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FOREIGN RETAILERS IN RUSSIA

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Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia.

NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector, as well as logistics and transport infrastructure. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics.

LUT has a long tradition in conducting research and educating students in the field of communist and post-communist economies. From the point of view of these studies, LUT is ideally located in the Eastern part of Finland near the border between EU and Russia.

This short report deals with development trends in Russian retail sector paying special attention to Western companies involved in super- and hypermarket business. Fast growing consumer demand in Russia cannot only be observed in food and general merchandise sector, but in consumer durables as well. IKEA (Sweden) is internationally well-known company in furniture and house decoration business with extensive activities in transitional economies. The chapter dealing with IKEA's business concept is written by Ms. Niina Malinen.

I want to express my gratitude to Ms. Rita Sergeeva, who helped me to finalize the book.

Lappeenranta, October 2006

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1 Introduction

The system of central planning existed in the former Soviet Union for more than seven decades. In the period of Cold War, the common Western image of the Soviet central planning was that of a workable, if not perfect, machine turning out welfare. Specialists at Gosplan (the State Planning Unit) sent orders out of Moscow resulting in the systematic production and distribution of millions of goods. Small mistakes of the system, such as non-delivery of planned shipments, and a prevalence of low-quality goods, could be corrected through minor administrative changes.

This image of the Soviet system is very far from reality. The history of centrally-planned systems with state-owned assets is not a story of machine-like precision of economic decision-making. In the early period of Soviet industrialization, central planners were able to calculate how many steel mills could be built with capital extracted from the rural economy. In the complex industrial society, it became more and more difficult to assess what the available resources were, and how to use them to satisfy consumers optimally.

Centrally fixed plans (input – output tables) had to be carried out by a huge bureaucracy. The Soviet model comprised a large number of sectored and functional agencies. Functional agencies, such as the Price Office, fixed all wholesale and retail prices. An agency called Gossnab (state supply office) replaced free market in inter-enterprise activity by linking supply and demand administratively.

In the Soviet system, the bureaucracy also managed the enterprise level via sectoral ministries (about 60). Enterprise managers were actually administrators obeying orders from above.

According to Soviet constitution, the communist party was the leading force in the society. The elite of the Party, called nomenklatura, was running the centrally planned economy. Every internal and external observer of the Soviet system knew that the planning scheme was only functioning in theory and malfunctioning in real life.

Therefore, it was only natural that within the official sector a “shadow” economy developed in all Soviet-type societies. There were legal, semi-legal and illegal components in the Soviet “parallel” economy.

In the early stage of central planning, the rural economy was collectivized. Two types of farms were created – kolkhozy (collective or co-operative farms) and sovkhozy (state farms). Peasants were allowed to farm a family plot and keep a limited number of livestock. Basically, this limited "family farming" was meant to be for own use. However, peasants were allowed to supplement the deficient state supplies by bringing their surpluses to the cities, in which so called "kolkhoz markets" were legal. By paying for the marketplace, peasants were able to charge a market price for their produce. If, for example, there was insufficient supply of butter in state stores (on cheap price), it was worth the peasants' while to sell it (at a higher price).

In the enterprise sector, there was a permanent unreliability of material supplies leading not only to "self-supply" (wasteful duplication), but also to unofficial horizontal links between enterprises, a network of personal relationships, supply agents known as tolkachi (pushers), and also corrupt practices. The shadow economy was based on large-scale stealing of state property. Its operation implied a close co-operation between traders and pushers with the party nomenklatura. It did not encounter social disapproval, because everybody tried to benefit from its spillovers.

In the Soviet retail trade, it was customary to store items in short supply in the backrooms, and sell them under-the-counter at high prices. Foreign consumer goods were easily available on the black market. The most visible form of the illegal economy in communist countries was currency exchange. Every Western visitor of the Soviet Union encountered "street banks", in which private citizens sold local currency to advantageous price beating clearly the offers of the official banking sector. Inconvertible Soviet roubles were massively converted into Western convertible currencies, which were the only means of payment in local "hard currency shops".

In the hindsight, it is clear that the Soviet system of central planning had been unable to function without the colourful activities of the shadow economy. There is now plenty of evidence that the communist elite of the Soviet society was deeply involved in the unofficial economic activities extracting a substantial part of profit generated by the black market with a multitude of non-planned actions. Thus, it is understandable that many of the old nomenklatura opposed economic reform before the collapse of the Soviet system, because they realised that any systemic change will deprive them of their ability to go on stealing from the state they controlled via the peculiar system of official and unofficial management methods.

The most visible part of the transition in post-communist countries (transitional economies, or TEs) has taken place in retail trade. In the early period of transition, there was a proliferation of small-scale retail outlets in each of TEs. Retailing literally took to the streets as stalls, mobile markets and kiosks found a ready market for long sought after consumer goods.

Rather soon the situation in the so called "tiger TEs" (Poland, Czech Republic and Hungary) changed radically. "Bazaar capitalism" was replaced by modern retail outlets, many of which were established by Western companies. A real invasion of foreign retailers in the TE-region started in the 1990s. One of the major players in TE-region's retail scene is Tesco from Great Britain (for details, see T. Tiusanen: Foreign Investors in Transitional Economies: Cases in Manufacturing and Services. NORDI publication no 27. Lappeenranta, 2006).

Russia's economy suffered a very severe slump in the 1990s. There was a currency crisis in 1998 in Russia, where investment activity showed permanent decline. However, in the post-crisis atmosphere, investment started to recover. In 2000, oil price increased substantially and has been on a high or even very high level ever since on the global market enhancing Russia's export income substantially. Thus, in the early period of the 21st century, the Russian economy has experienced a vigorous growth period. This new dynamism of Russian economy is naturally closely followed by potential foreign investors, retailers included.

This short research report pays attention to Russian economic scene from the point of view of foreign direct investment (FDI). The text concentrates on Russian retail sector. Three Western companies, Metro (Germany), Auchan (France) and IKEA (Sweden) are singled out as examples of FDI activity in transitional Russia.

2 Globalisation of Retail Trade

2.1 Some General Aspects of Globalisation

In the second half of the 20th century, FDI increased more rapidly than global production. A multitude of multi-national companies (MNCs) came into being. According to mainstream academic definition, an MNC is an economic unit with production in at least two different countries. International business studies concentrated on manufacturing firms spreading their production into several locations, and thus, by definition became global players.

In the early period of globalisation, the achievement of business goals was perceived to be culture-free phenomenon. It was assumed that Western technology, management and marketing skills are superior and can be moved via FDI into emerging markets with cheap labour costs. In the 1970s and 1980s, there was an increasing recognition, that because of country-specific differences in factor endowments, consumer tastes, institutions, culture, and government policies, foreign subsidiaries needed to be organised differently than their mother companies.

In the last decades of the last century, a new term in international business studies started appearing, which is called outsourcing. Many MNCs realised that cost savings can be achieved without FDI via contract manufacturing or licensing deals: contractual partners (contractee) may have a suitable capacity to produce end-products or components. Contract manufacturing and sub-contracting has increased massively in global scale. In the information society, many services can be outsourced to save in costs.

In the turn of the century, FDI activity virtually collapsed in global scale. The trend became negative for several years. This development of FDI obviously has cyclical but probably also structural features. It can be assumed that many MNCs have realized that investment money can be saved by increasing outsourcing. However, it is too early to tell whether FDI slump is of permanent or only of cyclical nature.

In international business studies, manufacturing activities have permanently been the focal point. However, service sector in the globalisation process has gained relative importance. This clear tendency is not yet fully recognised in academic texts.

Fortune Magazine traditionally publishes annually the list of 500 biggest companies in the world. In this list of 2004, Wal-Mart Stores is number one with revenues of USD 288 billion. This was the fourth time in the row this retailer won the race within MNCs (Fortune, no. 13, 2005). The turnover of this company is on the same level as gross domestic product (GDP) of Poland with almost 40 million inhabitants.

This list of biggest MNCs was in the last century permanently dominated by oil companies, car-makers and financial institutions. Two or three decades ago nobody was able to predict that at the beginning of the 21st century the largest company in the globe will be a retailer. Traditionally, retailing and more generally distribution altogether, has an image of a simple, low prestige business. This image is changing, because a multitude of retailers are presently in the list of 500 biggest MNCs.

One of the very visible features of the global development is the oligopolistic tendency in many branches. Car-making, household appliance productions, mobile phone manufacturing, etc. are typical oligopolistic branches, in each of which there is a handful of companies offering the big bulk of global supply. Normally, in an oligopolistic market, all (few) competitors have very extensive marketing budgets and they avoid price war. There is the obvious danger that price reduction aiming at increasing market share will not have the hoped-for result. It may be that all oligopolistic players will end up with lower prices, and thus, lower profits. Market shares will remain on the previous levels, but everybody is worse off.

This is hardly possible in retailing, in which, almost by definition, price is a decisive tool of competition. Global retailing giants have become big by offering good value for money. In modern super- and hypermarkets it is essential to offer an advantageous average consumer basket.

Obviously, no retailer can offer permanently low prices, which eat up profit margins. Big retailers can exploit economies of scale. When large retail chains purchase fast moving consumer goods (FMCG), they ask for volume discounts. In the traditional perception, strong manufacturers with well-known brands are able to organise their business relations with distribution partners via using their superior power. Presently, retailing giants have gained tremendous negotiation power and are ready to exploit it aggressively. There are estimates that in the industrialized part of the world, five biggest buyers (retail chains) buy about one third of FMCG industry’s products. Customer is the king or the queen in filling the retailing space of large shops.

It can be maintained that the globalisation drive of retailers is a rather new phenomenon. Living standard increased in West European and US markets for several decades in the post-war period. Food and general merchandise retailing went through several waves of restructuring and consolidation. With increasing car density, daily shopping was replaced by weekly visits in out-of-town super- or hypermarkets, while small corner-shops became old-fashioned and expensive in relative terms. Shopping habits changed radically and Western markets started to get saturated. Real estate in many big cities of Western Europe became expensive and suitable locations for shopping centres or malls were hard to come by.

Therefore, it is understandable that big retailers started looking for expansion options abroad in the 1990s. Wal-Mart started its internationalisation in the early 1990s in the neighbouring Mexico and Canada. In 1999, Wal-Mart bought Asda, a British supermarket chain, for USD 11 billion. In the same decade, Wal-Mart also entered Germany. Thus, competition in the West-European retail market intensified in the 1990s forcing retailers to look for options abroad. (Seth & Randall, 2005).

The second-largest retailer in the world is Carrefour (France), which is the most international one with operations in about 30 countries. However, its turnover is only about one third of Wal-Mart’s equivalent. According to Seth and Randall (Seth & Randall, 2005) Carrefour faces stiff price competition in its home market. Home market profits are essential source of financing international expansion.

Metro (Germany) is the third-biggest retailer in the world and second in Europe after Carrefour. The core business of Metro is Cash and Carry, the concept of which has been expanded into 26 different countries. Metro is the biggest retailer in Poland, Hungary and Czech Republic (for details, see T. Tiusanen: Foreign Investors in Transitional Economies: Cases in Manufacturing and Services. NORDI publication no 27. Lappeenranta, 2006). Metro is the largest Western company in Russian retail market. In the Fortune’s list, Metro was on rank 42 with revenues of about USD 70 billion, or about USD 20 billion less than Carrefour.

2.2 Pricing and Retailing

The phenomenal growth of Wal-Mart from a small-town shop established in 1950s by Sam Walton in Bentonwille, Arkansas, to the biggest global retailing company with turnover of USD 312 billion in 2005 coming from 6.200 stores in 15 different countries and employing 1,6 million people can be called a revolution in retailing. The colossus of retail business cannot be ignored by any potential competitor. With its deep pockets, Wal-Mart can presently and in the future enter any market it assesses as attractive enough.

The core of Sam Walton’s concept is simple: by cutting prices, sales increased and profits soared. There are three key elements, where Wal-Mart extracts significant and worldwide cost advantage: first, sourcing and logistic costs; second, keeping corporate overhead costs to a minimum; and third, low, fixed wages and salaries. Taken together, and spread across the massive, growing volume they represent huge competitive advantage, wherever Wal-Mart competes. By the 1980s, Wal-Mart began implementing a computerized sales and inventory system that made it more efficient than its competitors (Rothman, 2001).

However, the most striking part of the Wal-Mart story is how the retailing giant handles it suppliers, the FMCG industry, within which the largest US player is traditionally Procter and Gamble (P&G). This Cincinnati industrial giant focuses on paper, beauty, healthcare, food and beverage products, and has a turnover of USD 51 billion (2004).

The struggle between Wal-Mart and P&G is an important piece of economic history of modern times. Walton points out in his autobiography (Walton, 1993), how his retailing business was the victim of industry’s arrogance in the early period of Wal-Mart’s growth. P&G allowed a 2% discount if payment took place within 10 days, and if it did not, the discount was cancelled. After about 20 years of struggle, P&G officially announced (in the mid-1980s) that Wal-Mart needed to be dealt with specifically and cooperatively to ensure that P&G got its share of Wal-Mart’s growth. Sam Walton comments the controversy between industry and retail as follows: “In those days (in the 1960s and 1970s) we desperately needed P&G products whereas they could have got along just fine without us. Today we are their largest customer. But it wasn’t until 1987 that we turned a basically adversial relationship into one we like to think is the wave of the future – a win/win partnership between two companies both trying to serve the same customer.”

In this quotation, the dispute between industry and retailing is politely formulated. In the plain language it means that the most important FMCG-producer in America could not afford to ignore the demands of the most important retailer, who buys about one third of vendor’s product, which is more than the whole of Japan.

Rubbermaid is another US manufacturer with high turnover and prestigious brands, like Waterman and Parker pens. The vendor resisted Wal-Mart’s low price demands. As a result, the vendors’ products were replaced with alternatives in the shelves of Wal-Mart.

Rubbermaid weakened in the market and was taken over by Newell. The new owners restored the critical relationship with retailing giant, obviously by accepting price requirements of the client (Financial Times, July 8, 2004).

Levi Strauss, one of the most important icons of American apparel production, recently agreed to deliver exclusive jeans called “Signature” for Wal-Mart at a low price (Financial Times, August 12, 2004). Obviously, with this deal the embattled jeans maker with a valuable brand started making Wal-Mart’s own (private) label cloths.

International Herald Tribune (March 4–5, 2006) carries a long article titled “What Wal-Mart wants, Wal-Mart gets for its shelves”. Details below are picked up from that source.

In 2005, Coca-Cola prepared a new diet soda, to be called Coke Zero sweetened with aspartame, an old and low-calorie sweetener. However, Wal-Mart representatives wanted a drink that contained Splenda, an artificial sweetener. Thus, Coke executives went back to the drawing board and introduced a new drink called Diet Coke with Splenda.

Pepsi, Coke’s rival, has responded similarly to a Wal-Mart product request. Pepsi representatives were asked to come up with a new diet soda in flavours not widely available. The vendor quickly set about creating a new diet soda line called Slice One, initially to be sold only in Wal-Mart. The beverage contains Wal-Mart’s preferred sweetener, Splenda, and comes in orange, berry and grape flavours. If the test of Slice One in Wal-Mart is successful, the product will be sold by other retailers.

According to the same source, soda (soft drink) is the highest volume item in grocery stores after milk, eggs, bread and bananas. Wal-Mart represents 14–18% of all food and beverage sales in America. In the laundry detergent business, Wal-Mart has been pushing manufacturers to make super concentrate versions that require less packaging and thus, less shelf space.

The aim here is to show via these short news items how the balance of power between Wal-Mart and its suppliers has changed during the last 20 years. The retailer permanently underlines the best possible pricing from vendors so that the company can pass the savings along to customers. In return for recognition and support for this policy, Wal-Mart offers its suppliers volume and even more volume. This strategy obviously must be emulated by all retailers with international ambitions.

One important point in Wal-Mart's drive to offer permanently low prices is minimizing labour costs. Wal-Mart seems to fight a severe battle to keep labour non-unionised across the company. This strategy has caused plenty of bad-will against the mighty retailer: it is often pointed out that Wal-Mart's low prices are achieved by exploiting employees. Recently, the state of Maryland passed legislation forcing non-unionised retailers (a hint to Wal-Mart) to spend a minimum amount on health-care benefits. The health-care costs of Wal-Mart's lowly paid workers fall heavily on government in a country where such costs are usually picked up by employers. There is a widespread belief that Wal-Mart destroys local shopkeepers and reduces jobs in wholesale trade.

However, the existence of big-box retailers, such as Wal-Mart, is a substantial boon to shoppers – equivalent to offering households 25 cents back for every dollar they spend on groceries. Were the calculation repeated for other merchandise, the figure would be even bigger (for details, see The Economist, February 25 – March 3, 2006.).

It is often maintained that big-box super- and hypermarkets located mainly in suburbs of big cities in the rich part of the world are boring and universal-looking everywhere. However, the big-box retailers have one advantage: they offer low prices in comparison to old-fashioned corner-shops and convenience stores. High volume sales enable volume discounts in buying merchandise from vendors. Big volume makes international expansions possible.

In Netherlands, top five retailers (food and general merchandise) have a market share of no less than 93%. In France, the equivalent figure is 88%, and in Germany 70%; UK is not far away with 67%. The highest figure in this respect in the TE-region can be observed in Czech Republic with 27%. All five largest retailers in that country are in foreign ownership (AC Nielsen).

Wal-Mart has not entered any of European TEs, but has started operating in China. Therefore, European retailers have been able to get strong position in the former Eastern bloc. In the middle of the current decade, the Russian retail market had rather thin international colour (for details, see J. Louhivuori: Russia's Food Retail Sector from the Point of View of Finnish Food Producers, Lappeenranta, 2000. NORDI publication no 26).

3 Economic Trends in Russia

3.1 Macro-Economic Development

In the post-Soviet era, two very different trends can be observed in Russia. After the systemic change in 1991, Russia went through an extremely difficult phase of restructuring comprising a massive privatisation process of state-owned assets and creation of institutions needed to manage a decentralized market economy. In the 1990s, industrial production declined by almost 50%. Investment activity virtually collapsed: in real terms, investment dropped about 80% in the first post-Soviet decade. Dismantling centrally fixed pricing system caused rampant inflation after introduction of free price-setting (for details, see T. Tiusanen – J. Jumpponen: Russian Transition in the Early 21st Century. Lappeenranta, 2005. NORDI publication no. 22).

In the early period of Russian transition, there was one very peculiar feature in economic development. Wages calculated in "hard currency" (dollar, or other Western currencies) increased rapidly amid deep economic slump. The reason for this oddity is clear: Russia's strong internal inflation was only partially compensated by modest nominal Rouble depreciation. Thus, the official exchange rate of rouble became unrealistically "strong", which favoured imports, including foodstuffs. A semi-fixed exchange rate (ER) system was introduced in 1998 with a fixed central rate and fluctuation margins of ±15% (around the central rate). This system collapsed in August 1998. Rouble depreciated strongly in this context. Floating ER was introduced after this currency crisis (for details, see T. Tiusanen: Development of the Russian Rouble – The Crisis of 1998 and its Aftermath. Lappeenranta, 2003. NORDI publication no. 3).

In 2000, world market price of oil increased strongly supplementing Russia's export earnings essentially. A new price hike of oil took place in 2004 bringing the global price of oil to a high level obviously for a longer period of time.

These two events, rouble devaluation and oil price hikes, have been an enormous blessing for the Russian economy. The realistic rouble ER in the post 1998 era started an investment boom. Suddenly, it became profitable to produce import-substituting goods in Russia. "Petro-dollars" have helped general well-being to improve. State budgets have become well balanced. Current account shows permanent substantial surpluses. Thus, Russia's economy has in the second decade of transition gained dynamism after the clear decline in the 1990s.

Table 1 GDP per capita, 2005, EUR

	At official ER A	At PPP B	ERDI B/A	Growth 2000=100
Russia	4.294	9.000	2,10	149,5
EU-15		25.164		114,3
EU-25		23.226		115,8

Source: WIIW

The standard method in international development stage comparisons is to take Gross Domestic Product (GDP) figures from national economies and calculate them per capita. After that, all figures must be converted into one currency – normally into US dollars, or euros – to enable comparisons. In the above table euro is chosen.

One difficulty with this yardstick is that official ERs are not a reliable means to convert euros into all other currencies, because of imperfections of the exchange markets. EUR 100 normally buys more goods and services in an emerging market (e.g. TEs) than in its richer neighbour. In this case, the currency of the emerging market (TE) is undervalued at current exchange rate. GDP figures are thus made more accurate if euros are converted into other countries' money via ERs calculated on a purchasing power parity basis (PPP). Exchange rates need to be adjusted such way that an identical sample (often called "basket") of basic goods and services costs the same in one country as another.

Russia's GDP per capita at official ER is very low, only EUR 4.300. As prices of basic goods (comprising an average consumer basket) are low in Russia, the official exchange rate reflects Russian market reality very imperfectly, and thus, PPP adjustment is badly needed. As the above table shows, the PPP adjusted GDP in Russia is EUR 9.000. By dividing this figure (B) with the original figure (A), the level of undervaluation of Russian rouble can be measured. The result of this counting exercise is called exchange rate deviation index (ERDI), which in Russian case is about two. In real life it means that EUR 100 banknote buys in average a basket of goods with 100 euro value in the eurozone, while the same EUR 100 buys two equivalent baskets in Russia.

The traditional approach to exchange rates says that they move to keep international purchasing power in line (parity). Unfortunately, this does not happen in the global economy. Actually, A and B figures in the above table ought to be identical, but they are not. Exchange rate deviation index measures how much the official ER is distorted (in Russian case, undervalued), by about factor 2.

The above table contains GDP per capita figure at PPP in “old” EU (of 15 countries before the Eastern enlargement of EU). The living standard in this region (Western Europe) is almost three times higher than in Russia. The table also provides a second comparison comprising all 25 EU-members (including 8 TEs). This group of countries is about 2,6 times better off than Russia.

Russia’s new economic dynamism is far stronger than that in EU-15 and EU-25. When GDP figure at PPP in 2000 is marked with 100, was the equivalent figure in 2005 no less than 149,5 indicating that the economy in the early years of the new century has grown about 50%. In the same period, EU-15 shows a very moderate growth of only 14,3%; EU-25 is not essentially better with 15,8% growth.

In the positive macro-economic scene, it is interesting to observe how various components of overall demand have developed recently. For that purpose, the period between 2002 and 2005 is chosen.

Table 2 Demand Factors, Annual Growth (%)

	2002	2003	2004	2005
Private consumption (real)	8,5	7,5	11,6	11,1
Investment (real)	2,8	12,8	11,3	10,5
Export of goods	-0,2	6,0	22,5	33,8
Import of goods	7,4	4,4	16,4	28,3
Current account, % GDP	8,4	8,2	9,9	11,3

Source: WIIW

Private consumption in real terms has increased very rapidly in recent years, about 10% annually, or clearly faster than GDP. Growth in this sphere shows some acceleration in 2004–2005 in comparison to 2002–2003.

Investment has grown in real terms every year after the rouble crisis (1998). In the 1990s, investment slump was deep and long. Therefore, the present investment boom indicates that confidence on Russia’s economic future is on an entirely new level. Annual double-digit growth rates in 2003–2005 in real investment tell about a healthy trend, not about a sudden peak in the capital formation cycle.

Total value of Russian export follows closely world market fluctuations of prices of energy bearers. In 2000, Russian export income jumped no less than 60% and stagnated in two following years. Annual export growth in 2003 was moderate 6%, but accelerated to over

22% in 2004, and further to almost 34% in 2005. Import of goods shows an increasing trend with accelerating pace in two latest years.

Russia exported goods in total value of about EUR 200 billion in 2005, while expenditure on import was approximately EUR 100 billion. Thus, Russia earned a huge surplus in her balance of trade of some EUR 100 billion in 2005. Traditionally, Russia has a relatively moderate deficit in her balance of services. However, the overall current account in Russia has annual surpluses equivalent of about 10% of local GDP. It means that the country continuously is a net exporter of capital.

Obviously, one of the major reasons for permanent CA surpluses can be found in the exchange rate: rouble's external value has appreciated substantially in the post-crisis (1998) period in real terms, but the Russian ERDI value of over two (2005) indicates that rouble is still clearly undervalued. This ER value hampers imports and favours exports causing permanent and substantial annual CA surpluses: export (visible and invisible) earnings exceed import (goods and services) expenditure.

Altogether, Russian economy in the early years of the 21st century is in a very good shape. The strong boom described above causes difficulties in achieving price stability. Consumer price index increases continuously with double-digit figures, annually. Inflation is thus a problem, which is not derived from deficit spending in fiscal policy: budgets show surpluses every year since 2000. Obviously, inflow of "petro-dollars" makes controlling inflation difficult.

3.2 Micro-Economic Trends

The early period of Russian transition was full of turbulence. As input prices increased rapidly amid dismantling centrally fixed prices, many production units could not pay their bills.

Barter deals between enterprises reached massive dimensions. A high share of the economy became "dollarized", which meant that Western currencies, especially dollars, were extensively used alongside roubles. "Bank-note" financing of budget deficits took place in massive scale: new money was printed to cover loopholes in public sector bookkeeping. As rouble's value eroded, people and firms started hoarding dollars. In many cases, there were delays in wage payment, as well as in settling old-aged pensions. Workers were in many cases forced to accept barter-deals: instead of monetary compensation, they received products of their employers. Thus, very colourful trading took place in open market places.

In these turbulent years of early transition, nominal wages calculated in dollars increased substantially between 1992 and 1997. The reason for this oddity was clear: the Russian currency exchange market did not depreciate rouble value as much as the local (strong) inflation presupposed. Even if the nominal ER of rouble depreciated rapidly, the “real” exchange rate against dollars appreciated. Therefore, imported goods were relatively cheap.

This all changed radically via the rouble crisis of 1998. Rouble depreciated very strongly in nominal, but also in real terms. Thus, import decreased by 20% annually in 1998–1999. As average gross monthly wage was 150 calculated in euro in 1997, the equivalent figure in 1998 was EUR 95 and in 1999 only EUR 58. Also PPP-adjusted wage declined but in more moderate manner.

From the point of view of an average earner and average consumer, the Russian boom in the second decade of the transition has brought about huge benefits. This can be demonstrated by two time series in the table below.

Table 3 Average Monthly Gross Wages in Russia, EUR

	2000	2001	2002	2003	2004	2005	Growth (%), 2000–2005
At official ER	85	124	147	159	191	242	185
PPP adjusted	267	340	406	450	477	507	90
Price level EU-25=100	32	36	36	35	40	48	

Source: WIIW

Nominal average monthly gross wage converted into euro was only EUR 85 in 2000. The equivalent figure in 2005 was almost three times higher with EUR 242. In this context it is important to note that the figures are counted from nominal rouble wages by using official average annual exchange rates. Thus, there is an inflationary effect involved: growth in wages is not reflecting income improvement in real terms.

PPP adjustment wages also show vigorous growth, although not as strong as the first time-series: wages have roughly doubled in 2000–2005 when purchasing power parity adjustment is taken into consideration. In 2000, PPP adjusted average wage (EUR 267) divided by nominal average wage (EUR 85) was 3,14, which means that in the wage calculation the official exchange rate deviated from the PPP adjusted figure by more than factor three. In 2005, the equivalent deviation was only slightly over two. Thus, the official ER deviates from the PPP adjusted exchange rate much more moderately than before (in 2000).

According to WIIW, RUB/EUR official exchange rate was 35,2 in 2005, while RUB/EUR rate at PPP was 16,8. The difference between these two figures (35,2–16,8) is 18,4. An attempt is made below what this difference means on the personal level.

If a tourist from euro-area travels to Russia, he/she gets 35,2 roubles for every euro in exchanging currency, and not 16,8 roubles as determined by PPP adjusted ER. Thus, the Western visitor receives “an undervaluation bonus” of 18,4 roubles per every euro exchanged. This “bonus” is calculated on the basis of an average consumer basket, and thus, does not contain any special prices, like living in a first-class hotel or eating out in a luxurious restaurant.

The undervaluation of rouble has converse effect on a Russian tourist visiting euro-area. He/she pays 35,2 roubles per euro, instead of 16,8 roubles presupposed by PPP adjusted ER. Thus, in this case the traveller pays “an undervaluation penalty” of 18,4 roubles per euro when visiting the eurozone.

Thus, undervaluation of rouble, the level of which has become more moderate in the early years of the 21st century, is advantageous from the point of view of Russia’s current account. It makes imports (in visible and invisible trade) expensive and exports (including income in tourism) price competitive.

In this context it is worth noticing that in international comparison Russian rouble is relatively moderately undervalued. ERDI in China is over four and about five in India. In Turkey, ERDI value is about the same as in Russia. Therefore, shopping in these three emerging markets is advantageous for Russian travellers.

In April 2006, Customs regulations in Russia were changed. According to the new rules, Russians can import 35 kg goods when coming back home from abroad, instead of 50 kg allowed before. Personal imports in weight of that 35 kg are allowed only once a month, while weekly shopping was permitted previously.

These new limitations on the so called "shuttle trade" affect obviously all neighbouring countries, like Finland. However, revised customs rules were introduced to limit cheap personal imports from such countries like China and Turkey with advantageous prices.

According to Rosstat (Russian Statistical Office), about two thirds (64,5%) of income comes from wages. Profits from private businesses generate 11,5% of personal income, while social benefits comprise 13% of monetary income. The remaining part comes from capital income plus unclassified sources.

Money income is very unevenly distributed among population. The best-off quintal (20%) of the population receives almost half of the monetary income.

Table 4 Distribution of Total Volume of Money Income of Population

	2000	2001	2002	2003	2004
Money income, total (%)	100	100	100	100	100
1st quintal (with least incomes)	5,8	5,6	5,6	5,5	5,5
2nd quintal	10,4	10,4	10,4	10,3	10,2
3rd quintal	15,1	15,4	15,4	15,3	15,2
4th quintal	21,9	22,8	22,8	22,7	22,7
5th quintal (with highest incomes)	46,8	45,8	45,8	46,2	46,4
Gini coefficient (index of income concentration)	0,395	0,398	0,398	0,402	0,406

Source: Russia in Figures 2005

As the table above shows, income distribution in Russia has remained rather stable in the early years of the 21st century. The first quintal (the least earning 20% of population) receives about 5,5% of the income "cake". Three first quintals (60% of the population) earn taken together just over 20% of total monetary income, while the fourth quintal pockets more, about 23% of the cake. The best earning 20% of population takes the lion's share of no less than over 46% of the total income. Every quintal comprises a bit less than 30 million people.

4 Russian Consumer Market

4.1 Demand Structure

According to WIIW database, GDP in Russia was EUR 615 billion in 2005 at official exchange rate and EUR 1.290 billion with PPP adjustment. Consumption of households was less than 50% of GDP, or EUR 289 billion nominally and EUR 607 billion PPP adjusted.

Total retail sales in Russia were USD 245 billion in 2005, which is about EUR 198 billion. The equivalent figure PPP adjusted is over EUR 400 billion.

There are certain peculiarities in Russia's household expenditure structure. It can be assumed that these oddities continue to exist in the near future.

Table 5 Structure of Household Expenditure (% of total)

	2000	2005
Goods and services, of which	75,4	70,9
- goods	60,6	54,0
- services	14,8	16,9
Compulsory payments	7,8	9,7
Savings	7,6	9,5
Currency purchase	6,4	8,8
Cash holdings	2,8	1,1

Source: Rosstat

The most striking detail in the Russian average "family budget" expenditure is the low share of compulsory payments. This fact has certain historical background factors.

In the communist era, the whole housing stock was in the state ownership. The communist elite had luxury flats in the urban centres and private houses in the countryside, called dachas. These housing units were not allocated on the basis of purchasing power, but according to position on the party and state hierarchy.

In the early stage of transition, a big part of the housing stock was privatised. There are estimates that about two thirds of households own accommodation units they live in. The rest of the housing stock was removed from the state to municipal ownership.

In the market conditions, households with high income started building new residences in the outskirts of big cities and weekend houses in the countryside. Also luxury flats were constructed for paying clients.

In the meantime, the Soviet-time housing stock has permanently deteriorated. In the majority of high urban buildings, there is no proper financial arrangement for maintenance.

Furthermore, utilities are not yet functioning on market basis. Thus, electricity, gas and water bills are permanently low in the household sector. Western type mortgage systems have been created but they are still in an embryonic stage. Some “rich” municipalities have constructed new apartment blocs for the citizens.

However, it is quite clear that the post-Soviet society in Russia cannot maintain present-day cheap housing costs for the majority of the population forever. Fundamental repairing is needed in the near future especially in those housing blocs, which were constructed in the post-war period (in the 1940s to 1960s). This large-scale mending of the housing stock must be financed one way or another.

Compulsory payments are in increase anyhow. Car density is still low (less than 200 cars per thousand), but increasing rapidly. A compulsory traffic insurance has been introduced for car owners. Health care system is in a rather bad shape. In this sphere, insurance policy is changing slowly: people must take more personal responsibility of their own health – and pay for it. With increasing wealth in the form of consumer durable stock household insurance becomes more popular. Prices of utilities are likely to increase in the foreseeable future.

As the above table shows, the share of compulsory payments of household expenditure has increased by about two percentage points between 2000 and 2005. This moderate growth has not changed the scene fundamentally: this position still takes less than 10% of money spent by Russian average family.

The second amazing feature in average Russian household budget is the high level of saving. It is often assumed that in high income countries there is high propensity to save. This assumption is not necessarily correct in the present-day world.

In average Russian household budget there is a clear “surplus”; not all the available money is spent. The share of savings in family budget has increased almost two percentage points in 2000–2005 from 7,6% to 9,5%.

In the early period of Russian transition with high price hikes and permanent inflationary expectations, households started converting local money into some hard currency. In the 1990s, dollar was the most desired hard currency, but also German mark was sought after. Obviously, in many cases converted dollars or D-marks were taken out of the country. However, a large part of Western currencies were simply hoarded.

It was rather widely assumed that this form of hoarding will come to an end with increasing stability in the Russian economy, especially after the rouble crisis of 1998. However, there is evidence that it is not the case.

As the table shows, hard currency purchases had a share of 6,4% of household monetary use in 2000, while the equivalent figure in 2005 was more than two percentage points higher, or 8,8%.

Every year of the new century, Russian annual inflation has been in double-digit numbers. It can be assumed that the annual consumer goods price index increase of some 10–12% is the main reason behind this phenomenon: Russian households look for protection against inflation. One option in this context is to exchange a part of the savings into hard currency (obviously into dollars or euros). It is possible to have a hard currency account in local banks. However, there is anecdotal evidence that a part of dollars and euros in private possession are just hoarded (kept in banknotes stored back home).

This system of hard currency saving brought windfall profits for dollar-holders in 1998 when rouble exchange rate collapsed (1998). The crisis did not bring hard currency purchases by households to the end. The opposite is true: this activity has increased from 6,4% to 8,8% between 2000 and 2005 (as a percentage of household money use).

Savings together with hard currency purchase make up over 18% of household budget in 2005. The equivalent figure in 2000 was 14%. These figures indicate that an average Russian household has an accumulated stock of purchasing power. This reserve of money put aside is growing with increasing speed.

In all societies, increasing living standard is linked with growing relative importance of services in the overall personal consumption. The average Russian household spent in 2000 over 60% of the family budget on goods and about 15% on services. The equivalent figures in 2005 were 54% and 17%, respectively. Thus, the relative importance of services is increasing and demand for goods is decreasing in the Russian household expenditure. This trend is clear, but the structural change is not dramatic.

4.2 Supply-Side: Retailing in Russia

As mentioned above, total retail turnover in Russia was almost USD 250 billion (about EUR 200 billion) in 2005. The growth in nominal terms in the first years of the 21st century has been about factor 2,5. Annual growth in real terms has at the same time been about 10%. Thus, there is extreme dynamism in the Russian retailing. This dynamism is likely to last because of high world market prices of oil feeding Russian disposable income development.

In the 1990s, post-communist boom in Central Eastern Europe attracted Western retailers to enter the region in quick steps. Retailing was modernised in a very short period of time with heavy involvement by Western retailing giants (for details, see T. Tiusanen: Foreign Investors in Transitional Economies: Cases in Manufacturing and Services. NORDI publication no 27. Lappeenranta, 2006).

The first decade of post-Soviet era in Russia was full of uncertainties and risks for investors. Therefore, involvement of Western retailers in Russian market was very limited in the 1990s. However, modernisation of the sector started taking shape, mainly by local new companies. Many of them had a solid business basis in the turn of the century. Strong super- and hypermarket chains have come into being in Russia.

However, in the middle of the present decade, Russian retail sector is still very far away from modern structures achieved in the rich part of the world. In 2005, old-fashioned grocery stores (not involved in retail chains) occupied a dominant market share of some 40%. Open-air food markets (remnants of Soviet era “kolkhoz-markets”) sold about one fifth of foodstuffs. Pavilions and kiosks occupied 15% of the grocery market. Thus, modern format retail chains have still plenty of terrain to gain: their market share is less than one quarter.

In the Russian retail market, non-food items make up about 54% and food 46%. With increasing living standard it is likely that the share of the latter will decrease slowly.

Table 6 Russian Top Retailers 2005: Turnover, USD Million

1	Tander (discounter)	1.800
2	Metro (cash and carry)	1.777
3	Pyaterochka (discounter)	1.637
4	Perekrestok (supermarkets, hypermarkets, convenience stores)	1.222
5	Dixy (discounters, hypermarkets)	867
6	Seventh Continent (supermarkets, hypermarkets, convenience stores)	860
7	Auchan (hypermarkets)	750
8	Kopeyka (discounter)	682
9	Lenta (hypermarkets)	649
10	Viktoria (supermarkets, discounters)	605
11	Ramstore (supermarkets, hypermarkets)	600
12	O`Key (hypermarkets)	380
13	Paterson (supermarkets)	294
14	Mosmart (hypermarkets)	230
15	Marta (supermarkets, hypermarkets)	189

Source: Renaissance Capital

As the table above shows, there are four retailers in Russia with a turnover of over USD 1 billion. The largest one, Tander, has ten times more sales than the smallest in the list, Marta. On the second place in the list is the biggest foreign player, Metro.

The market leader (Tander) operates over 1500 stores with a selection of goods limited to about 3.000, while the main challenger, Metro, runs 22 stores offering no less than 50.000 items. These two giants have very different business strategies.

In 2005, only two of the Russian retailers listed above were public companies: Pyaterochka (on the 4th place), and Seventh Continent (6th). More listings are expected in the near future.

As the market is fragmented and assets mainly in private hands, there is no comprehensive information on profit rates of Russian retailers. Gross margins are said to be 15–30%. It is obvious that Russian retail market is far from perfect: it is likely that high profits will attract new capital into the sector. Increasing competition will hopefully benefit consumers in the near future. There seems to be plenty of leeway especially for hard discounters, which will offer a limited selection of goods with really advantageous prices. There are plenty of opportunities for modern retailers outside the two metropolitan areas, Moscow and St. Petersburg.

4.3 Foreign Capital in Russian Retailing

In the food and general merchandise retailing, Western firms were busy launching operations in Central Eastern Europe (CEE), as mentioned before. Therefore, it is surprising that the most serious invasion of foreign capital into Russian mass consumption market took place by a Turkish company.

In the communist era, Turkey had very intensive economic relations with the Soviet Union. In this context, Turkish conglomerates offered, for example, construction work in the Soviet market with excellent price-quality relationship.

One of these conglomerates, Koc Holding, entered the post-Soviet Russian market via its retailing arm, Migros, in 1997. This Turkish retailer, whose Russian arm is called Ramstore, did not exit Russia in the period of rouble crisis.

In 2005, Ramstore run 48 shops (supermarkets and hypermarkets), mainly located in Moscow region. The company has also been involved in building shopping centres and running them. All Ramstore retailing operations take place in company-owned facilities. The company offers a relatively wide variety of items (10.000–40.000 depending on location of individual stores).

With an annual turnover of USD 600 million (2005), Ramstore is on the rank eleven in the Russian retail competition. Thus, her market share within the leading fifteen big chains is almost 5%. The Turkish company is a serious player in the transitional retailing of Russia.

Wal-Mart is said to have had negotiations with Koc Holding concerning acquiring Ramstore operations in Russia (Seth & Randall, 2005), but no deal has been clinched. If this deal will materialize, the Russian retail competition will essentially intensify. However, this acquisition rumour has not been in headlines in the financial press lately. It does not mean that Wal-Mart’s Russian entry is excluded.

There are two Western retailers among the top ten chains in Russia. These companies are Metro (Germany) and Auchan (France). Both cases will be dealt with below.

4.3.1 Metro

The German retailer, Metro, was on the 42nd place in Fortune's list of world's 500 biggest companies with a turnover of USD 71,2 billion in 2004. In CEE-region, Metro is very clearly market leader in retailing. In Russia, Metro is the main player in the retailing game among Western investors.

Metro's history is long and colourful. The modern Metro really started in 1964 with the first Metro Cash and Carry (C&C). This special format is actually a self-service wholesale business aiming at commercial customers and large-scale private consumers. Thus, this format is actually a hybrid of wholesaling and retailing. Metro is the global market leader in C&C business segment.

Metro Group has several formats. Its C&C business units are called Makro Cash and Carry in Germany. Real is Metro's hypermarket arm, while Extra runs supermarkets. Media Markt-Saturn concentrates on music and consumer electronics. Praktiker sells do-it-yourself (DIY) items and Galeria Kaufhof is a department store chain.

Metro's supermarket performance has not been strong recent years, Real and Extra have both experienced volume losses. In 2004, Metro sold one fourth of its supermarkets to Rewe, another German retail chain, and closed about 20 others. These measures indicate that competition in German retailing is extremely fierce.

Almost half of Metro's total sales come from C&C format. Saturn's contribution is over one fifth (Facts and Figures of the Metro Group, 2004). Thus, C&C is the core business of the Group.

Cash-and-carry method is an attractive way of entering immature markets with a multitude of small traders. Therefore, it is no accident that the global leader in C&C business has become very active in emerging markets, transitional economies included. Small retailers can use C&C shops as a substitute of wholesaling. Hotels, restaurants, coffee shops etc. can also replenish their stocks from Metro, instead of using wholesalers. Private clients with cars use Metro C&C to buy big quantities at low prices. The format seems to be in many respects ideal for transitional economies.

In 2005, Metro restructured its business concept by merging super- and hypermarket operations (Real-Extra). Praktiker (DIY) became an independent unit (outside of Metro

Group) via IPO. Department store unit is now called Galleria (containing Kaufhof department stores).

It is obvious that Metro Group, which is publicly owned, realizes that in the Western market expenditure on food forms a decreasing proportion of personal consumption as general wealth increases. One option is to carry horizontal diversity: start selling music, electronics, DIY-goods, etc. Now Metro cut out its DIY-unit, but maintains its Media Markt, which was merged with Saturn unit. This new Metro branch sells everything from music, to consumer electronics and consumer durables.

In the middle of this decade, it is clear that Metro concentrates on two main formats: Cash and Carry (C&C) and Media Markt-Saturn (MM-S). The company looks for expansion possibilities abroad, especially for these two formats.

According to Metro Group's Annual Report 2005 (all details below are from this document), Metro is present in 30 countries in 2.100 locations. From the overall annual turnover (2005) of EUR 55,7 billion, more than half (53,4%) came from abroad. About 51% of total business came from cash-and-carry shops.

Metro's C&C outlets are present in 544 locations in 28 countries. The selection of goods on offer is up to 50.000 per shop comprising about 20.000 food and about 30.000 non-food items. The former sphere makes up about 70% of total sales. Metro underlines the fresh food component in its supplies. Metro's C&C sales in 2005 reached EUR 28,1 billion, or 6,2% more than a year before.

About one fifth of Metro's C&C business is done in Germany. The rest of Western Europe generates no less than 44% of C&C sales by Metro. The equivalent figure of TE-countries is 31,5%. Thus, post-communist Europe is a more important market for Metro's C&C unit, that its home country.

Table 7 Number of Metro C&C shops in TEs

	2004	2005
Bulgaria	7	7
Croatia	3	5
Moldova	1	1
Poland	21	22
Romania	21	23
Russia	14	22
Serbia-Montenegro	0	3
Slovakia	5	5
Czech Republic	11	12
Ukraine	4	8
Hungary	13	13
Total	110	121

Source: Metro Group, Annual Report 2005

The average size of an outlet of C&C Metro is no less than 7.800 square metres. There are more than 120 of these huge markets in TE-region.

It is somehow surprising that Romania is on the top of the list above: Metro has 23 C&C outlets in that country. Poland and Russia have 22 outlets each.

Metro started its Russian operations in the turn of the century. The growth has been rampant. The number of Metro C&C increased by 8 units in 2005.

Metro has established C&C operations even in Moldova and Serbia-Montenegro. These two TEs have low living standard, but they seem to offer some potential to Metro. Also Ukraine is a relatively poor TE, but the country with almost 50 million inhabitants seems to interest Metro, who has established 8 C&C markets in that country.

Alongside with its C&C shops, Metro runs 30 Real supermarkets in Poland, which is with about 39 million inhabitants far the biggest new EU country. Three Real supermarkets were established in Russia by Metro in 2005.

Media Markt-Saturn is the second most important business branch of Metro Group after C&C operations earning nice revenue of EUR 13 billion in 2005. This segment is present only in two TEs: there are 31 MM-S outlets in Poland and 15 in Hungary. Only some 6% of turnover in this sphere is generated in the Eastern part of Europe.

Metro employs about 43.000 people in the post-communist Europe. The highest number of Metro employees can be found in Poland (14.500), because Metro runs three business formats in that country. In Russia, Metro has about 6.500 people in its payroll.

It is highly likely that Metro's operations in Russia will continue to grow strongly in several years to come. High world market prices of energy bearers will keep Russian income level, and thus, consumption to improve rapidly. The hybrid format of wholesaling and retailing in Metro's C&C sector is not easy to copy by competitors.

4.3.2 Auchan

Carrefour is the biggest retailer in Europe. This French giant runs a full range of formats, hypermarkets, supermarkets, convenience stores and hard discounters. It has a complicated network of international operations. Carrefour has not established itself in Russia.

Auchan is another French retailer that has presence in many countries. Carrefour is a public company, while Auchan is controlled by its founding family. In the fiercely competed French market, Auchan has been successful, and thus, has the means and also willingness to grow internationally. Auchan is the second biggest Western retailer in the Russian market after Metro.

Auchan is firmly established in the hypermarket and supermarket formats in France, where the rise of hard discounters is a fact. Les Halles is the name of Auchan's hard discount hypermarket chain, while Au Marché Vrak consists of relatively small stores without selling fresh food. A modest selection of items is sold at extremely low prices.

Auchan started its TE-operations in the Czech Republic in the mid-1990s. The target was Pruhonice, a little village 20 km from the centre of Prague on the Brno highway. The whole project, including development and infrastructure would have covered about 90 hectares. The aim was to have a huge shopping area with a hypermarket, car dealership, Merlin DIY-shop, and fast food restaurants.

In this project, a variety of decision-makers were involved, including the state, several municipalities and private landowners. After lengthy and difficult negotiations, Auchan gave the mammoth project up. Instead of investing in Czech Republic, Auchan started building up presence in Poland, Hungary and Slovakia. The company is within the top ten Western retailers in these countries of Central Eastern Europe.

Auchan opened its first hypermarket in Moscow in 2002. After entering the booming market of Russia, Auchan has expanded rapidly: in 2005, Auchan had already 7 hypermarkets operating in Russia, all in Moscow region. Two more stores are to be opened in 2006 in Moscow, and four in other Russian cities. In addition, Auchan has opened its first Atak convenience store. This format will grow by 7 units in 2006.

Auchan's turnover in Russia was USD 750 million in 2005, which gave it the 7th rank in the list of the big retailers in Russia. Metro's sales were about one billion dollars higher than Auchan's.

4.4 Other Western Retailers in Russia

Rewe is one of the largest retailers in Germany. This company established in 2004 a joint venture with Russian Marta, which is at the bottom of the list of 15 biggest retailers in Russia. The JV, 75% owned by Rewe, runs 19 Billa stores in Russia. Rewe with very strong foothold in Central Eastern retail market, has plans to expand rapidly in Russia.

Stockmann, established in 1862, is Finland's best-known department store chain. Stockmann started its operations in Russia in 1989 as the first Western retailer. Before that, the company had for several decades supplied diplomats and other foreigners in the Soviet Union. Presently, Stockmann runs a handful of supermarkets in Russia, which are clearly positioned in the premium segment. The company has obviously no plans to get involved in the Russian mass market.

Tradeka is another Finnish retailing group with a rather modest market share in its home base. Tradeka runs three Siwa shops in St. Petersburg.

It can be expected that retail trade will grow by 7–12% annually in the near future. The market is not yet consolidated. Mergers and acquisitions are thus likely. There is also plenty of space for newcomers.

It is maintained that there are no really hard discounters in Russia yet, only "soft" ones. Therefore, it is interesting to observe whether some hard discounters will enter the Russian market in the near future.

Aldi is a German retailing group owned by Albrecht brothers, Karl and Theo. Aldi follows a simple but successful strategy: a typical Aldi has only 700 products, compared with more than

20.000 at many traditional supermarkets (and as many as 150.000 at a Wal-Mart superstore). Established brand names like Nestle, Nivea or Persil are irrelevant at Aldi. Almost everything on display is an Aldi – exclusive label such as Frisco toothpaste, or Rio D'Oro orange juice.

Because Aldi sells so few products, it can exert control over quality and price. The limited selection simplifies shipping and handling. The secret of Aldi's success is as follows: shoppers find little difference in quality, assortment and service at Aldi, versus traditional retailers, but they rate Aldi better in price.

Lidl is another German hard discounter. It is possibly Europe's fastest growing food retailer with operations in over 20 countries. It is a family business, and thus, highly secretive. Lidl is now challenging the successful Aldi, while adopting the same limited range, rock-bottom price model to Aldi. Lidl belongs to Schwarz Group, which also runs hypermarkets and superstores with Kaufland label. Schwarz Group also uses own private label products, like Aldi, which are sold 20–30% cheaper, than equivalent branded goods.

Schwarz Group is already heavily involved in Central Eastern Europe, where the company makes annual sales of over EUR 1 billion. Thus, it can be assumed that the Group has plans to enter Russia in the near future.

Carrefour, the biggest retailer in Europe, has presence in post-communist region. In 2005, Carrefour gave up its operations in the Czech Republic and Slovakia via an asset swap with Tesco, the British retailing giant. The latter received in this deal Carrefour's 11 outlets in the Czech Republic and 4 stores in Slovakia. In exchange, the French company received Tesco's stores in Taiwan. Carrefour continues its operations in Poland.

Carrefour and Tesco, which are both real heavy-weights in European retailing, have not established presence in the Russian market. Thus, Metro is the only European retail giant with activities in both Central Eastern Europe and in Russia.

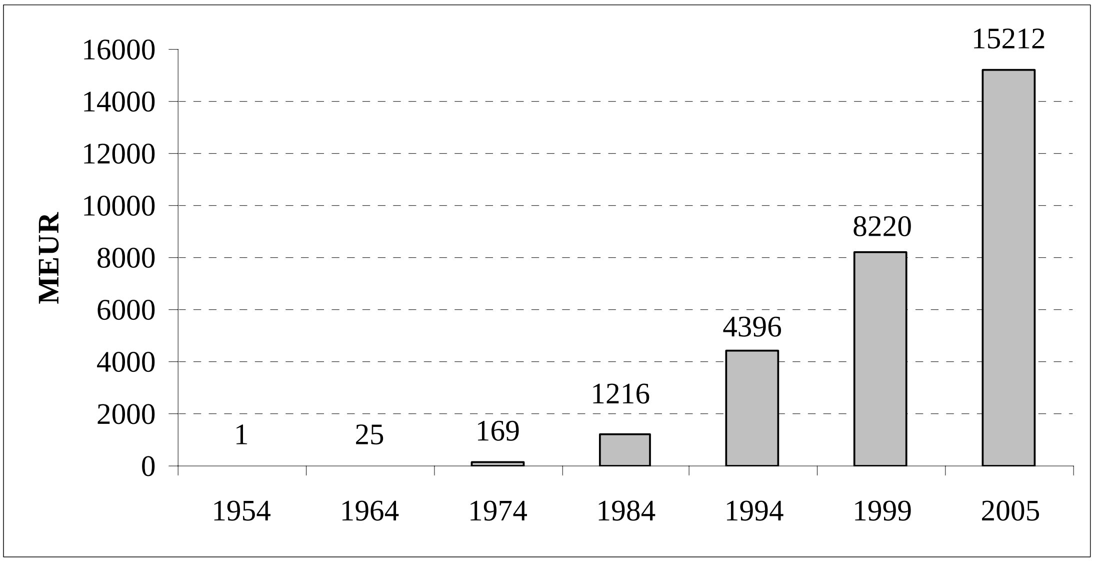
In the winter, it was announced that Pyaterochka (the third largest retailer in Russia) and Perekrestok (on the fourth place) will merge. The combined turnover of these two units in 2005 was close to USD 3 billion.

In this context, it is worth noticing that the Russian retail sector is still fragmented, and thus, offers plenty of options in mergers and acquisitions. Consolidation of Russian retailing is likely to have Western involvement in the next 10-year period.

5 Special Case: IKEA

Big Wal-Mart, Tesco, or Metro shops are not called “one-stop” or “big-box” outlets by accident. Modern super- and hypermarkets offer a large variety of foodstuff and general merchandise, but cannot cover all consumer needs. Consumer durables, clothes and “Do-It-Yourself” goods are available in one-stop stores in a massive scale. In clothing business, there are many internationally operating chains, like Hennes & Mauritz (Sweden), Zara (Spain), GAP (USA), etc. Previous iron mongers are replaced with big DIY-shops (Home Depot in USA, Bauhaus in Germany etc.). Household appliances and consumer electronics are available in massive shops selling these durables around the world. In furniture retailing, there are only a few firms which have carried out the internationalization process successfully. IKEA (Sweden) is obviously the best-known of them. The core business idea of this Scandinavian company is very feasible in transitional economies: it offers furniture and house decoration items in modern style at affordable prices. IKEA’s turnover has shown rampant growth during the last twenty years, during which it has created a very visible presence in the TE-region.

Figure 1 IKEA Turnover (EUR Million)



Source: IKEA

IKEA is a Swedish retailing company with a worldwide presence. It has managed to grow from a small mail-order company to the largest retailer of home furnishings in the world. The name of the company is formed by the initials of the founder, Ingvar Kamprad, his farm Elmtaryd and his village, Agunnaryd in Småland, South Sweden. Kamprad began his entrepreneurial career in 1943, at the age of 17, by selling fish, Christmas magazines and seeds. Within a few years, Kamprad had established a mail-order business with a wide product range from new ballpoint pens to furniture. It was furniture selling that turned out to be the most successful business.

The post-war boom was one of the most important factors for the growth of retailing in Sweden. Kamprad found a business opportunity when the furniture prices rose by 41% between years the 1935 and 1946 due to cartels of Swedish manufacturers and retailers. He opened the first IKEA outlet in Ålmhult in 1953 by converting a disused factory to a warehouse showroom. The first store doubled its turnover in two years, and in 1961 its turnover was 80 times bigger than the average turnover of a furniture store. The second outlet was opened in 1965 in a suburban area of Stockholm. At that time, it was the largest in Europe. Several of IKEA's basic practices, which will be discussed below, were developed in this period. In the late 1960s and early 1970s, IKEA captured a 15% share of the Swedish furniture market and opened seven new stores in Scandinavia.

Ingvar Kamprad was an idealist in addition to an entrepreneur and wanted to offer new and beautifully designed products to the majority of people. He announced that "IKEA shall offer a wide range of home furnishing items of good design and function at prices so low that the majority of people can afford to buy them". This is the mission behind IKEA, and the company has managed to become a curator of people's lifestyles with more than 200 stores in more than 30 countries and more than 90.000 co-workers. Most of the stores are owned by the IKEA Group, but in some areas the shops are run by franchisees (24 franchisees in 2005). Inter IKEA Systems B.V. which is located in Delft, the Netherlands, is the owner and franchisor of the IKEA concept. The IKEA Group, on the other hand, is a private group of companies owned by a charitable foundation in the Netherlands. It is active in developing, purchasing and selling IKEA products. However, most of the global product policy (including product development) and global marketing are still centralized to the Swedish part of the company, IKEA of Sweden (Hollensen, 2004). The principal target market of IKEA is similar across the countries and regions where IKEA is located, and the target group is composed of people who are young, highly educated, liberal in their cultural values, white-collar workers, and not especially concerned with status symbols.

IKEA stores are unique in design and operation. Usually the stores are situated in suburban areas close to big cities in order to have a low-priced site with a large parking area. IKEA stores are large showrooms with different combinations of their products. The products are grouped together to offer not just chairs and tables but designs for living. It is possible to furnish an entire house with IKEA products, as the products vary from sofas and bookshelves to curtains and tableware. There can also be found huge amounts of smaller items, such as candles, picture frames and soaps; things you might not need but are so cheap you end up buying. The product range is enormous, over 10.000 products in one store. The bins and shelves constantly hold surprises, and IKEA replaces a third of its product line every year. Next to the showroom can be found a self-service warehouse where the customers can collect the products displayed in the showroom. To keep the costs down and the prices low, IKEA sells unassembled furniture of simple Scandinavian design, offering a large selection of colors, styles and materials. IKEA saves money in labor costs with the idea that the customers are met at the door not by salespersons but with catalogues, tape measures, pens and notepaper. They move through a standardized store layout which allows them to look at the merchandise, get information and make purchase decisions without sales help. It is still easy for the customer to get the needed information from catalogues and well-designed showroom notice boards. Catalogues are an effective marketing tool. It is usually the catalogue that attracts the customer first (Hollensen 2004). IKEA printed 160 million copies of catalogues in 2006 in 52 editions and 25 languages, and they claim that it is more than the annual print of the Bible. (BusinessWeek, 2005)

Shopping in IKEA is more than a basic shopping experience. IKEA offers a wide range of services to its customers. Restaurants, coffee shops and day care facilities attract families to spend a whole day in the store. The restaurants offer Swedish specialties at low a price and even warm up baby bottles. One service that IKEA does not offer is home delivery: customers pick up the purchased items in the warehouse themselves. However, in some locations, IKEA co-operates with car rental companies to offer vans and small trucks for customers needing delivery service. In addition, they sell car roof racks that make it easier for the customers to carry the purchased items home.

IKEA has a standardized product strategy with an almost identical assortment around the world. It has largely ignored the retailing rule that international success involves tailoring product lines closely to national tastes. Instead, articulated by Kamprad, it sells a basic product range that is “typically Swedish” wherever it goes. This has proved to work and IKEA also thinks that consumer tastes are merging globally more and more. Still, in addition to a basic, universally accepted product range which is the main core in every IKEA store, they also have product lines that appeal to local customer preferences.

Each IKEA product is carefully planned and developed in teams which consist of designers, product developers and purchasers. Together these discuss designs, materials and suitable suppliers. The purchasers contact suppliers and find out who can make the product of the best quality for the right price at the right time. The products are developed in close co-operation with the suppliers. IKEA uses contract manufacturers all over the world. In order to manage such a large network, IKEA depends on leading-edge technology and has developed its own global distribution network. The suppliers are carefully selected and they receive technical support, leased equipment and the necessary skills needed to produce high quality items. In addition to outsourced production, IKEA acquired Swedwood, the furniture-making subsidiary of Hexagon, in 1991 and started its own manufacturing in the low-cost countries of Eastern Europe.

IKEA offers prices that are 30%–50% lower than fully assembled competing products but are still able to have high operating margins, approximately 10%, which is among the best in home furnishing (BusinessWeek, 2005). The prices vary from market to market mostly due to fluctuations of exchange rate and differences in taxation regimes, but the price positioning is kept as standardized as possible. One of IKEA's methods of keeping the costs down is to pack the items compactly in flat standardized packaging and stack them as high as possible to reduce storage space. The main reasons for low prices are large-quantity purchasing, low-cost logistics, store location in suburban areas, the do-it-yourself approach and an effective network of suppliers. It has close co-operation with the suppliers – 1.300 in 53 countries in 2005 – in material sourcing and production efficiency. Often one supplier is appointed to supply all stores around the world, and because orders for the global market are large, the suppliers are able to cut costs through economies of scale. The suppliers are usually located in low-cost nations with close proximity to raw materials and reliable access to distribution channels. IKEA had 46 trading service offices in 32 countries in 2005.

The logistics network of IKEA is very effective. The manufacturers are responsible for shipping the components to large warehouses where the components are put to the final package. The different components needed for one piece of furniture can be produced by different manufacturers. The distribution centers – 28 in 16 countries in 2005 – supply goods to various stores.

IKEA uses very effective promotion methods. For example, in the US there were more than 2.000 IKEA fanatics waiting for the opening of a new store, because IKEA offered a USD 4.000 gift certificate to the first person in the line. Some people were present only for the carnival atmosphere. Also in the Saudi Arabian city Jeddah, IKEA's offering drew thousands of shoppers to the opening, and the first outlet in London attracted up to 6.000 people before the police was called in (BusinessWeek, 2005). The campaigns of IKEA are unique. No other company offers a free haircut or manicure to store visitors or washes the socks of single visitors on Singles Day (Bartlett & Ghoshall, 1995).

The Swedish furniture market doubled between 1963 and 1970. However, due to the low population growth rate and saturated market in Sweden, Kamprad felt IKEA had to expand internationally in order to continue growing. IKEA started conquering foreign markets sooner than other retailers. In the early years of its international operations, it established itself in the neighbouring countries, Norway and Denmark. After this, it expanded quickly to more distant locations during the 1970s and 1980s, using mostly its own subsidiaries. IKEA does not enter a new potential market by opening a retail outlet, but by establishing a supplier link with the host nation. This is a strategic, risk-reducing approach in which the local supplier can provide valuable input on political and legal, cultural, financial and other issues for the IKEA concept. (Hollensen, 2004)

In the last 20 years, IKEA has used franchising as the mode of entry. It approaches unknown, relatively small and high risk markets by franchising. Franchises are granted only to companies that have a strong financial backing and a proven record in retail. In order to maintain standards in service, quality and logistics, IKEA periodically audits and compares individual franchisees to overall corporate performance (Hollensen, 2004). The expansion of IKEA has been fast, and it has opened new stores in new countries almost every year. In 2006 over 20 new locations will be opened. Although IKEA has become a curator of people’s lifestyles and has a turnover over EUR 15 billion, it still has room to run. The retailer accounts for just 5%–10% of the furniture market in each country in which it operates. However, the awareness of IKEA’s brand is much bigger than the size of the company. One important issue for the future growth of the company is the fact that more and more people are striving to enter the middle class from Moscow to Beijing and beyond (BusinessWeek, 2005).

Though IKEA normally uses a standardized product strategy, there are still some exceptions, such as in the US where IKEA has modified some of its products to match the customer needs. IKEA entered the North American market in 1985 and opened six stores during the next five years. Still, unlike in Europe, the companies did not become profitable. Part of the problem was an adverse movement of exchange rates, but the largest difficulties were caused by different preferences and physiques in the US. Swedish beds were too narrow and measured in centimeters, and also the kitchen cupboards were too narrow for large dinner plates. In 1990 the company’s top management made the decision to change their products to fit the customer needs. After modifications, IKEA's North American sales tripled and it became profitable also in the US. (Hill, 1999)

In the Cold War era, it was not easy to do business across the ideological borderline called the Iron Curtain. However, IKEA managed to create supply contracts in the former Soviet Union and in the former Eastern Bloc. Selling Western furniture via IKEA's own retailing outlets in communist states was not a feasible concept.

In that era Hungary was the most liberal national economy of the communist bloc. In 1988, IKEA agreed to build a big store in the outskirts of Budapest. This 12.600 square meter hall was inaugurated in 1989, the year of systemic change in Eastern Europe. IKEA's first store in Budapest became an important landmark of the new system in the very heart of the former Eastern Bloc.

After the systemic change, IKEA started extensive operations in Poland, a country of almost 40 million inhabitants. The company not only opened stores in Poland, but also expanded production via its manufacturing arm, Swedwood.

In the early period of transition, the former Czechoslovakia was a Federation with some 15 million inhabitants. IKEA invaded this country with two stores, one in Prague and the other one in Bratislava. After the split of the Federation in 1993, IKEA had presence in both new states, in the Czech Republic and in Slovakia.

Obviously, Russia with her big internal market is of special interest for IKEA among TEs. The company used a Russian wood processing factory, Priosersky, as a supplier in the Soviet era. After the collapse of the Soviet Union in 1991, IKEA expanded its supplier network in Russia rather rapidly. Some 75 Russian manufacturers belong presently to this network.

In the early period of Russian transition, IKEA had plans to launch furniture retailing in this largest TE-market. However, the first IKEA store in Russia was opened in 2000, near Moscow. In the middle of the first decade of the 21st century, IKEA had already three stores in Moscow, one in St. Petersburg and one in Kazan (Southern Russia).

IKEA is conquering the Russian market with a heavy investment spree. Swedwood has production near St. Petersburg (in the surrounding area – the Leningrad region), and another in Kostamus, a city close to the Finnish border in the North. Two further production units will be constructed near Moscow. The Swedish company has also been involved in constructing shopping centres with retailing operations in three locations mentioned – the metropolitan areas of Moscow, St. Petersburg and Kazan. In addition the company has built its own distribution centre near Moscow.

It is a well-known fact that business climate is not very favourable for newcomers in TEs. Real estate purchases are not easy to achieve. The rules concerning landed property are often unclear, and the enforcement of the rules may be confusing. Plenty of permits and stamps are required, involving official and unofficial payments. Thus, foreign companies have often experienced unpleasant surprises linked with construction projects. According to Western financial press, IKEA has encountered some surprises in its Russian operations in this context. As mentioned above, Auchan faced serious difficulties in the Czech Republic with its shopping centre scheme.

Amid the Russian economic boom the real estate market is overheated in the main metropolitan areas: office space, shop floors and storage facilities are in short supply. It can be assumed that present-day pioneers will earn very good returns on their investment in the future. The best business locations will be occupied during the next two decades. IKEA will certainly be able to earn a nice rent income in its shopping centre business in Russia.

IKEA’s core activity, selling furniture and interior decoration, in Russia looks very promising. In that segment, it is far the largest foreign competitor with a share of some 10% of the market. Latecomers will have a tough time to beat it.

For the Russian economy, IKEA’s presence is very beneficial. The success of the Swedish company is based on selling standardized products in big volumes at affordable prices in as many markets as possible. Therefore, the IKEA’s suppliers – whether they are company-owned or independent manufacturers – can produce for the local Russian market, but also for export purposes. In both cases, IKEA benefits from the low production costs in Russia.

6 Conclusions

In the second half of the 20th century, Western Europe experienced a long and strong boom. Especially in West Germany, the period of the reconstruction was called “economic miracle”. A very complicated process of economic integration took place in Western Europe at the same time. Increasing living standard and welfare attracted massive scale immigration in several countries of present-day EU area.

In the early days of the post-war period, supply of consumer goods was a problem in West European economies. Rationing of foodstuffs took place in many corners of the Old Continent. Thus, there was something, which is called “sellers’ market”. Whatever retailers had on their shelves was in high demand.

In the last quarter of the 20th century, the situation changed radically. Amid the economic boom, labour force became increasingly expensive in Western Europe. Manufacturing companies started looking for cheap production opportunities outside Europe, while retailers started restructuring the branch by erecting big shopping centres and supermarkets in outskirts of urban areas. “Buyers’ market” was established with mobile and wealthy clientele. “Big box” or “one-stop” shops became predominant in Western Europe, which basically copied the retailing model from the USA.

In the 1990s, all markets in the rich part of the world were mature and became increasingly concentrated. Expenditure on food forms a decreasing proportion of total consumption squeezing food prices in a deflationary stage. Modern retailers thus offer a wide selection of food and non-food items in their one-stop big boxes.

In the consolidation process of retailing, price has become a crucial factor of competition. Big retailers can ask for volume discounts when buying from vendors. Fast moving consumer goods (FMCG) producers feel the pressure in price negotiations exercised by big supermarket chains.

In the saturated Western markets, there is rather little leeway for growth in the retail sector. Therefore, big retail chains are, so to speak, forced to become international, when manufacturers have been doing it for decades. Retailers really must keep growing, in order to maintain and improve the volume discount weapon. The bigger the order from FMCG industry, the higher is the discount, at least potentially. At the same time, big retailers are forced to develop own (private) label products (offer cheap alternatives for branded goods). No internationally active retailer can ignore price competition.

In the Cold War era, the communist side of the Iron Curtain promised unique welfare for its citizens in the former Eastern Bloc and the former Soviet Union. At the same time, supply of consumer goods was neglected in central planning. State owned retailing outlets had empty shelves and dissatisfied clients. Disillusioned citizens caused the collapse of the communist system, which took place in remarkably peaceful manner in the turn of 1980s and 1990s.

In the early period of post-communism, there was a proliferation of small-scale retail outlets in each of the countries of the TE-region. Small retailers lacked the capital and expertise to modernise shops into western-style businesses.

Thus, transitional economies offered enormous opportunities for western retailers suffering from saturated traditional markets in the 1990s. The invasion of Western retail chains in TEs of Central Eastern Europe started as a trickle, but soon begun to resemble a flood with major companies from Western Europe entering the post-communist scene. Already in the turn of the century, many transitional economies were full of Western labels and modern shops run by international companies. The former Eastern Bloc changed visually in a very short period of time.

General instability in the post-Soviet Russia made Western companies reluctant to invest in retailing. Many foreign investors burnt their fingers in the financial crisis of 1998 in Russia. Therefore, capitalist retailing revolution in Russia has taken more time, than in Central Eastern Europe.

In the early period of Russian transition local entrepreneurs started emulating western retailing models. Obviously, it was essential to acquire advantageous trading places to start with. The “two capital cities”, Moscow and St. Petersburg, were the most desired locations. Concentration of purchasing power in these two metropolitan areas was obvious in the early period of transition. Modern formats of retailing started to appear in Russia – mainly owned by local capitalists. Early starters were able to skim the cream from the emerging market and accumulate capital for further expansion.

In 2005, only four retail chains had a turnover of over USD 1 billion in the Russian market of 144 million inhabitants. More than one third of Russian food retail is done in open markets, kiosks and pavilions. Over 40% of food is sold in traditional grocery shops. Modern supermarkets and discounters have a market share of 10% each. Hypermarkets have a slice of 3% only of the food retailing.

These details show clearly that the post-Soviet retail revolution in Russia is far from complete. There are some 6 hypermarkets per one million inhabitants in Poland. The equivalent figure in Russia is 0,6. Therefore, the Russian retail sector still has enormous growth potential.

Metro is far the largest foreign player in the Russian retail game with an annual turnover of USD 1,8 billion. Auchan is far behind the German giant with an equivalent figure of USD 750 million. Ramstore (Turkey) is the third foreign competitor with USD 600 million sales in 2005.

In average, large retail chains in Russia increased their turnover by almost 50% in 2005. This high dynamism ought to attract newcomers into the branch, in which the estimated profit rate is somewhere between 15% and 30%. At the same time, it is maintained that risks in doing business in Russia are still high. However, expected strong growth of purchasing power combined with high profit margins in the Russian retail trade is likely to enhance international interest in the branch in the near future.

From the point of view of Russian consumers, it is advantageous to have more competition in retail trade. Prices will be affected by the maturing process of the retail sector. Really “hard discounters” are still missing in the Russian market.

It is said that IKEA is an icon of modern lifestyle. The basic business idea of the company is to offer nice and comfortable house interior decoration for everybody at affordable prices. The core of IKEA’s international operations is retailing: own design is used in furniture and other items on sale, while supplies mainly come from contractees. IKEA has a global network of contract manufacturers, but a marginal amount of the merchandise comes from company-owned outlets.

Obviously, the big bulk of IKEA’s products are rather labour-intensive, and thus, suppliers are mainly located on emerging markets, TEs included. Cheap labour must be combined with advantageous retail prices, which are the most important marketing slogans in IKEA’s business strategy.

IKEA's concept is ideal for the post-communist era with gloomy atmosphere and murky decoration of living environment; it is a delight for consumers to get access to modern house decoration items with rational design and at reasonable prices. IKEA is obviously one the best-known brands in the TE-region.

IKEA entered the Russian market relatively late. Therefore, it is understandable that the company is now conquering the Russian market with high inputs. From the Russian point of view it is important that IKEA's local investment has a cumulative effect: not only retail should takes place, but also extensive orders of supplies from local manufacturers. Obviously, a considerable amount of IKEA-designed products manufactured in Russia is exported to IKEA's international network of furniture shops.

The timing of IKEA's entry into the Russian market seems to be optimal. In the first years of the 21st century, a broad middle class is emerging in Russia eager to improve its every-day living environment. It can be assumed that IKEA will expand its Russian operations rapidly.

According to the newspaper Helsingin Sanomat (June 7th, 2006), Wal-Mart is seriously interested in acquiring Lenta hypermarkets in Russia. In addition, it was announced that this biggest global retailer sold its outlets in Germany (to Metro) and in South Korea. Thus, there is a rather high likelihood that Wal-Mart with her deep pockets will enter the Russian market soon. Retailing in Russia will offer plenty of excitement for several years to come.

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