



# The military-industrial phoenix

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## Overview

The February 2007 appointment of Sergey Ivanov as First Deputy Prime Minister in charge of the real sector conveniently puts a state control enthusiast in charge of top-down reorganisation of the defence industry. But Ivanov has his work cut out to bring definition to the sector. Holding companies created to shepherd firms into consolidated blocs are still emerging, with boards well stocked with government officials, unpredictable movements of assets, contradictory public statements about new and existing entities and elastic deadlines. Clarity remains a future prospect.

Research, design, serial construction, export and maintenance of aircraft, weaponry, engines, ships and relevant construction materials involve broad swathes of the economy. Arms exports are buoyant, and strongly expanding domestic defence procurement is now following. The sector is exposed to international competition and, alongside tightening central government control through vertical holdings, is looking for both foreign strategic partnerships and portfolio investment.

### Context

The consolidation of state ownership in the defence sector still leaves room for private capital

### Public Judgements

Positive accounts of a rebuilt military are overstated

- > **Mikhail Barabanov**, Centre for Strategic and Technological Analysis
- > **Alexander Golts**, Yezhednyevny Zhurnal

Holding-company strategy is sub-optimal

> **Ruslan Pukhov**, Centre for Strategic and Technological Analysis

> **Alexander Lebedev**, Duma deputy  
Actually, government-controlled holdings make sense in the defence sector

> **Sergei Markov**, Institute of Political Studies

> **Yuri Zaitsev**, Russian Engineering Academy

### Wrap

Will money be spent effectively and the habitual inefficiencies of state control overcome?

## Context

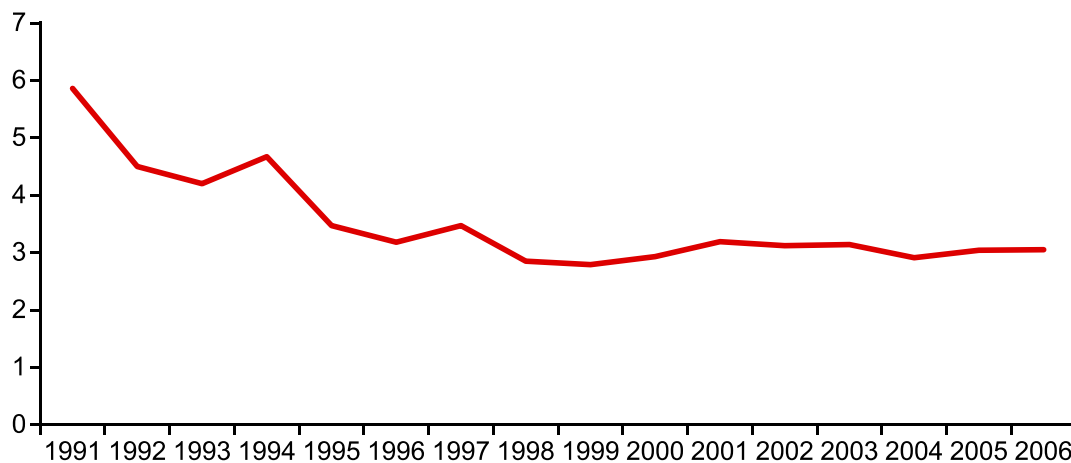
### State control to collapse to consolidation to state control

In the mid-1980s, the Soviet 'military-industrial complex' dominated the planned economy, and was estimated to devour between 15 and 30 per cent of GDP, while other sectors crept along with minimal inputs. The division between defence and nondefence sectors was so profound that exposure to the outrageously shoddy output of Soviet light industry obscured the reality that elsewhere this economy produced world-class fighter aircraft, weapons systems and other military goods.

The sector's privileged position and detachment from the restorative influence of market forces through the 1990s meant real and sustained collapse during the transition. From the late 1980s to 2003, the number of design bureaus fell by two-thirds, weapons production by 75 per cent and R&D specialists by 55 per cent before the government was finally able to afford material real-terms increase in defence procurement spending in 2004-5.

Putin stated in March 2007 that \$189 billion over eight years (through 2015) would be devoted to re-equipping the armed forces, including replacing half the army's hardware. The Defence Ministry has indicated that military spending will reach \$32 billion in 2007, and Finance Minister Aleksey Kudrin has forecast that it will rise to nearly \$50 billion by 2010. This turnaround in defence spending follows the wider economic recovery; thus, as a percentage of GDP, defence expenditure is merely showing convergence towards 'normal' (roughly European) levels (see chart). For 2007, \$32 billion in projected defence expenditures over a \$1.2 trillion projected dollar GDP (at market exchange rates) is 2.6 per cent.

**Russian defence expenditures, including military pensions (as per cent of GDP)**



Source: compiled by warfare.ru from Rosstat, MinFin, Institute of Economy in Transition

Meanwhile, earlier mixed messages about the government's management policy towards the defence industry have yielded to a government-control-over-'strategic sectors' approach (not entirely coherent - see our piece analysing the larger [strategic sector policy debate](#)). So, while in mid-2003, a government representative could still state that the government 'does not pursue the objective of nationalisation of these enterprises, it aims at supporting them', by the end of 2005, state holding companies were buying up - sometimes, oddly, through proxies - majority stakes in defence companies. In 2006, the holding companies were acquiring official definition. In mid-March 2007, Ivanov spoke of the government taking matters fully in hand 'to stabilise and develop the defence sector' and 'step up the measures of state support of the sector and put in operation a system of state guarantees'.

## Consolidation under government-controlled holding companies

Before the latest surge of state consolidation, analysts were already noticing consolidation taking place spontaneously. This had even been encouraged by the transition-era effort to spread the meagre bounty of contracts or exploit the staff-poor design bureaus by obliging the winner of a contract to subcontract some work to the losers, hence integrating and maximising the human resources to hand. Rival design bureaus and manufacturers, intentionally disaggregated geographically and functionally in Soviet times, were also setting aside differences to cooperate on one-off export projects. By 2004, some defence companies (for example, Ufa Motors, Rostvertol, Ulan-Ude Aviation Plant, Kazan Helicopters and Irkut) had sufficiently gained a business footing for equity analysts to initiate coverage and urge investors to buy shares.

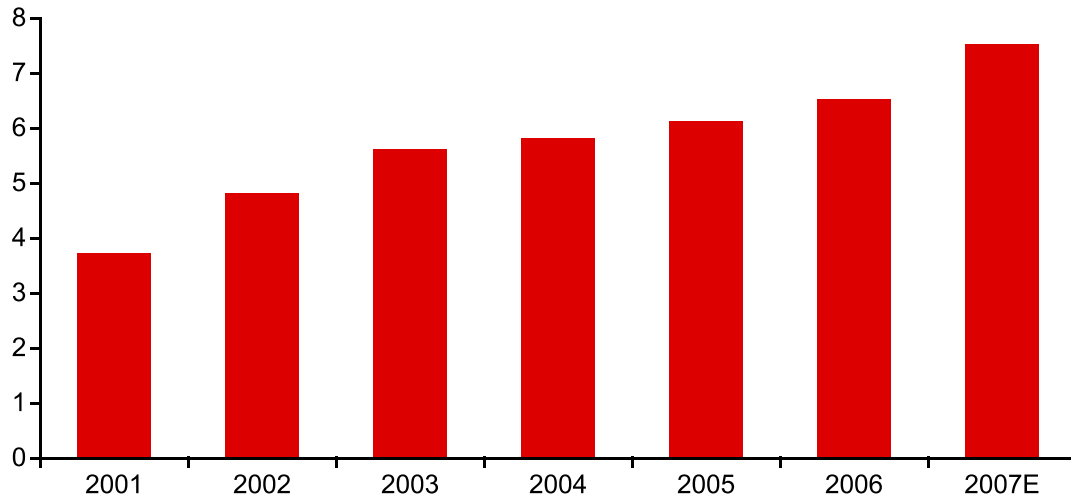
Since then, these companies have mostly been swallowed by government-controlled holding companies (with, in the case of Irkut, some loss of minority shareholder value). But there is some indication that the holdings will try to incorporate, where possible, the earlier spontaneous integration, particularly in aviation design and shipbuilding. The major holding companies explicitly tasked to consolidate the sector are listed below (for additional detail and discussion, see [military holding companies](#)):

Entity and its head	Area of consolidation
Rosoboronexport, run by Sergey Chemezov, a former KGB officer posted in East Germany with Putin	Combined two Soviet-era entities in 2001, given arms export monopoly status in December 2006; 'parent' organisation to Oboronprom
Oboronprom, run by Denis Manturov (b. 1969), formerly with Kazan Helicopters and Ulan-Ude Aviation Plant	Joint-stock company since 2002; tapped in 2005 to consolidate helicopter-makers and some engine producers, with further expansion possible
United Aircraft Building Corporation (a.k.a. UABC, UACC, UAC and OAK), chaired by First Deputy Prime Minister Ivanov	Created definitively in 2006 as umbrella for non-helicopter civilian and military aviation
United Shipbuilding Corporation (OSK), to be run by Colonel General Alexander Burutin	Created 2007 as umbrella for three regional shipbuilding (for surface vessels and submarines) subholdings based in northern, western and Far East port complexes

## Export picture

Exports saved the defence industry during the lowest point of post-Soviet transition. Overseas orders for equipment and replacement parts were about the only income the defence industry had. High levels of Soviet arms exports (in 1985 reaching \$14 billion in 1990 dollars) left a big market for maintenance and replacement parts. No-frills, but durable and cost-effective Soviet equipment, from Sukhoi fighter jets to the workaday Kalashnikov, have commanded genuine international demand (rather than merely being foisted on Soviet-bloc client states). Building on relationships that date from the Cold War, Russia is working with India to create a 'fifth-generation' fighter jet and produce supersonic Brahmos cruise missiles. China contents itself with slightly less than cutting-edge weaponry, in large quantities. In Latin America, Venezuela, Mexico, Brazil and Argentina there are clients and prospective clients.

### Russia's arms exports (US\$ billion)



Source: Kommersant, Ivanov's public statement

#### What's left for investors?

While consolidating state ownership for the sake of both control and the companies' viability, the Putin administration is not locking private capital out of the defence sector. Sukhoi Civilian Aircraft raised \$192 million in a debut bond issue at the end of March 2007, and is in talks with Italy's Alenia Aeronautica to sell a 25 per cent plus one share stake, leaving 10 per cent for VEB and 15 per cent for other private investors. Within UABC, Kazan Aviation Production Association and MiG Russian Aircraft Corporation are intended to be reincorporated as joint-stock companies in the near term. There is talk of IPOs both for individual companies and for the overall holding companies themselves.

EADS has been pursued as a strategic partner, although Minister of Economic Development and Trade German Gref has raised the idea that others could be better and more willing partners. India already is a partner in producing aircraft and weaponry, and China is keen to play that role as well. France expresses interest in Russian helicopters as well as reconnaissance, amphibious and unmanned aircraft. Pursuit of EADS has not prevented Boeing from enjoying major leasing arrangements, and Airbus relies on Irkut and VASO for 'large work packages' on its A320, A330 and A380 families.

## Public Judgements

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### Positive accounts of a rebuilt military are overstated

**Mikhail Barabanov**, of the Centre for Strategic and Technological Analysis, writing in the Moscow Defense Brief. President Putin's annual address to the Federal Assembly in May 2006 offered a 'fairy tale': reviving military ship-building, re-equipping army divisions with massive serial purchases and substantially upgrading nuclear missile forces. Small purchases of experimental prototypes would be more accurate. Putin's address tried to 'patch over the continuation of the deep, systemic crisis facing the Russian armed forces and defence industry', leaving us to 'wonder whether the authorities understand the inadequacy of their measures, or whether the President's address has crossed the line from propaganda to self-deception'.

**Alexander Golts**, deputy editor of Yezhednyevny Zhurnal, writing in the Moscow Times (6 March 2007). The magic phrase from First Deputy Prime Minister Sergey Ivanov - 'fifth generation' - opens the coffers of the Treasury to support a new defence 'system of systems' due for completion by 2015 to unite informational, tactical and management elements of the anti-missile, anti-aircraft and anti-space weaponry defences. Asked for clarification, specialists reply that this is gobbledygook. 'Or perhaps Russian scientists have an eight-year deadline to deliver a weapons system based on as yet unknown principles of physics'. Little more than a reshuffle of existing elements of weapons systems should be expected.

### The holding-company strategy is sub-optimal

**Ruslan Pukhov**, director of the Centre for Strategic and Technological Analysis. A bipolar approach, like that in France where EADS handles military projects and Dassault deals with commercial projects, would have been better than UABC. In other words, Sukhoi could have been left out of the vertically-integrated holding. But an overall holding company may well be better at preventing weak Russian aircraft companies from perishing in a free market.

**Alexander Lebedev**, Duma deputy and prominent businessman with aerospace interests, quoted (in February 2007) by Ria Novosti. With the emergence of the new state holding companies in the defence sector, 'we are again returning to government management - the worst option' in a market economy.

### Actually, government control in the defence sector makes more sense than in any other

**Sergei Markov**, of the Moscow-based Institute of Political Studies, quoted by Bloomberg upon the creation of UABC. Since the government is the main buyer, it is hardly illogical to give more control over the company to the consumer; and the government is incentivised to have well-functioning companies.

**Yuri Zaitsev**, of the Russian Engineering Academy, writing for Ria Novosti (in February 2007). Since UABC is a monopoly itself, it will aim to promote competition among its *subcontractors*, thereby producing better quality hardware and neutralising the dictatorial tendencies of monopolies.

## Wrap

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### **Export markets may provide competition; strategic partners may guide on corporate governance**

The Russian government has settled on vertical integration and firm state control in the defence sector. Unlike in the energy sector, there was never really much question of significant private ownership of Russia's defence industry. So the rollback of private ownership is not an issue here.

Questions remain on two fronts. First, these relate to whether, as Barabanov and Golts fear, applause and buzzwords still outweigh fundamental improvement to the Russian defence sector, despite real Kremlin interest and massive funding. The sector has been desperately underfunded for many years, and the recovery is patchy. Not only money but money well spent will make the difference, of course. The relevance for investors is: how deep does the pit need to be filled before genuine progress and improvement are discernible?

The next important question is whether the predictable inefficiencies of state control will be mitigated in some other way, and there are indications they may. The quality-enhancing competition which was prevented by domestic monopolies can come from abroad, in the form of the increasingly open and competitive global arms market. Although Russian military exports remain concentrated on China and India, together with controversial supplies to rogue states (Iran, Syria, Venezuela) causing tensions with the US, the Russian defence sector is pursuing sales across the board - including to NATO countries - as Cold War alignments ease; this opens an opportunity for competition among producers for international contracts. So quality-enhancing competition that does not happen domestically happens internationally.

Second, the clear role and oft-repeated desire for foreign strategic partners working on specific projects - especially in aerospace - usefully expose the sector not only to technology exchange but, perhaps more important, to best operational and management practice. As for private portfolio investors (bond buyers, minority stake-holders), they will force issuers to improve corporate governance practices.