

# Country & Industry Analysis

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## **Introduction**

In order to properly analyze our country we felt it necessary to report on some critical information. We have researched Russia and will include our findings in this report. However, since we are entering into business in a country that we know little about, it is important to first learn something about the history of that country. So we will begin by reviewing some history of our country and then speak more specifically about topics like culture, currency, physical infrastructure, legal environment and so forth. Finally, we will sum up what we feel like the business climate is in Russia, what we believe it will be like in the next 12 months and the next 10 years, and we will choose an industry giving facts to back up our choice of industry and entry method.

## **Brief History of Russia**

Early Russia was made up of scattered cities that eventually grew into a large empire and what would become geographically the largest country in the world. Russia is a very old country with the first settlers believed to be have been a Scandinavian people known as the Varangians who settled the area in 862 A.D. in the city of Novgorod on the Volkhov River. From here migration extended south to Kiev a Slavic city that began in the 5<sup>th</sup> century. Kiev became a major trading center between Constantinople and Scandinavia. Over the next few decades other kingdoms lead by leaders, such as Vladimir I and following him Yaroslav, added territory to what would become modern day Russia. Over the next few hundred years Kievan Rus, the name given the territory, flourished until around 1054 when internal divisions began to weaken the kingdom. In 1237 the kingdom was destroyed by the Mongols lead by Batu Khan, a grandson of Jenghiz Khan. It wasn't until 1480 when Ivan the Great defeated the Mongols that the Russians began to throw off the ruler ship of the Mongols. However, it was Ivan the Terrible that unified

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Russia in the 1540's by reorganizing the military and finally defeating the Mongols (Ancient Russia).

Over the next seventy-five years Russia endured invasions from the Poland and leadership changes until finally Michael Romanov took the throne as Tsar. The Romanov Dynasty would rule Russia for the next 304 years until the October Revolution of 1917 began what would become Communist domination of the country for the next 80 years.

Prior to the October revolution, Russia had endured an embarrassing military defeat against Japan in 1905 and then again during War World I they were not militarily or industrially prepared to fight a war. They suffered severe food shortages and economic ruin. Finally, enduring all they could, revolution broke out in the major cities of St. Petersburg and Moscow resulting in the Tsar stepping down from his throne. The revolution continued for the next three years when finally the Bolsheviks were successful in gaining control of the country and forming what became known as the Soviet Union.

Under new leader Vladimir Lenin the country enjoyed a relative prosperous period until his death in 1924 when new leader Joseph Stalin soon gained control of the Communist party. Stalin changed economic plan to one that was managed from the very top. Farms were seized and formed into state run giants, art and literature were placed under tight control and churches were either closed or destroyed. Under Stalin thousands of Russians were murdered or taken away to be imprisoned.

Once again, with World War II, Russia found herself unprepared to fight a war near and eventually on her territory. World War II was a devastating war for Russia in terms of infrastructure damage and the lost of millions of Russia lives. After the end of World War II

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Russia spent next 40 years fighting what amounted to a Cold War with the west. Pouring a vast amount of their country's profits into military equipment and ignoring what was already a poor and crumbling infrastructure. Finally, in 1989 for the first time since the October Revolution of 1917, citizens were given a right to vote in an election where there was more than one candidate. Many of the Soviet states began feeling the pressure of revolution and began to fall. Moreover, what had become known as the Iron Curtain was torn down and finally in 1990 many of the Russian republics began to claim independence and the collapse of the Soviet Union was complete. Over the next decade Russia endured devastating financial and economic trouble as the country began switching to a free market and tried to improve its infrastructure. The work continues to this day with much progress made but with much more to go (Russian Federation).

### **Demographic Information**

The population of Russia as of 2007 was 141,377,752 people. The age structure consists of the age population between infant and fourteen years is about fourteen percent, the majority of the population which is seventy-one percent between the ages of fifteen and sixty-four, while the last age group, sixty-five and over is around fourteen percent. The total median age for the population is about thirty-eight years old. The median age for males is around thirty-five years old and females being a little over forty-one years old. Life expectancy at birth for the total population is nearly 67 years old. Females live longer with an average age of 73 years, whereas males are projected to live to almost 60 years of age. In literacy terms, 99.4 percent of the population fifteen and older can read and write. Males are higher with 99.7 percent while females are 99.2%

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The population growth rate has been declining with a rate of nearly negative half percent. The death rate is higher than the birth rate, which leads to having more deaths in Russia than births. The death rate is 16.04 deaths per 1,000 people while the birth rate is lower with 10.02 births per 1,000 people. The sex ratio for the total population is 0.859 males per female. The highest sex ratio between the two is at birth is 1.06 males per female. Second is the age group under fifteen years old with 1.054 males per female. Thirdly, fifteen to sixty four is 0.93 males per female. Finally, the age group of sixty five and older is 0.456 males per female.

### **Legal Environment**

Russia has federation type of government and their legal system is based on civil law. Russia earned its independence on August 24, 1991, and within a couple of years adopted a constitution on December 12, 1993.

The administrative divisions include forty-six oblasts, twenty-one republics, four autonomous okrugs, nine krais, two federal cities which are Moscow and St. Petersburg, and one autonomous oblast.

The executive branch includes the chief of state and the head of government. The cabinet includes the ministries of the government which is composed of the premier and his deputies, ministers, and selected other individuals which are all appointed by the president (Russia). The president is elected by popular vote and whoever wins. The president serves a four year term, but can only be in office for two terms. There is no vice president to replace the president if anything happens. Instead, the premier will serve as the president until a new presidential election is held (Russia).

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The legislative branch consists of bicameral Federal Assembly and State Duma. The Federal Assembly consists of 168 seats. The members are appointed by the top executive and legislative officials in each of the 84 federal administrative units (Russia). The assembly members each serve four year terms like the president. The State Duma consists of 450 seats. All of the members are elected by proportional representation from party lists that win at least seven percent of the vote and members are elected by popular vote to also serve a four year term (Russia).

The judicial branch consists of a Constitutional Court, Supreme Court, and Supreme Arbitration Court. The judges for all the courts are appointed for life by the Federation Council on the recommendation of the president (Russia).

### **Cultural Issues**

As you may suspect with such a long history full of changing times and an evolving society, Russia's culture is rich and full of many traditions, great art, literature, and architecture. Russian art includes the painting of icons, generally dealing with religious events and figures from older biblical times. Russian churches are full of such icons depicting Saints, Mother Mary and recreating the life of Christ during his time upon this earth.

Most societies have their own style of cuisine and Russia is no different, as a mostly agrarian society for many years their diet is mostly derived from fish, poultry, wild game, mushrooms, bread, berries and honey. During a trip to Russia you are almost certain to encounter soup during your meal and chances are good that soup will be borscht, which is made from cabbage.

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A well known staple in Russia is vodka which is more likely than water to be the beverage during a meal. Russian tradition is very deeply derived from their lively music and folk dances. Many of these dances are centered on telling a story such as the departure of winter and arrival of spring. Russians are highly superstitious with such beliefs as not shaking hands through a door and looking into a mirror if you leave the home and return. Finally, one distinguishing fact about Russian culture is their unmistakable architecture from the wondrous and huge metro system in Moscow to the colorful and beautiful churches like St. Basil's cathedral in Moscow. Ironically it is the onion domed and historically unforgettable churches that were once burned and closed by Stalin that are such architecture wonders.

### **Currency and Exchange Rate**

Russia's currency is called the ruble and is derived from the Russian verb rubit which means to chop. A ruble is a varying weight chopped from a silver ingot. This name has survived since the early Russian Empire dating back to 1721 (Russian Federation).

In the same manner that 100 pennies make up a dollar in the U.S. monetary system 100 kopecks make 1 ruble. The ruble coins come in denominations of 1, 2, and 5 with paper rubles in denominations of 10, 50, 100, and 500. The current exchange rate for the Russian ruble is 24 ruble to 1 U.S. dollar a steady improvement since the near collapse of the Russian economic system in the late 1990's. As an example in 2000 the Russian ruble was 33 rubles to 1 U.S. dollar.

### **Physical Infrastructure**

Russia's physical infrastructure is vastly outdated and in many areas in huge disrepair.

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After decades of neglect under the government run control in many ways this may Russia's main concern when it comes to attracting business. However of the past decade Russia has began making a concerted effort to improve its infrastructure, particularly around the major cities. As of 2007 Russia's physical infrastructure consisted of the following (Russia):

1. Transportation
  - Railways – 87,157 km
  - Highways – 871,000 km paved and 738,00 km unpaved
2. Waterways
  - 102,000 km
  - 72,000 km in European Russia links Baltic Sea, White Sea, Caspian Sea, Sea of Azov and Black Sea.
3. Ports and Harbors – 33
4. Airports
  - 601 paved and 659 unpaved
5. Heliports – 47
6. Pipelines
  - Condensate – 122 km
  - Gas – 158,699 km
  - Oil – 72,347 km
  - Refined Products – 13,658 km
7. Merchant Marine
  - 1,130 ships
8. Electricity Production – Total 771.94 billion kilowatt hours
  - 67% by burning fossil fuel
  - 20% from hydroelectric
  - 13% from atomic generating stations

### **Industry**

Russia possesses major deposits of oil, natural gas, timber and other strategic minerals in its vast territory. However, much of this area contains many difficult and often times formidable

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obstacles that make mining of these resources very difficult and often times cost prohibited. Even with these obstacles Russia is still a leading producer and exporter of gold and all major fuels, especially oil and gas, which are the main sources of Russia's hard currency. In fact Russia is 1<sup>st</sup> in the world in gas production, 3<sup>rd</sup> in oil, and 4<sup>th</sup> in coal (Russia Industry).

Other Russian enterprises include shipbuilding, manufacturing of road and rail transportation equipment, production of electric power generating equipment, medical and scientific instruments, consumer durables, textiles, foodstuff, and handicrafts.

### **Economic Environment**

As of the end of 2007, Russia achieved its ninth straight year of growth. The average annual growth is 7% ever since the financial crisis of 1998. The Russian Ruble, which is the official currency of Russia, combined with high oil prices is attributed to the expansion in Russia. During the growth period, poverty has declined and the middle class is in expansion. Overall, the people of Russia are better off then they were ten years ago.

Russia's international financial position has improved since the financial crisis of 1998 as well. The federal budget has had surpluses from 2001 to the end of 2007. Business and investor confidence has risen due to the implementation of important reforms in the area of taxes, banking, and labor. Foreign direct investment has increased from 2005 to 2007 by nearly \$28 billion.

Despite Russia's economic improvement, many difficulties remain. According to [www.cia.gov](http://www.cia.gov), "oil, natural gas, metals, and timber account for more than 80% of exports and 30% of government revenues, leave the country vulnerable to swings in world commodity

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prices.” Also, Russia’s banking system is small compared to many of its market peers. Although the system has been in a growth stage, the size of the banking system can hinder its purpose because it will need to grow twice as fast as its market peers to have a major impact globally.

Another issue is Russia’s manufacturing area. The manufacturing industry is impaired and needs to be reestablished and modernized to gain broader economic growth. Finally, there is much uncertainty in the Russian economy due to a recent transition of power, corruption, and lack of trust in government institutions. This has caused concern for many domestic and foreign investors. Russia has done little to improve the rule of law in the land.

### **Labor**

The labor force in Russia consists of roughly 75 million people. Labor is split into three categories. Agriculture contains 11% of the labor force, industry makes up just over 29% and services dominate much of the labor force with an estimated 60.5 %. The unemployment rate has improved recently and stands at 5.9%. The population below the poverty line is around 16% which has been reduced because of the growth of the economy.

### **Exports and Imports**

In the year 2007, Russia accumulated over \$365 billion in exportation. Some of the major exporting commodities are petroleum and petroleum products, natural gas, wood and wood products, metals, chemicals, and a wide variety of civilian and military manufactures. Russia’s major exporting partners are Netherlands, Italy, Germany, China, Ukraine, Turkey, and Switzerland.

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Also in the year 2007, Russia's imports amounted to over \$260.4 billion. Some major commodities that Russia imports are machinery and equipment, consumer goods, medicines, meat, sugar, and semi-finished metal products. Russia's major import partners are Germany, China, Ukraine, Japan, South Korea, US, France, and Italy.

### **Communication Infrastructure**

The telephone system in Russia is experiencing many changes. There are over 1,000 companies licensed to provide communication services. There are over 40 million telephone main lines in use in Russia and over 150 million mobile cell phone users. As far as radio goes, there are over 61 million radios in Russia. Radio broadcast stations include 323 AM stations, 1,500 FM stations, and 62 shortwave stations. In Russia, there are over 60 million televisions and over 7,300 television broadcast stations. As far as the internet goes, there are over 2.844 million internet host in Russia. Internet service providers (ISPs), total 300 in number. The amount of internet users is estimated to be over 25.5 million as of 2006.

### **International Trade and Investment Policies**

Russia has adopted many laws and regulations that are consistent with the WTO. Although not currently a member, it is thought that Russia will join the WTO soon. This is evidence that Russia is undergoing major changes when it comes to international business. It is increasingly important in this integrating world to become linked with other nations. With the adoption of WTO rules and regulations, Russia is expanding their international reach as interdependence of national economies increase.

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Currently Russia has over fifty Bilateral Investment Treaties (BITs), with different states and forty of those are actually in force. Some of the BITs were inherited from the former USSR and a being renegotiated. Russia has just recently got into the Regional Investment Treaty game.

These treaties cover investments and activities that involve more than two countries. At this point in time Russia is negotiating a treaty with countries from Europe and Asia. The countries include Russia, Belarus, Kazakhstan, Tajikistan, Turkmenistan, and Uzbekistan. This is a regional treaty aimed at enhancing the level of trade and liberalizing investment.

### **Business Opportunities and Risks**

There are business opportunities in industries such as transportation, software development, and paper. Each of these areas is growing in certain sectors of Russia and opportunity for development continues in these areas. In St. Petersburg opened a new General Motors plant last year. INTEL's software development center is growing in Nizhny Novgorod. Finally, International Paper is performing good business in Svetogorsk, which employs over 3000 people.

Business moves in Russia are risky because of the poor business climate, lack of transparency, and corruption. Despite these risks, Russia is providing double digit returns to investors and attracting new investments because of Russia's great macroeconomic fundamentals and the consumer and retail boom.

The banking system is a major drawback in Russia. Russia's banking system lacks the resources, the capability, and the trust of the people in Russia. These characteristics are needed to attract investments and generate substantial savings. The banks of Russia only contribute nearly

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3% of total investment in Russia and the banking system is small compared to other international peers. Russians tend to keep their money out of the banking system and since the ruble is appreciating, many Russians are keeping currency in ruble form instead of exchanging it for other currencies.

### **Choice of Business**

After completing our country analysis and research into what type of business we would like to begin in the Russian Federation, we felt the environment was right to begin an exporting business consisting of aftermarket automobile parts. In particular spare parts for newly produced American made automobiles which are made in Russia and used American made automobiles which are imported into Russia.

### **Background**

In recent years, the Russian economy has entered a period of strong economic boom, supported by the significant increase in oil prices since the August 1998 crisis. Russia is one of the world's fastest growing automotive markets. In value terms it grew 14 % in 2005, 36 % in 2006, and 67 % in 2007 (Krkoska). This is leading to more foreign investors being interested in entering the increasing market in the automotive industry. Several U.S. companies, such as Ford and GM, have already entered the market seeking to expand their business presences Russia.

### **Business Opportunities**

After the financial collapse of 1998 the car industry in Russia began a massive turnaround from an industry that limited its citizens to around 4 or 5 locally produced vehicles of poor quality to what it has become today – the fastest growing automobile market in Europe.

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In 2001 Russian citizens owned cars at a rate of 140 per 1,000 inhabitants, which is double the 59 per 1,000 in 1993(U.S.Automotive Parts and Components). In 2006 that number had grown to 157 cars per 1,000 and according to Ernst & Young -- Russia is poised to become Europe's biggest auto market by 2012. Further figures for 2007 show the market grew by 57% making it the sixth largest auto market in the world and third in Europe.

Many of the world's automakers seen the potential for growth in the Russian market and began investing in Russia around the turn of the 21<sup>st</sup> century. Ford opened its first assembly plant in St. Petersburg in 2002 and became the first wholly owned foreign business in Russia. General Motors followed by joining with Russian owned Avtovaz in producing the Chevy Niva and Viva. Moreover, in 2006 GM began construction on its first fully owned plant outside of St. Petersburg (Ford and General Motors in Russia).

Most of the automakers have focused on the production of new vehicles, but with the average income of most Russians still very low, many of them are still unable to purchase a new automobile. It is because of this low purchasing power that a large market for importing used vehicles from Europe and the United States has developed. Prior to the economic collapse of 1998 most of the vehicles sold in Russia were made in Russia so the aftermarket parts and service for new and used foreign vehicles are scarce. Because of this scarcity a large market exists for automotive parts and components. The U.S. Commercial Service recently stated it believes there is a significant opportunity for growth and expansion in Russia for U.S. manufacturers of automotive parts and components. Obviously with this expansion comes the need for auto part dealerships to sell the needed parts to the customer. With a consumer base approaching 21 million Russian car users and growing annually at a rate of about 10% there is a very real market for spare parts, accessories and car care products. Many industry experts believe

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there is a good market for manufacturers of engines, electric and electronic components, trim, exhaust systems, plastic parts and instruments. Moreover, a future need for air conditioners, ABS, airbags, power steering and automatic transmissions (U.S. Automotive Parts and Components).

### **Government Regulations**

Even though we are not going to start a business in Russia, it is good to know how the business world works in Russia, should we plan to expand there in the future. When doing business in Russia, there are eight registration requirements that have to be fulfilled. The first part of the registration is to notarize foundation documents. The time estimated to complete this part is one day and there is a charge of 200 rubles per copy of the documents. The second part is to deposit capital in the bank and get proof. The time to do this is one day and there is no charge. Following the deposit, there is a registration requirement that is no charge but requires one day to complete. Then the business will need to register with the unified register at the Ministry of Taxation of the Russian Federation on the local level (Starting Business in Russia). It requires 18 days and a fee of 2,000 ruble. The fifth stage includes the notarize registration certificate, the tax payer identification number, and bank signature card. It takes one day to complete and 400 rubles plus an additional 800 ruble for the signatures and bank card. Next, the company needs to open a company bank account that requires one day with a nominal amount. Following the sixth step, the Ministry of Taxation will need to be informed of the company account number and obtain a special letter of confirmation (Starting a Business in Russia). It requires five days with no charge. The last stage is to register the company with the Moscow Center of Quotation of Work Places that requires no charge but takes a day to complete.

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The government is apprehensive about allowing foreigners into the market. According to the 2005 U.S. Trade Representative's National Trade Estimate, Russia continues to maintain a number of barriers with respect to imports, including tariffs and tariff-rate quotas; discriminatory and prohibitive charges and fees; and discriminatory licensing, registration, and certification regimes, and non-tariff barriers are frequently used to restrict foreign access to the market and are also a significant topic in Russia's WTO negotiations (Background Note: Russia).

U.S. companies should pay special attention to the government when entering the market. Corruption is still continuing in the Russian government and it could possibly affect entering the automotive industry. Although investors are returning to Russia, excessive bureaucracy, corruption, insufficient and insufficiently enforced legislation, selective interpretation of laws (particularly tax laws), unclear limits and conditions on foreign investment, obsolete infrastructure, and stalled economic reforms still remain a problem (Background Note: Russia). Corruption is a serious problem, so foreign investors need to be aware of the problem when entering the market.

### **Potential Risks**

Even with the major financial improvements in Russia since the economic collapse of 1998 there are still many potential risks for business investors. General Motors learned about one of these risks after opening a partnership with Russian owned Avtovaz. In 2006 a dispute developed that forced GM to halt production for nearly 11 days. The dispute occurred after a change in leadership at Avtovaz when the board of directors was taken over by government officials in what has become a trend in greater state control of Russia's economy (International Herald Tribune).

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Although there has been a steady increase in the Russian economy over the past 9 years, mostly because of increasing oil exports, new and existing businesses must still deal with the fact that most Russians maintain a low purchasing power, especially when it comes to purchasing big ticket items like new vehicles.

Finally, businesses considering FDI in Russia must still compete in a business environment where many of the Russian law makers view foreign investors with distrust; inefficiencies exist due to inadequate infrastructure, a poor functioning legal system, a criminalized business environment with widespread bribery and corruption, and a highly bureaucratic state and central government (Ford and General Motors in Russia).

### **Demand Factors**

According to the European Bank for Reconstruction and Development, with every one percent increase in GDP, there is at least a two percent hike in car sales. The Russian economy has been steadily growing over the past ten years and the demand for automobiles and automobile parts has increased. The EBRD also states that the average Russian vehicle is ten years old. This brings the demand for newer vehicles to higher levels. Foreign locally produced vehicles are converting Russian consumers and sales. Russian made vehicles are declining in sales.

With the annual increase in overall vehicle purchases the demand for auto parts has increased as well. Foreign car manufacturers such as GM and Ford have opened new plants in St. Petersburg to expand the market for their vehicles. Now with such foreign presence, spare auto parts are needed for those foreign made cars.

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## **Local Competitors**

As far as competition on the local level, Russia has very little because they lack the modern technology to provide component parts for foreign made cars. “The Russian products are 20 years behind the rest of the world.” (Paul Webster ) According to GAZ, a Russian company that builds unique Russian style vehicles, buying existing foreign technologies will help to speed up the process of bouncing Russia back into the level of being internationally competitive. Once the technology is bought and learned, local competition of auto parts for foreign made vehicles will increase.

## **Foreign Competitors**

The competition among foreign companies is increasing due to the huge demand of foreign-made auto parts. This demand is brought about by the increase in the number of foreign-made vehicles in Russia. Even withstanding that Russian technology is not as modernized as much of the world, foreign competition is growing due to countries bringing their technologies in or exporting their products to Russia. FDI's may also be established. This will bring in foreign technologies to the heart of Russia to mass produce auto parts for the growing industry.

## **Entry Strategy**

For most firms to expand globally, exporting is usually the first step taken to establish international relationships. As a foreign company, it would be the safest solution to start out with. Creating an FDI would be a move with much more risk. It would be better to start with exporting auto-parts to Russia before jumping into the Russian market with an FDI. The hope would be to establish connections within major Russian sectors. Then, after creating these bonds

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with Russian companies, an FDI can be considered. The FDI would most likely be created within a joint venture with another company. The joint venture would help us get our FDI establish, cut costs between the companies involved in the joint venture, benefit all parties involved.

### **When to Enter**

It would be in the interest of the company to enter the Russian market as soon as possible. Even though it would begin with just exporting, the advantages of entering this market in the early stages would allow for greater market power and the availability of more strategies than later entrants. Although there is more potential for risk when entering a market early, higher returns are usually generated by those companies who enter the market early. The risks generated by entering early will be considerably less due to the fact that the company will be exporting goods initially instead of establishing an FDI.

### **FDI Policies**

With the huge demand for foreign-made auto parts, duties have been cut on imported auto components for foreign vehicles in Russia. In some cases the duties were reduced by a certain percentage and in other cases they were completely cancelled. This strategy has been employed by Russia to extract foreign investment into the country. This policy is indeed attractive to foreign companies and will bring investments into Russia to satisfy this growing industry.

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