not stronger than that of the leading enterprise or bank of that group (Y.Pappe, 1998:3). The following chapters on bank-led and raw-material FPGs show their internal resources, state policies towards these groups and changes in external investment flows shaped their developmental trajectory in ways that differ remarkably from that of the industry-led FPGs.

3.6 Industry-Led FPGs and the State

The supporters of registered FPGs were primarily policy-makers and governmental officials (including former vice-premier Oleg Soskovec and Duma Representative Nikolai Gonchar) who in general favored governmental intervention into the economy. To some scholars and politicians, FPGs seemed to be the intermediate, corporatist structures that could ease the transition from full centralization at the state level to arms-length, market-based transactions. They argued that it is mistaken to rely solely on the emerging markets to coordinate economic relations and organizational restructuring and that FPGs may function as an intermediary coordinating mechanism between the market and the state. They claimed that FPGs may help to resolve the problem of coordinating supplies and sales, increase cooperation in production among related enterprises, attract investors and stabilize and strengthen relationships between enterprises and credit institutions and between the raw-material producers and the processing sectors. They hoped that FPGs will be able to consolidate investment resources, optimize material and financial flows, increase the regularity of the production processes and lead the process of economic restructuring (V. Dementev, 1999:85). Governmental institutions that supported the formation of FPGs included the Ministry of Defense, the League of Support for Defense Industries, the Governmental Committee on Industrial Policy various sectoral committees (V.Dementev, 1998:15-16).

The supporters of corporatism and FPG-led economic restructuring never established themselves within the Yeltsin government which remained under a more or less consistent influence of laissez-faire reformers such as Anatoly Chubais who re-gained political stronghold after Yeltsin’s victory over the communist presidential candidate Gennadi Ziuganov in 1996. Reformers such as Chubais and institutions such as the State Property Committee (GKI) that managed privatization were suspicious of agglomerative tendencies among post-Soviet enterprises. They believed that such tendencies are efforts to circumvent the marketization of the economy

¹⁵ That crisis eliminated most of the founding banks of bank-led FPGs.

and re-establish Soviet-style industrial structures. Many of the restrictions on the formation of FPGs were included in the 1993 law "About Financial-Industrial Groups" upon the initiative of GKI (V.Dementev, 1998:15). However, the same reformers were willing to support specific bank-led groups which they perceived to be the leaders of an effective process of capital accumulation.

Although governmental attitude towards registered FPGs oscillated between legal restrictions and promises of support, the government remained consistent in not acting upon its occasional declarations of support for registered FPGs. The creation of registered FPGs was initiated by a Presidential Decree No 2096 "On the formation of financial-industrial groups in the Russian Federation" passed in 1993. This decree set off the initiative on the part of the state to manage a grass-root, unregulated integrative efforts of post-Soviet enterprises and to synchronize this process with the objectives of the reforms. The decree reflected the contradictory attitudes of various state groupings towards the formation of FPGs. While in some sense the decree legitimated the integrative processes within the economy, it tried to constrain these processes by making cross shareholding illegal, by limiting the ownership of shares of FPG member organizations by financial institutions to no more than 10% of shares of any member enterprise, and by limiting enterprises with over 25% of governmental ownership from entering FPGs. Enterprises that employed over 25 000 workers or had a domineering position on local or Russian market were not eligible to enter FPGs (Y.Vinslav, Y. Yakutin, 1998:32). FPGs were not allowed to have over 20 member organizations and employ over 100 000 workers (V.Dementev, 1998:18-19).

The government eased some of these limitations in 1995 and 1996 for a variety of reasons. First, privatization of state property and decentralization of Soviet conglomerates did not lead to effective economic restructuring and growth. The government conceded that the post-Soviet industries were not restructuring into efficient, market oriented firms after privatization and that a strong core of effective shareholders did not develop (Y.Vinslav, Y. Yakutin, 1998:32). Moreover, the relative macro-economic stabilization reached in the summer of 1995 did not lead to the activation of investment into the productive sectors (V.Dementev, 1998:20). The government was criticized by the opposition parties for lacking an industrial policy that would assist enterprise restructuring and that would promote the establishment of linkages between the financially strained industries and the booming banking sector. Facing a strong communist opposition prior to 1996 presidential election, President Yeltsin was willing to trade concessions to businesses for their political support and formally declared the creation of FPGs to be an official governmental policy.

Prior to the 1996 elections, Yeltsin met with the leaders of registered FPGs on two occasions to discuss their needs and problems. At the meetings it was decided that the formation of FPGs would be a priority of economic reform, that the registration procedure needed to be simplified and that the constraints on FPG formation ought to be lifted. The following measures of governmental support were proposed: 1) lowering the restrictions on the size of FPGs; 2) abolishing the restrictions on cross-shareholding among group members; 3) increasing the percentage of shares banks can own in FPGs; 4) giving FPG member banks the status of governmental agents; 5) providing governmental insurance of non-commercial risks of investments into FPG projects; 6) allowing FPG member banks and investment institutions to manage pension and other non-budgetary funds of the groups; 7) developing a mechanism that would allow to provide governmental guarantees of resources attracted by FPGs to finance projects prioritized by the government; 8) offering tax subsidies for profits reinvested into FPG projects; 9) allowing for increased amortization rate of the basic funds of FPG members in the case that the amortization resources are directed towards investment; 10) examining applications of FPGs to participate in contests for governmental support (A.Kalin, 1995:23).

These proposition resulted in the adoption of a new law "About financial-industrial groups" in 1995 and a Presidential Decree No 443 "About measures to stimulate the formation of financial-industrial groups" in 1996. These laws eliminated some of the restrictions regarding FPG formation such as the limit on state ownership in FPG member organizations and the limit on the number of enterprises and workers in a FPG. They allowed for cross-shareholding among FPG member organizations and the restrictions on bank shareholding in FPG enterprises were lifted. The presidential decree from 1996 provided for various measures of governmental support, including a demand that the government of the Russian Federation allocates budgetary resources to finance a support of financial-industrial groups in accordance with the declared priorities of industrial and social policy starting in 1997.

These promises inspired a sharp increase in the formation and registration of primarily industry-led FPGs and also worries on the part of bank-led and raw-material FPGs that they may lose support unless they register. Bank-led and raw-material FPGs rarely registered with the state. They enjoyed state support independently of their official status and preferred not to be constrained by the legal guidelines the registered FPGs were expected to follow such as disclosing their internal structure and relationships within their groups. While the bank-led and raw-material FPGs did not want to register, neither did they want to lose the candidacy for governmental support in case it was to be given exclusively to registered FPGs. After the governmental declaration of support for FPGs prior to the elections, the representatives of these groups started to question the proposition to support only registered FPGs. For example, A. Kulikov, an economist and a professor of the Financial Academy in Moscow and Sergei Rodionov, president of the bank "Imperial," one of the 10 largest Russian banks which was a member of an informal raw material FPG, argued that the bank-led and the raw-material FPGs are larger and more important than the registered FPGs. At the same time, according to the law on FPGs, only registered FPGs are eligible to receive governmental support:

“[According to the law]...only formally registered conglomerates have the right to claim the status of FPGs (and also measures of governmental support). But informal financial-industrial groups are developing parallel to them and the scale of operation of some of the informal groups is considerably larger and more important than that of the formal ones. These informal FPG include businesses such as "Gasprom," RAO "EES of Russia," and groups headed by banks such as "Menatep" and "Inkombank." This situation is distorting the picture of the development of financial-industrial integration and is placing the two types of FPGs in unequal standing” (Kulikov, 1997:107).

The authors further argue that the solution should not be to try to force the unregistered FPGs to register. That would be like forcing "collectivization." Rather, the conditions for registration should be made simpler and easier and the conditions for governmental support of FPGs should be clarified. Ultimately, the government should give support to registered or non-registered FPGs if they act in agreement with the priorities of governmental economic policy. Or the law should specify whether the non-registered FPGs are eligible for such support or not (Kulikov, 1997:107).

The dissertation research explores the different levels of support the government offered to the registered industry-led FPGs and to the bank-led and raw material groups showing that these concerns were unfounded. In practice the non-registered but powerful bank-led and raw-material FPGs received considerable support from the state while the registered industry-led FPGs did not. The trend towards FPG formation and registration had weakened after it became clear that the official status of a FPG does not guarantee governmental subsidies and that in practice the state uses other criteria than official FPG membership to grant support (V.Dementev, 1998:82).

For most registered, industry-led FPGs, the question of governmental assistance has been

central while this support had never materialized. Although a few registered FPGs that included the flagships of Russian industry were able to obtain some forms of governmental assistance on individual basis, small and medium industry-led FPGs could only rely on the support of their regional governments. Some of the regional groups managed to obtain such support and became important players in the regions (V.Lenskii, A.Cvetkov, 1999:169-170). However, in comparison to the politically influential bank-led and raw-material FPGs, none of the registered, industry-led FPGs was able to reach a comparable political spot light at the federal level.

According to V.G. Panskov of the **Scetnaia Palata** (Accounting Chamber), the executive branches of the government did not realize any form of support of registered FPGs provided for within the 1996 presidential decree and the law on FPGs that preceded it. Although the government made promises to participate in corporate investment programs of the registered FPGs it failed to allocate any investment credits to the groups. Neither did it provide governmental guarantees that would allow the groups to attract various forms of private investment although such form of support was specified within the law on FPGs.

The provisions within the presidential decree gave FPG participants the right to independently determine the amortization period of equipment and to apply a method of faster amortization using the obtained resources to finance investment projects. These provisions were not utilized in practice as a result of the lower usage of production capacities and the decrease in profitability and competitiveness of production. The enactment of the 1996 presidential decree was initially frozen and in the middle of 1998 repealed (A. Ponomarenko, 2000:39).

Other FPG researchers also confirm that the registered FPGs did not receive much if any governmental support. According to A.Voitenko, (1999:26), the registered FPGs received no financial support from the federal government between 1997-1998. O.Velicko (1999:178) claimed that governmental help has been and remained only declared while in reality it never materialized. For example, according to the Federal law on FPGs, Article 15, FPG member banks that invested in FPGs were eligible to lower their mandatory reserves in the amount of the sum of the investment. However, the Central Bank never acknowledged this provision and introduced new regulations that were directed to derail the participation of commercial banks in FPGs.

The law also declared that governmental authorities were prepared to entrust governmental packages of shares of FPG member organizations to the FPG's central company. However, the State Property Committee (GKI) ignored this clause (O.Velicko, 1999:178). Only four groups were able to gain control over these shares and with great difficulties. However, their victory seemed to be only temporary--their trust contracts had expired and the head of the GKI declared that these contracts would not be extended (O.Velicko, 1999:178).

Registered FPGs were in general not invited to participate in federal programs—only four out of the 84 FPGs registered in 1999 were given the right to participate in federal and regional programs. Other provisions of the Federal law were also not realized. FPGs did not receive governmental guarantees for investment, their share dividends were not tax exempt and neither was the tax on profits of banks from crediting FPGs (16 O.Velicko, 1999:179). O.Velicko (1999:179) also notes that the law on FPGs remains aloof from other laws and contradicts existing privatization and anti-monopoly laws that include provisions that block the formation of FPGs. Neither is the law supported by enforcement mechanisms.

According to V.Dementev, (1998:27) the registered FPGs did not have the capacity to lobby the government more than other financial and industrial structures that were not associated into groups—this is easy to assess by examining the level of governmental support given to these groups in the course of the last several years.

Thus, in spite of its legalized promises, the Russian government failed to support the registered, industry-led FPGs. This was largely due to the liberal wing of reformers and institutions that dominated the government, and partially due to the internal economic weakness of

registered, industry-led FPGs that were unable to pressure the state and to trade internal resources and capital for political favors and legitimacy.

3.7 Industry-Led FPGs and the Banks

According to Article 3 of the Federal Law "About Financial-Industrial Groups" from 1995, a FPG has to include "organizations that operate in the sphere of production of goods and services and also banks and other credit institutions." This signifies the interest on the part of the government to use FPGs to promote a linkage between the industrial and the financial sectors. The "marriage" of the emerging commercial banks and the post-Soviet industries has been one of the most frequently stated justifications for the formation of FPGs. The Yeltsin government had hoped that the newly emerging banks—as the forerunners of the emerging capitalist economy—will replace the government in managing and investing into post-Soviet enterprises and expedite their transition to capitalism.

The supporters of FPGs among leaders of business and the government argued that FPG banks would 1) give the FPG members credit to finance trading operations and help them to increase their liquidity and basic capital; 2) manage the temporarily free financial resources of enterprises; 3) lend money under the collateral of stock and real-estate property of FPGs; 4) finance group projects; 5) provide leasing and consulting services (including assistance in the development of business-plans); 6) participate in audit and analysis of financial and economic condition of FPG enterprises; 7) administer clearing operations using systems of non-monetary ("beznalichnye") accounts among FPG enterprises; 8) offer bank guarantees of transactions to partners of the FPG enterprises; 9) work as an investment fund during FPGs' operations on the stock and bond market; 10) develop an overall financial strategy for the FPGs, 11) coordinate the activity of other financial-credit institutions (such as insurance companies) in accordance with the objectives of their FPGs and participate in shared projects with these institutions (Y.Vinslav, 1998:97).

The data on the participation of banks in registered, industry-led FPGs suggest that these objectives were not achieved and the industry-led FPGs did not gain a greater access to capital through the FPG banks. One reason for the undercapitalization of industry-led FPGs was that in the majority of cases, the financial-credit institutions that belonged to registered, industry-led FPGs were weak and not capable or willing to provide long-term investment to the group. According to V.Lenskii and A.Cvetkov, (1999:174), the vast majority (76%) of financial-credit institutions that participated in registered FPGs were small commercial banks and credit institutions incapable of making any large investment into the group. Many of the banks that operated within these FPGs were "pocket banks" that were set up directly by the industrial companies and were as undercapitalized as their founders. These banks were subordinated to their founding organizations, not well managed and often "eaten up" by their founders who conceived of these banks as cheap and readily available source of financing. V.Lenskii and A.Cvetkov (1999:173) argue that 55% of the groups did not have any access to financial resources.

In a similar line of argument, O.Velicko, (1999:164) claims that one of the major obstacles for the development of the registered FPGs was the absence of financing due to the weakness of FPG financial institutions. The majority of credit-financial institutions that were part of registered FPGs were small commercial banks and financial companies that were unable to undertake large investment. The larger banks were often only loosely affiliated with the registered FPGs and lacked interest in the activity of the groups given the low profitability of production of FPG member enterprises and the low volume of financial flows.

The volume of credit obtained from FPG banks was minimal and so was the level of intra-group lending. The 1996 data on the lending activity of FPG banks to their groups collected by Goskomstat, the governmental statistical agency, (table #13 Y.Vinslav, 1998:96) show that most

registered FPGs received a small amount of short-term credit and primarily from non-FPG banks. According to the data, in 1996 the banks of 19 registered FPGs contributed only 546 06 billion rubles to FPGs, which is 15.9% of the whole sum of credits received by these FPGs. Only 10 out of the 19 FPG banks decided to provide credit to the FPG member organizations and these credits were primarily short-term loans to finance trade and middle-man operations. The other banks limited their role to financial consulting. Y.Vinslav argues that this can be explained by the lack of common group strategy developed by the bankers and the enterprises directors. Moreover, the fact that the FPG banks contributed on average only 3.4% of the consolidated actives of FPGs suggests that that financial infrastructure of registered FPGs was not developed (Y.Vinslav, 1997:31). The non-committal approach of Russian banks was also reflected in the bank's investment in the FPG central company. The average level of banking capital in the basic capital of the central companies did not reach beyond 8% and in many groups it was less than 1% (E.Chekmareev, 1999:21).

In 1997 the volume of credits provided by FPG member banks was only 1.7 trillion rubles while the overall volume of credit attracted by registered FPGs was 17 trillion rubles (in non-dominated prices). In a number of FPGs there was no internal lending activity (E.Chekmareev, 1999:26). In a few cases, the proportion of loans that FPG banks provided to FPG member enterprises was relatively high: in the FPG "Kuzbas" it was 100%, in "Dragocennosti Urala" it was 72%, in "Nizhegorodskie Avtomobili" it was 67% and in "Tulskii Promyslenik"—64% (according to Goskomstat statistics). There were no data regarding the performance of these loans (E.Chekmareev, 1999, 26).

As other banks, the FPG banks were affected by the mounting problems within the Russian banking sector. Between 1997 and 1998, prior to the financial crisis in August 1998, a number of FPG member banks lost their licenses (including "Kredobank," "Akcionernyi Vostochno-Sibirski Bank," "Interbank," "Evropeiskii Torgovy Bank," KB "Novbiznesbank," "Era-Service Bank," "Chodynka," "Legabank" and others). The situation of many FPG banks became even more critical after the collapse of the banking sector in 1998. According to the Department of Bank Monitoring, 29.7% of FPG banks showed financial difficulties, 9.2% banks showed serious difficulties and 23.8% were in critical condition. Thus, at the end of 1998 around half of FPG banks were insolvent or close to insolvent (E.Chekmareev, 1999:27). According to O.Velicko, (1999:166), the situation of the industry-led FPG banks was "sad"—out of the 78 banks that entered FPGs at the time of the registration, 5% of them "died" immediately after the registration of the group. 25% of the FPG member banks lost their licenses prior to the 1998 financial crisis and 35% of the banks were paralyzed as the result of the 1998 crisis and it was unlikely that they could be saved. The remaining 60% of FPG banks were primarily small and medium banks that were at best engaged in financial accounting and at worst they were "pocket banks." Neither type of banks was engaged in investing into industry. Either they did not need that or it was too expensive for them to do it O.Velicko, (1999, 166). In 1999 the 84 registered FPGs included around 100 credit organizations and filials—down by one third compared to 1998. The majority of them were small and few were medium-sized banks¹⁶.

Researchers such as Dementev (1998:69) argued that the creation of industry-led FPGs without strong banks created difficulties for their development and forced the FPGs to look for governmental subsidies and outside sources of investment. The small and medium-size banks did not have the financial muscle to play an active role in the groups. E.Chekmareev (1999:22) also argues that in the case of the majority of FPGs the banks did not have enough resources to

¹⁶ According to the data of the Department of Bank Monitoring of the Central Bank of Russia from June 1999, the registered basic (ustavnoi) capital of FPG banks was 20 to 30 million rubles on average (E.Chekmareev, 1999:21).

provide investment for the development of FPGs. In many cases the groups brought in financial institutions only to qualify for registering as FPGs. The practical role of these banks within the groups was to administer the accounts of the FPG members.

Practice had shown that large banks were interested in creating diversified groups that included enterprises with valuable internal resources, stable market niches and guaranteed sales. Under the economic and political conditions of post-Soviet Russia these were primarily export-oriented companies (i.e. raw-material companies) and also some food industry companies (E.Chekmareev, 1999:23). The largest of these enterprises were part of the bank-led or raw-material FPGs discussed in the following chapters.

According to V.Dementev (1998:25), the merger of industrial and financial capital that FPGs were expected to accomplish was difficult because the majority of Russian banks were short of long-term investment resources, undercapitalized, and had no history and experience with lending to industry. The basic capital (ustavnoi kapital) of 49% of Russian banks did not extend \$100 million. 41% of banks were worth between \$100 and \$1000 million and only 10% of banks had capital over \$1000 million. That made it difficult to create FPGs large by world standards and to bring financial resources into industry. The banks were willing to provide short-term credits for trade and middlemen transactions but were not ready to focus on making long-term investment into industry. They were primarily interested in clients who had access to real or prospective money flows and whose accounts they could service—and the majority of industry-led FPGs did not fall into this category (V.Dementev, 1998:34).

The data that capture the role of banks in registered, industry-led FPGs suggest that most commercial banks shied away from investing into registered, industry-led FPGs and those banks that did participate did not offer long-term loans for restructuring but financed only small, short term transactions. 80% of FPG member enterprises surveyed stated that questions regarding the financing of their production activity were not resolved though their entry into a FPG, not even mentioning investment activity (V.Lenskii, A.Cvetkov, 1999:169:177; O.Velicko, 1999:169).

The reasons for the failed connection between banks and registered FPGs can be explained through several variables. First, the lack of internal resources on the part of member enterprises of industry-led FPGs made them unattractive to banks. However, even enterprises that had greater developmental potential had difficulties gaining access to credit due to the nature of the developing banking sectors that will be discussed in the following chapter. The banking sector developed on the basis of cheap governmental credits and the grew out of the inflationary spiral of the early 1990s. It developed in close connection with the state and without any real connection to the post-Soviet industries. Thus, in order to explain the lack of investment in registered FPGs and post-Soviet enterprises in general, it is necessary to examine not only their characteristics and resources, but also the nature of the banking sector and state economic policies that defined the investment environment.

3.8 Conclusions

Industry-led groups were formed by post-Soviet enterprises from a variety of sectors on the basis of a variety of linkages and relationships—spatial, sectoral, multi-sectoral, vertical, horizontal. These relationships were reflective of Soviet-era structural and relational ties among enterprises. The formation of FPGs was motivated by various agendas including the anticipation of governmental support, the need for investment and linkages to banks and the effort to recreate, strengthen or replace upstream and downstream linkages broken in the course of the transition. The motivation for the formation of industry-led FPGs changed relative to the economic and political situatedness of their founders. Organizations that were economically stronger were interested in using FPGs as mechanisms of control over markets and other organizations. Weaker enterprises were interested in joining FPGs to strengthen their uncertain position vis-à-vis their

environment, enhance their survival capacity, and achieve even marginal improvements in their economic situation. Most registered FPGs had hoped that formal registration would make them eligible for governmental support.

The development of industry-led FPGs has been affected by three sets of variables: 1) their internal structural resources and capacities; 2) governmental policies towards FPGs; and 3) linkages to banks and availability of investment. The structural resources were determined by the historical origin and sectoral affiliation of FPG member enterprises. The governmental policies were shaped by the dominant ideology, governmental coalitions and foreign institutions and governments. The linkages to the financial sector were shaped by the internal resources and capacities of different FPGs, state policies towards the banking sector and the nature of the new Russian banks.

The lack of internal resources and financial capital was reflected in the weakness of FPG central companies and other developmental problems of industry-led FPGs. The weaknesses of these FPGs reflected the internal structural, financial and resource deficiencies of the enterprises that founded them. In other words, the organizational structure of FPGs could not compensate for the numerous, path-dependent structural problems of the organizations that founded these FPGs and for the environmental challenges they encountered. Many such problems were sector-wide and related to the positioning of different sectors within the post-Soviet political economy. The estimates of the economic performance of registered, industry-led FPGs available suggest that enterprises from sectors that controlled internal resources valued on foreign markets were able to create better performing FPGs.

Internal resources and capacities of FPG-forming enterprises was an important factor for the performance of industry-led FPGs especially given the nature of state policies and of the financial sector. Although the Yeltsin government had promised support for registered FPGs and even passed a legislation to that extent, such support had never materialized. This can be explained not simply by the claim that these FPGs were not worthy of support due to their internal weaknesses and Soviet origin. In retrospect, the industry-led FPGs had proven to be not less worthy of governmental attention than the bank-led groups which had received it and failed nevertheless. The ruling coalition of pro-laissez faire reformers and pressure of foreign governments and institutions such as the IMF compelled the government to focus on financial stabilization as opposed to structural reform of the post-Soviet industries and contributed to the lack of support for registered FPGs.

The third factor that fundamentally affected the adaptive capacities of FPGs was the nature of their connection to the banking sector. One of the main objectives of industry-led FPGs was to create a linkage to the new Russian banks. The data shows that this effort was generally unsuccessful and that the majority of FPGs surveyed in this chapter were unable to create such a linkage. The reasons for such failure point not simply towards the structural weaknesses of the industry-led FPGs and their members and founders that made them unattractive to investors but towards the nature of the emerging banking sector and state economic policies towards the new Russian banks. The following chapter provides a more in-depth explanation as to why the Russian banks did not offer investment to industries and preferred to gamble on financial and bond markets and ties these preferences to specific policies of the Yeltsin government that allowed for the banks to operate in segregation from the industrial sector¹⁷.

The position of the industry-led FPGs within the post-Soviet economy can be further illuminated by a counter-example of the bank-led and raw-material FPGs. Chapters 5 and 6 examine internal resources, capacities, reasons for formation, access to capital and governmental

¹⁷ The chapter on bank-led FPGs provides a more in-depth explanation as to why the Russian banks did not offer investment to industries and preferred to gamble on financial and bond markets under the auspices of the Yeltsin government.

support on the part of these other two groups of FPGs to develop this comparison.

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