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Russian Furniture Industry: Enterprises' Upgrading from the Value-Chain Theory Perspectives

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Abstract

Russian furniture market is demonstrating fast and stable growth and is both attractive and promising. At the same time, many Russian furniture enterprises exhibit insufficient and inconsistent restructuring.

On the basis of in-depth semi-structured interviews with different types of furniture market participants (furniture producers, including downstream integrated and specialized, retailers and suppliers of raw materials), the paper tries to explain restructuring strategies of domestic furniture producers in the framework of value chain theory. Particularly, the article is aimed at explaining the obstacles for Russian enterprises to upgrade as a supplier of specialized products (parts of products), in spite of the experience that fragmentation of production became a way for successful restructuring in furniture industry of former socialist countries in Eastern Europe.

1. Introduction

Since 1998 the Russian furniture market has been growing rapidly (the average annual growth rates 1998-2004 are about 10%). In the first years of recovery it was the growth due to the expansion of domestic furniture producers, but since 2001 they have given place to import goods. In 2003 the threshold of 50% of the furniture market held by the import goods was exceeded. This evidence confirms that domestic furniture producers are not competitive enough. But why are they not?

This paper is an attempt to explain the low competitiveness of Russian furniture industry in the framework of value-chains concept. From the value chain perspectives there are at least two important questions to identify the level of competitiveness of a certain producer (cluster of producers). First, to what extent is the value chain the producers participate in competitive? Second, what is the location of a certain producer (cluster of producers) in the value chain? Even in a value chain which produces highly competitive products the value added by a certain cluster of producers and the possibilities to upgrade for those producers may be small enough [Kaplinsky, 2004].

The performance of the participants inside the value chain depends on what stage of the chain is responsible for the rent created. The rents are associated with the stages at which entry barriers are the highest. These barriers are not static but dynamic; they are associated with the property rights on specific resources, both because of scarcity of natural resources, and because of uniqueness due to successful innovations. So, for the barriers and rent inside value-chain the Schumpeterian-type process of “*creative destructions*” is typical. All the value chains are divided into two types: driven by the producer and driven by the buyer. The “driving force” imposes some type of *governance* for the chain participants. The governance includes setting of standards (as *legislative governance*), monitoring the compliance of activity to these standards (as *judicial governance*), and assisting suppliers to meet the standards (as *executive governance*) [Kaplinsky, 2004]. Therefore, the whole chain is affected by the policy of driving segment. Usually the participants able to govern value chain also appropriate rent. Here an important effect arises: on the one hand, rent is due to the use of specific high-valuable resources, on the other, driving force in the value chain may prevent other participants from upgrading and, therefore, may protect the ability to appropriate rent. The combination of these two effects, according to value chain approach, explains many features of modern international labor

division and income distribution, including the puzzle why the participants of efficient value chains may have very bad financial performance and prospects to upgrade [Kaplinsky, 2004].

Value chain analysis has a relatively short history and still lacks clarity in terms of the choice of research approaches. Both theoretical and empirical studies have been undertaken, mainly since the early 1990-s, primarily at the Institute of Development Studies (United Kingdom, Sussex) which hosts working groups and conferences focused on the subject. The first book to thoroughly outline the main issues and to offer an analysis methodology was *Commodity Chains and Global Capitalism* [Gereffi and Korzeniewicz, 1994]. *A Handbook for Value Chains Research* [Kaplinsky, Morris, 2003] was a significant (though not final) landmark in this evolution. A number of empirical studies have been undertaken since the mid-1990-s. No empirical studies, to our knowledge, have been undertaken in Russia so far involving the methodology of value chains analysis.

At the same time there are research papers devoted to the trends in the furniture industry and other industries which belong to buyer-driven value chains development in transition economies. The success of former socialist countries in Eastern Europe (Czech Republic, Poland, Romania and Slovenia are among the fifteen major exporters of furniture in the world) is explained by specialization on parts of furniture (product fragmentation) and outsourcing for MNCs and specialized buyers in the way of European Union integration [Kaminsky, Ng, 2001]. On the other hand, there is research on the role of global retail company IKEA in restructuring of Russian furniture market [Tarnovskaya et al., 2005].

In accordance with the objectives of our paper, the results of the analysis of both international trends in development of furniture industry, especially in the developing countries, and the improvement of other value chains, driven by buyers, in transition economies are important. In the first place, these are the papers of Institute of Development Studies devoted to furniture sector in different countries. South Africa experience [Kaplinsky et al., 2002] shows that even if there are local comparative advantages in resource base, the absence of coordination between the participants in the chain (for South Africa – between sawmills and furniture producers) may prevent competitiveness. Indonesia provides the example of how the industry where informal activity is prevalent, can be at the same time more or less successfully

integrated into global furniture value chain, with incentive to upgrade, provided by IKEA [Loebis, Schmitz, 2003]. As for the second type of analysis, it should be noticed the explanation of vertical relation in agri-food sector, especially in dairy industry [Swinnen, 2005; Swinnen et al., 2006]. As in furniture industry, in dairy and other agri-food sectors the development of efficient vertical contracts is of crucial importance for the market-oriented restructuring of the producers; and the critical role in the process belongs to the buyers, i.e. refineries and supermarkets.

The present study aims at testing the value chain analysis methodology as it applies to Russian furniture industry, at explaining the obstacles to Russian enterprises to upgrade and at discussing the implication of the analysis. The problem discussed implies much more than furniture sector only. To escape the trap of resource-dependent growth in Russia it is necessary that new industries and new sectors develop. The wood and timber sectors are definitely among the sectors with rich unutilized potential and at the same time – with high risk of extensive and inefficient use of resources. On the one hand, the scale of timber cutting in Russia is less than $\frac{1}{4}$ of environmental safe level. On the other, products with low value added dominate in the structure of export. From the international perspective, there are examples of successful development of high value adding activities on the base of wood and timber. Finland, for instance, is an example of progress of the sectors with high added value based on forestry [Sutela, 2002]. Success in value-adding sector requires new vertical relations within the existing chains as well as emerging ones and that makes the problem discussed of vital importance for Russia.

The paper is organized in the following way. The next section is devoted to the data used and methodology to collect and interpret them. In section 3 the sources and obstacles to competitiveness of the Russian furniture industry are analyzed on the example of our sample using “traditional” approach to competitiveness. Section 4 explains the relationships between the economic agents in the value chains in the Russian furniture industry with different types of governance and how they influence on the ability and incentives of furniture industry enterprises to upgrade. Section 5 concludes with the discussion of challenges Russian enterprises face on the way to upgrading.

2. Data and methodology

The results of the in-depth semi-structured interviews with the managers of 21 companies producing and trading furniture in different Russian regions provide the empirical base of the paper. The interviews were conducted in autumn 2004 in the framework of the project “Ensuring Russian enterprise competitiveness within value chains” financed by the Ministry of Economic Development and Trade RF. Apart from furniture industry, pipe and tube value chain was under consideration [Avdasheva et al., 2005]. Table 1 presents the basic characteristics of sample in furniture industry.

The design of the sample meets the requirements of the project. Furniture value chain includes many successive stages: machinery, forestry, sawmills, furniture manufactures themselves, wholesalers and retailers. Every stage of value adding needs supporting product and services such as seed and water for the forestry, chemicals, machinery and logistics for the sawmills, again specialized machinery, design, paint, adhesives and logistics for furniture manufacturing. The end of value chain is recycling and refuse disposal [Kaplinsky et al., 2003]. In our project only part of value chain is under analysis from furniture industry itself (including parts of furniture) to retailing.

In the sample we tried to include the representatives of different types of participants in the value chain. On the one hand, we need producers (17 respondents) as well as retailers (4). Producers are divided into four sub-groups. The first one are companies which included in the value chain with neither global retailer nor domestic vertically integrated companies (respondents 1-5). The second group consists of suppliers (or former suppliers) of the global retailer (respondents 6-12). The third group is the only respondent being the largest domestic vertically integrated company (respondent 13). Finally, the fourth group is formed by the suppliers in the value chain of domestic vertical integrated company. Not all the respondents are producers of furniture or furniture parts. For instance, suppliers of domestic vertical integrated company produce only raw materials such as boards, accessories etc. All the retailing companies are “one-shop retailers”, according to Kaplinsky's classification [Kaplinsky, 2003]. It may seem strange to interview only small retail companies, but this can be explained by the fact that in Russia there is practically no such market participant in furniture as *specialized buyers*. The only exception, to my knowledge, is company *Soyuz-T* developing wholesale network in Western Siberia.

Table 1. Sample description

No	Position in value chain (operations completing)	Types of furniture produced	Region	Number of employees (2004)	Relations with main buyers in Russian furniture market	Respondent
1	drying, product design, assembling, wholesale and retail trade, after-sale services	kitchen suits, bedroom sets , cabinet units	Voronezh	1700	No	Head of manufacturing department
2	assembling, retail trade, after-sale services	cabinet units, kitchen suits, sliding-door wardrobes	Novosibirsk	25	No	Director
3	product design, assembling, retail trade, after-sale services, transportation	upholstered furniture sets, bedroom suites, kitchen suits, sliding-door wardrobes, beds, sofas	Novosibirsk	40	No	Consultant
4	board making, blank making, product design, semimanufactures, assembling, wholesale and retail trade, after-sale services, personnel training, marketing, advertising	cabinet units, upholstered furniture sets, kitchen suits, sliding-door wardrobes	Novosibirsk	400	No	Regional wholesale manager
5	blank making, product design, assembling, retail trade, after-sale services, transportation, tailoring, marketing advertising	cabinet units, bedroom suites, kitchen suits, sliding-door wardrobes	Novosibirsk	10	No	Director
6	timber cutting, blanking, semimanufactures, assembling,	cabinet units, wardrobes	St.Petersburg	500	Enterprise within the holding of global buyer	Director
7	timber cutting, blanking, product design, development of technologies, assembling, wholesale and retail trade, after-sale services, personnel training, advertising	Upholstered furniture sets	St.Petersburg	100	Supplier of global buyer	Commercial director
8	timber cutting, drying, recycling, blank making, product design, semimanufactures, wholesale trade, personnel training, frame-house production, marketing, advertising	shelves, beds, bedside-tables	Mariy El Republic	1150	Supplier of global buyer	Executive director

9	timber cutting, drying, recycling, blank making, product design, semimanufactures, assembling, wholesale and retail trade, personell traning, transportation , marketing, adverrtising	sofas, beds, shelves, doors	Tver	440	Supplier of global buyer	General director
10	product design, semimanufactures, assembling, wholesale and retail trade, after-sale services, personnell training, transportation, marketing and advertising	upholstered furniture sets, sofas, folding divans, armchairs	Moscow	400	Supplier of global buyer	Commercial director
11	timber cutting, drying, board making, blank making, semimanufactures, product design, assembling, wholesale and retail trade, after-sale services, personnell training, transportation, mirror production, marketing, advertising	cabinet units, bedroom suites, sliding-door wardrobes, dinner-tables, writing tables, beds, chairs	Kirov	500	Supplier of global buyer	Commercial director
12	timber cutting, drying, waste recycling, board making, blank making, product design, semimanufactures, assembling, wholesale and retail trade, personnell training	cabinet units, bedroom suites, writing tables, chairs	Tyumen	1240	Supplier of global buyer	Head of marketing department
13	all operations plus financial and research infrastructure	all kind of furniture	over Russia	3500	Domestic vertical integrated company	Deputy director on corporate governance and finance
14	accessories production	Accessories	Moscow	40	Supplier of domestic vertical integrated company	Executive director
15	semimanufactuers, assembling, wholesale trade, personnel training, marketing , advertising	bedframe, bedlegs	Kaluga	100	Supplier of domestic vertical integrated company	Commercial director

16	timber cutting, recycling, board making, semimanufactures, personnell training, matches production, poligraphy, marketing and advertising	wood fiberboard, chipboard, modified fiberboard	Kaluga	2150	Supplier of domestic vertical integrated company	Commercial director, financial director
17	accessories production, wholesale and retail trade	Accessories	Kaluga	130	Supplier of domestic vertical integrated company	Executive director
18	assembling, wholesale and retail trade, after-sale services	-	Novosibirsk	12	No	Deputy director
19	product design, assembling, retail trade, after-sale services, personnell training	-	Novosibirsk	20	No	Manager
20	retail trade, after-sale services, transportation	-	Novosibirsk	15	No	Manager
21	retail trade, after-sale services, transportation	-	Moscow	15	No	Director

Source: results of the interview.

It is easy to see from Table 1 that respondents are widely spread across Russian regions. Enterprises of very different scales are presented. Almost all of them are formerly privatized enterprises, a substantial part of them was sold after privatization, and almost each enterprise is managed by the executive director appointed after privatization and change of the main owner. In the time of the interview all furniture companies were in relatively good financial performance, none had losses. At the same time a remarkable share of respondents was quite skeptic as far as future performance is concerned. The main sources of danger according to most part of respondents, are expected to be an increase of import, especially from China, a repeal of tariff preference on imported equipment and a decrease of import tax rate on furniture within the process of WTO accession.

Interviewing scenarios were designed on the basis of Kaplinsky/Morris's methodology described in *A Handbook for Value Chains Research* [Kaplinsky, Morris, 2003]. This toolkit is pitched to obtain expert assessments from respondents inside the value chain, permitting to characterize value chain patterns, to identify the composition and roles of their agents, and to explore the potential for increase in added value.

In the course of interviewing, all the respondents were asked a *basic set of questions* pertaining to the development of end markets for products, the composition of the value chain, barriers impeding access to the chain, major factors determining competitiveness of Russian companies on domestic and international markets. This set also included questions regarding consumer preference patterns and an assessment of their willingness to pay a higher price for product features relevant to them. The answer to these questions allowed to draw conclusions about the allocation of rents inside the value chain (on the example of wooden furniture). The common "nucleus" of questions permitted to verify information received through expert query from a variety of respondent types. The basic set of questions was complemented by questions *specific to the value chain positioning of various agents*. In the interview scenario for manufacturers and merchandisers, the emphasis was made on identifying market leaders, selecting suppliers, on determining the more relevant selection criteria, characteristics of relations with suppliers, discussion of product competitiveness and link-specific upgrading issues. Besides the respondents' answers, statistical data characterizing the Russian furniture industry

are used in order to check whether the picture drawn on the basis of a very restricted sample correlates with the general tendencies in the industry.

Analyzing the data of the survey we should keep in mind that the respondents' answers reflect not only the market conditions, what they are, but also the respondents' perception of these conditions. On the one hand, that gives us an advantage because we can draw conclusions not only about competitiveness in general but also how the directors of enterprises reflect the current situation, and therefore, what we should expect they choose as a main direction of upgrading. On the other hand, we should be extremely cautious interpreting some of the answers because Russian managers tend to overestimate their competitive advantages and at the same time the obstacles they face. In order to be marked out the respondents' statements are in *Italics*.

Finally, it should be emphasized that not all the respondents were ready to answer all types of questions (for the reason of trade secrets etc.). That is why further in the paper the number of answers received is specially indicated.

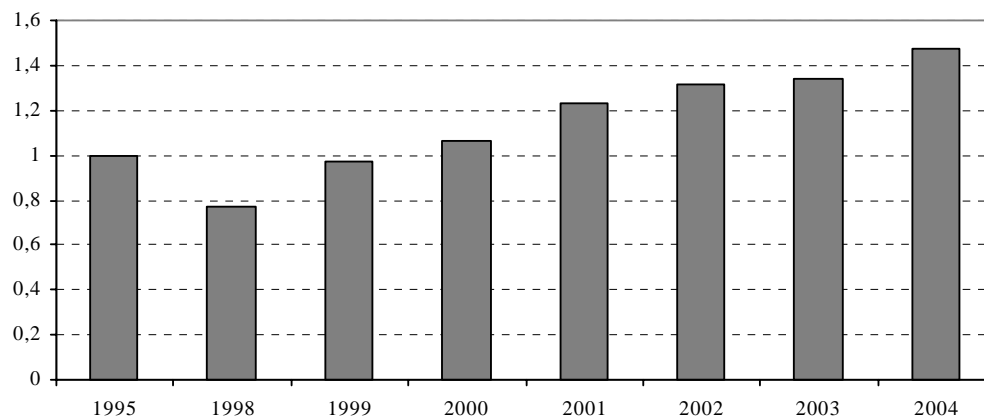
3. Sources and obstacles to competitiveness in the Russian furniture industry: a traditional view

3.1. Why Russian furniture producers have to be competitive?

Furniture industry is the one where there are strong predictions about high competitiveness and good financial performance of Russian producers after 1998.

Firstly, there was considerable different demand for the furniture at the beginning of 1990s and then, at the end of the decade. During the late soviet period furniture was in short supply. The main obstacle to the huge increase of industry sales immediately after liberalization was a sharp decline of Russian citizens' income. So, the increase of salaries since 2000-2001 should have resulted in a remarkable market growth (as it really was, see figure 1). From 1998 to 2004 the average annual growth rate of furniture market in Russia in real terms was about 10%. According to the State Statistical Agency RF (Rosstat, hereafter), the annual retail purchases of furniture in 2004 was about 3,6 bn euros and these data definitely underestimate the market due to large informal sector.

Figure 1. Sales of furniture in Russia in real terms: 1995-2004, 1995=1



Source: Russian annual statistical survey-2004 by the data of retail trade, author's calculations.

Secondly, though the Russians have stable preference towards imported furniture as being of better quality, domestic producers have country-specific advantages in manufacturing the kind of furniture that you will never meet over the world. The striking instance is "Malyutka ("little one") sofa", folded in three, very suitable for a

typical Russian room with little space. Regardless of tastes, preference, advertising and quality reasons, “Malyutka sofa” will remain among the most popular kinds of furniture until the whole style of living in Russia (including type of housing) changes. The same is true for many types of furniture including kitchen suites, bedroom suits, and upholstered furniture and so on.

Thirdly, furniture is a labor-intensive industry, in which lower wages in Russia should be a competitive advantage. For our sample the average share of labor cost in the total cost of enterprise is about 20% and doesn't exceed the threshold of 30%, while in the European Union this share averages about 70%.

Fourthly, in the sector of wooden furniture domestic producers can rely on the wide national resource base, including growing production of chipboards, fiberboard, etc. Potentially the domestic board should be of relatively good quality and affordable prices (unfortunately it is not always so, as we will see from the interview, but the existence of domestic resource base is incontestable).

In the fifth place, Russian vast expanses leave room for the local producers of goods which require high transportation costs. Since furniture is not a very compact kind of commodity, it remains true.

Last but not least, up to now there have been relatively high import tariffs on furniture in Russia. Custom duties on furniture products during last five years are constant on the level of 20%¹. Of course, importers try to evade duties as they can. On the popular way to decrease custom fees is to declare furniture (which is transporting non-assembled) as wood fiberboard. Custom duties on raw materials are generally lower (the lowest rate is applied for accessories and that is 5%).

In spite of all that, we know that competitiveness of Russian furniture producers is not high enough. The share of imported products sold in Russia declined after Rouble devaluation in 1998, but after that it has demonstrated stable increase. According to the data of retail trade in 2003 the share of imported products in value of furniture bought by the Russians was 53% and in 2004 it achieved the threshold of 60% [Social situation and living standards in Russia, 2004, 2005].

¹ Custom duties are so-called combined: 20% on custom value but not less than 0,6 - 0,85 euro/kg (for different items).

3.2. Why Russian furniture producers have to be non-competitive?

Let's refer to our sample to explain why the producers in the sample (thinking of them as representatives of the industry as a whole) could be of low competitiveness. First, from the international perspectives most of these companies seem to be too large. Table 2 shows that this is not intermittent error of our sample: the Russian furniture industry as a whole is dominated by relatively large establishments². If the size of an enterprise exceeds the efficient one, this would provoke diseconomies on scale.

Table 2. International comparisons of furniture industry structure by size of firms

Country	Year	Percentage of establishments by size		
		<20	20-99	>100
Sweden	1992	92,5	6,2	1,1
Germany	1987	89,3	-	10,6
South Africa	1993	67,6	26,0	6,3
Italy ^a	1986	75,1	18,0	6,8
Russia ^b	2002	11,8	27,0	61,2
Russia ^c	2002	24,0	14,8	61,2

Notes:

^aThe Italian data distinguish enterprise size categories as follows: 1-49; 50-99; >100.

^bThe Russian data according to the size categories as 1-19; 20-99; >100.

^cThe Russian data according to the size categories as 1-49; 50-99; >100.

Source: Dunne (1999). Condensed version is reproduced from Kaplinsky et al. (2003). The Russian data are from the author's calculations based on the data of companies' annual reports to the Russian State Statistical Committee. Year 2002 was the last when companies were obliged to report the number of employees.

Secondly, the output of a typical company is highly diversified. Even small enterprises have product variety of at least 4-5 items. Again, under certain circumstances we could expect diseconomies on scope. It seems not accidental that suppliers of the global buyer (which should be more competitive than the industry on the average) are at the same time more specialized. Among other operations carried on within companies boundaries, the mysteriously frequent appearance of *marketing and advertising* needs to be explained below.

² The result of calculation should be interpreted very cautiously because of large number of dropped data in the enterprises' statistical reports. For the year 2002, from about 2500 registered as working companies in Russian furniture industry (OKONH 15271) only 310 establishments reported the employment data. But even though all the enterprises with dropped data belong to the categories of establishments with less than 100 employees (what is extremely unlikely) we should conclude that industrial structure is shifted towards relatively large companies.

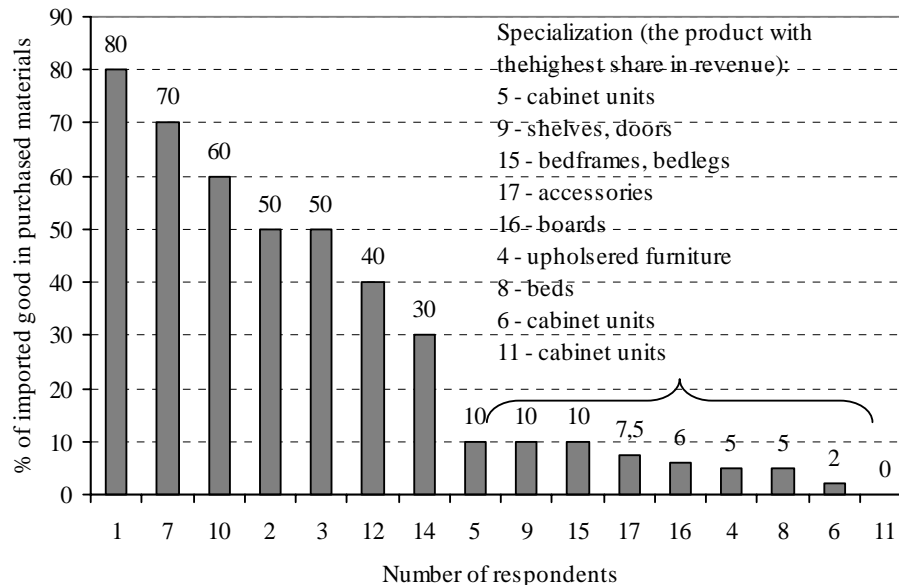
In the third place, the degree of vertical integration is quite high. Again, it is a characteristic feature not only of furniture industry, but of a great deal of privatized enterprises in Russia. Kakha Bendukidze, one of the most famous entrepreneurs in Russia (and now minister of economy in Georgia), compared a typical Russian enterprise at the beginning of privatization with the *Mysterious Island* (the novel by Jules Verne) [Bendukidze, 2003]. In the *Mysterious Island* Captain Nemo had to grow up all he needed, the same as the director of a Russian enterprise got use producing all the inputs. To diminish the scale of the activity out of core competence and to outsource are important components of restructuring for almost all Russian companies. Unfortunately, high level of vertical integration is not only Soviet legacy. High transaction cost and unsatisfactory vertical coordination make vertical integration the most successful and widespread form of coordination in Russian market [see, for instance, Swinnen, 2005]. In the international context, however, Russian companies seem to be overweighed by the activities out of core competence, and this could restrict competitiveness seriously. Sometimes the employment in core business is less than the employment in adjacent activities. In one of furniture producing companies in our sample, for instance, half of 400 workers are employed at transportation unit only.

Fourthly, there are limitations for competitiveness of furniture producing in the adjacent technological chains. The Russian machine-building industry doesn't produce the necessary equipment of satisfactory quality. The same situation is with the accessories: the use of domestic accessories leads to losses of competitiveness of final products. Assessing the achievements and prospects of Russian furniture, many respondents indicated: *"During the last fifteen years a lot of successful product renewal took place,, quality increases... but accessories are definitely an exception"*. Because of that, the share of imported components in purchases of materials is high enough (figure2). Exceptions are the enterprises producing cabinet units, beds, boards, shelves etc., the main components of which are domestic boards.

In the fifth place, most respondents use obsolete equipment and technologies. This gives rise to at least two specific features of management in the Russian industry (not only plants, producing furniture) with far-reaching implications. The first is that obsolete equipment prevents flexibility of product variety and production management. Several respondents said: *"to be competitive we have to adopt*

production facilities according to the needs of design... But what we do is the opposite: our design is adopted according to what is available using our equipment”.

Figure 2. Share of imported goods in purchased materials and specialization (16 respondents)



Source: results of the interview, author's calculations

The second feature is that managers rely upon momentary, not strategic decisions in the sphere of technology. Moreover, they see the possibility to implement a kind of home-made equipment as an advantage. One respondent told the interviewer the following story: *“We needed a machine, which costs about 50 thousands euros and is produced in Italy. I showed the picture of it to my friend Michalych, who works for a military plant and asked him, whether he could assemble the same. He could, and you see, I have it only for 7 thousands”.* Not discussing the ability of the smart engineer Michalych to assemble the machine by picture, it is necessary to emphasize that the reliance upon *Michalych's wisdom* is quite common for Russian directors, and could be of remarkable importance in the future. In short, Russian production managers even if they has money for restructuring, could spend them on *Mychalych-made* equipment.

All these premises are important but they cannot explain why very few Russian furniture enterprises can overcome obstacles to be competitive. Why during the last fifteen years it was difficult to adjust employment and product variety, to attract

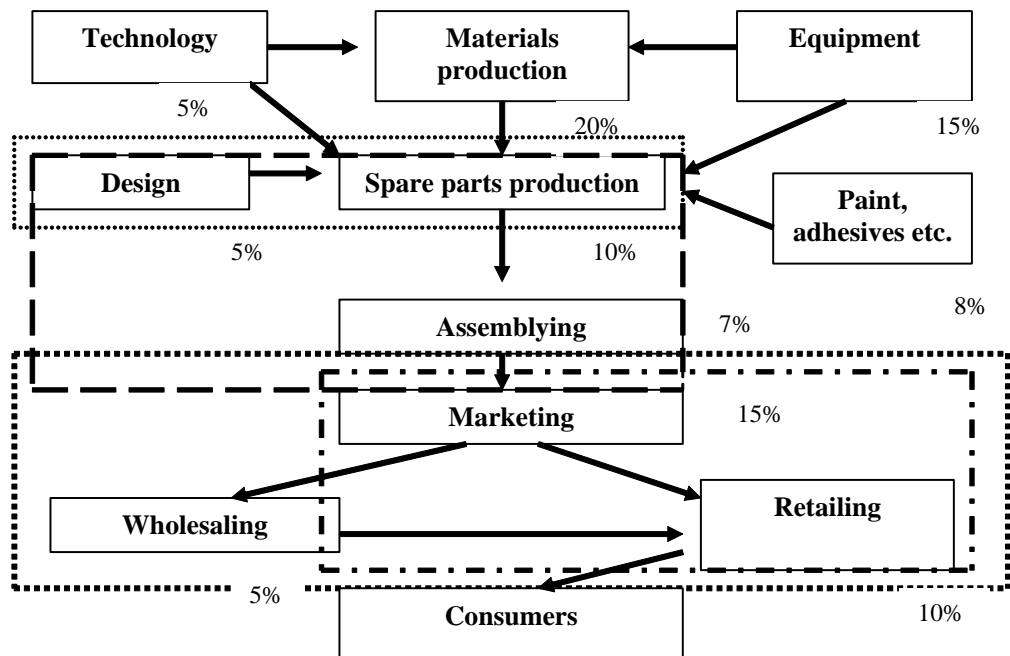
financial resources and to renew equipment in order to use advantages of location and domestic resources. To answer these questions it is necessary to analyze the governance in Russian furniture value chain and incentives of economic agents in it.

4. Prospects for competitiveness in the Russian furniture industry from the perspective of value chain theory

4.1. Russian furniture industry: types of value chain organization

As it was mentioned above, furniture industry belongs to the buyer-driven value chain. Wholesale and especially retail trade is characterized by significant entry barriers, which mainly have to do with the need to possess a brand, to offer a broader slate of services to the consumer and to organize product promotion. Therefore, a considerable part of value added generated in this chain is accounted for marketing, while production of components and assembling of furniture claims on a smaller share of overall value added. Figure 3 presents the contributions in the whole value added by successive stages of production and promotion, on the example of wooden furniture.

Figure 3 Value chain and value added distribution in the Russian wooden furniture (2004).



Note*: The value chain includes functional links but not the types of companies. However, the figure demonstrates typical options of Russian companies' organization inside the chain.
Source: author's estimates on the base of the interview results.

Another segment with rather high entry barriers and a significant share of rent is the production of chipboard and fiberboard (especially chipboard). Virtually all Russian

producers of cabinet units note that the availability of chipboard is a bottleneck for output expansion. The special role of chipboard in the Russian value chain is proved by the fact that IKEA, a company which on other national markets usually invests exclusively into design, marketing and retail infrastructure, pursues a different policy in Russia and invests into the build-up of its own capability for chipboard and fiberboard production (*Swedwood Tikhvin company*). Other foreign companies are also active in this segment: according to current estimates, to 2010 every second board in Russia will be produced by the foreign-owned company.

There are three alternative governance mechanisms in Russian furniture value chains: market-based, hierarchical, and modular. The most interesting options in terms of value chain upgrading are the latter two. Market-based governance mechanism is mainly the legacy of the Soviet sales system whereby independent producers supplied their products to independent wholesale warehouses and retail outlets. The industry segment organized along these lines has been shrinking consistently in recent years. On the contrary, segments with vertically integrated, hierarchical and modular governance systems have been displaying a swift growth rate.

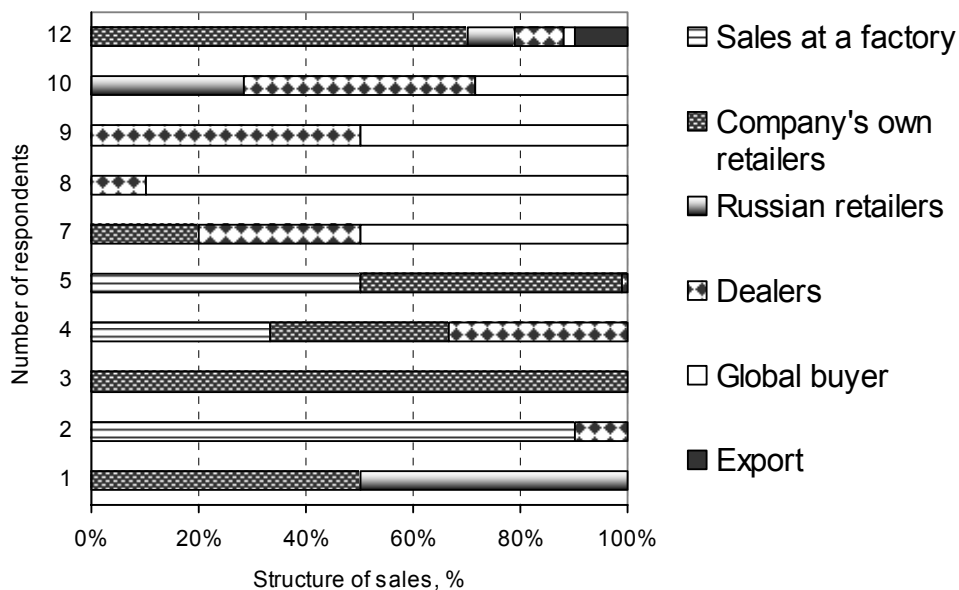
Vertical integration type of governance is presented by several Russian companies, most known of them is *Shatura*. Founded thirty years ago, privatized and restructured ten years ago, *Shatura* became a *great expectation* of domestic furniture industry in 1999, when its annual growth rates rose up to 30-40%. Recently growth records and financial results became modest, but still *Shatura* is considered the only domestic company that can compete with the global buyer *IKEA*. *Shatura's* share in domestic furniture production is about 12%, correspondingly, the market share is about 6%. The company provides several types of furniture, but specializes in wooden products. The furniture produced is bedroom suites (50%), office units (30%) and other furniture from wooden or wooden-modified boards (20%). Other types of furniture (upholstered furniture, first of all) are supplied to the *Shatura's* shops by other furniture producers. Product variety of *Shatura* is oriented to middle-income consumers, so the target market is the same as that of *IKEA*. The trademark *Shatura* is the only national brand in furniture, known almost by every Russian (at the time of the interview the ratio of brand recognition was 70% in Moscow and 58% over Russia). *Shatura* is almost completely oriented to the Russian domestic market, exporting only to Kazakhstan and the Ukraine. At the time of the interview export to

Europe was organized, but, as a respondent indicated, *out of sporting interest only*. The company becomes not only a big producer but also a big retailer.

The biggest actor implementing modular type of governance is *IKEA*, a global buyer active in Russian market since 2000. Five big furniture supermarkets opened in Moscow, Leningrad region and Kazan, it's expected that this presentation will increase in the nearest future. *IKEA's* share in Russian furniture market is about 8-10% (derived from the evidence that 20% of furniture import in Russia is *IKEA's* import and the share of furniture produced by the domestic enterprises and sold in *IKEA* stores is 15-20%). About 75 domestic furniture producers are suppliers of *IKEA*.

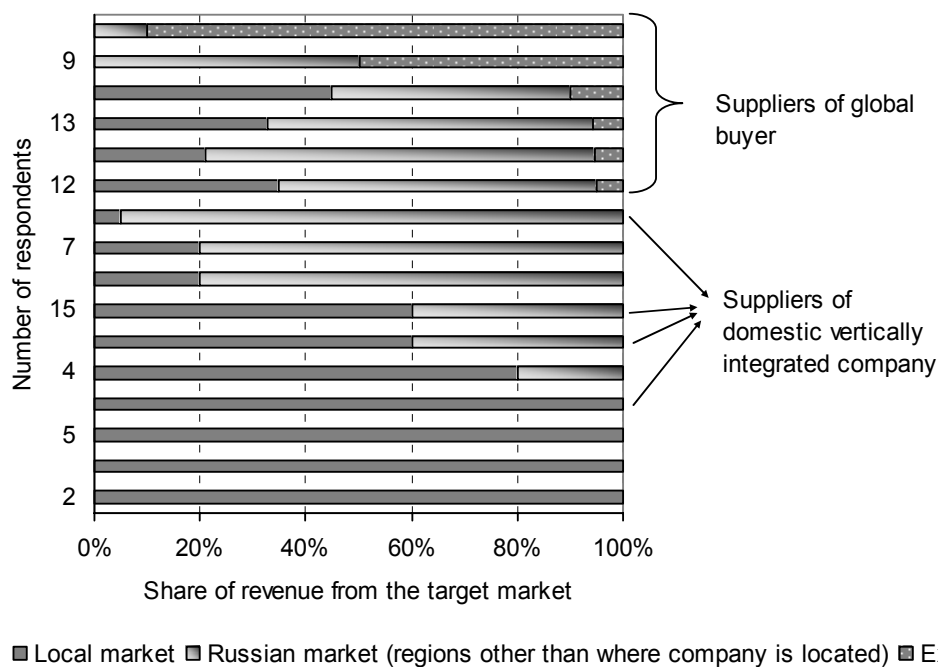
Figure 4 depicts the comparative importance of these types of governance in domestic industry. It is easy to see that the most important channel of sales is the companies' own retailers. Even the companies which are not included in the vertically integrated or modular-governed chain prefer not to supply to Russian retailers. Instead, sales at the factory (as a sort of retailing without using specialized retail capacities), widespread in the early 1990-s, are present even now. From this perspective, the global buyer replaces not the independent retailers, but the development of retailing capacities by the producers. And here again, integrated and modular types of governance in the industry are prevalent.

Fig.4. Organization of sales by furniture producing enterprises, % (10 respondents)



The analysis of target markets for the respondents (figure 5) allows us to draw preliminary conclusions about the comparative advantages of alternative type of governance. Most part of the companies working in the framework of vertically integrated chains are supplying for the local markets only. Certainly vertical integration by the companies of small size could not be competitive enough in comparison with all-Russian or global retailers. Instead, suppliers either of global buyers or domestic vertical integrated companies (as well as rather large vertically integrated companies themselves) supply to the all-Russian market. Suppliers of the global buyer are the only exporting producers in the sample. It is also characteristic of the Russian furniture industry: *IKEA* accounts for over 50% of very modest amount of furniture export.

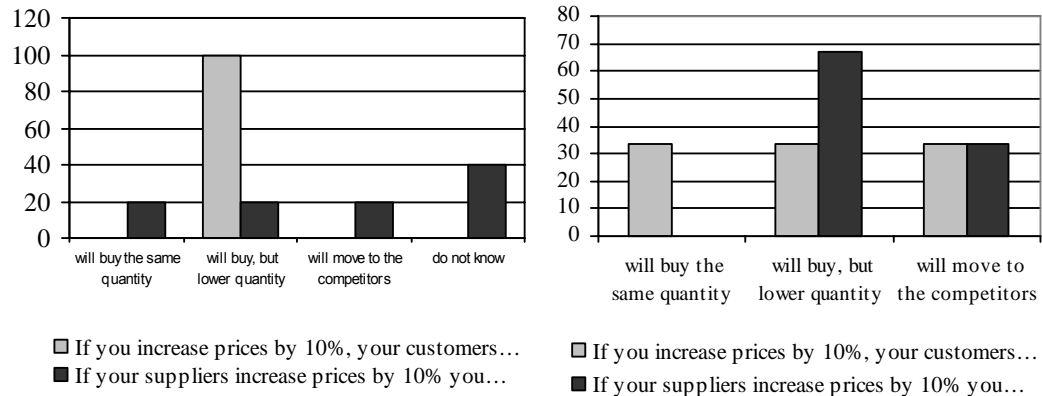
Figure.5. Target markets for the furniture companies, % (16 respondents)



Why market type of governance is so unattractive for furniture enterprises? To answer this question it is necessary to stress the common feature of any type of supplier-buyer relationships in Russian industry and that is fierce competition. Furniture producers feel that if they increase the price, the consumers will buy fewer amounts (fig.6), i.e. the price elasticity of demand is high enough. The same respondents are not sure about their own reaction to the price increase of input: some managers think they will have to buy the same amount at a higher price. On the contrary, Russian retailers think their customers are loyal to their services and may be ready to buy at higher prices but the retailers are not loyal to producers.

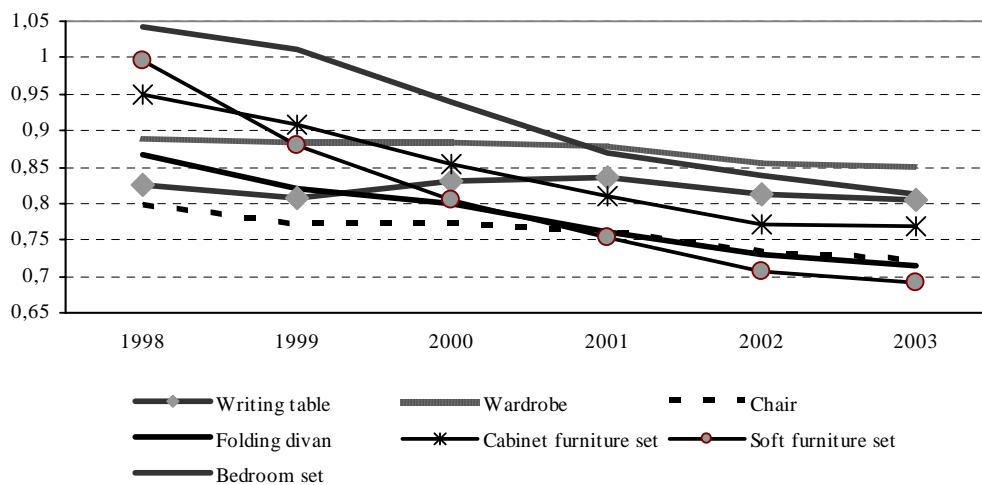
From the perspective of value chain it means that the competition is most tough in the link of furniture production. The data of the dynamics of average furniture prices (figure 7) confirms this conclusion: during six years the average prices on different types of furniture reduces from 15 to 30%.

Figure 6. Competition in Russian furniture markets: answers of producers (left, 5 respondents) and retailers (right, 3 respondents).



What are the results of the competition, which should provide market participants with incentives to upgrade? For the buyer (whoever it is – a vertically integrated company, a global buyer or a one-shop retailer) there are unrestricted opportunities to change the supplier, therefore, upgrading by the given supplier is not of serious importance for them. Let's illustrate that comparing the perception of crucial success factors by different types of market participants, on the one hand, and requirements of retail and vertically integrated companies for their own suppliers, on the other.

Figure 7. Real prices of selected items of furniture sold in Russia: 1997-2003; 1997 = 1

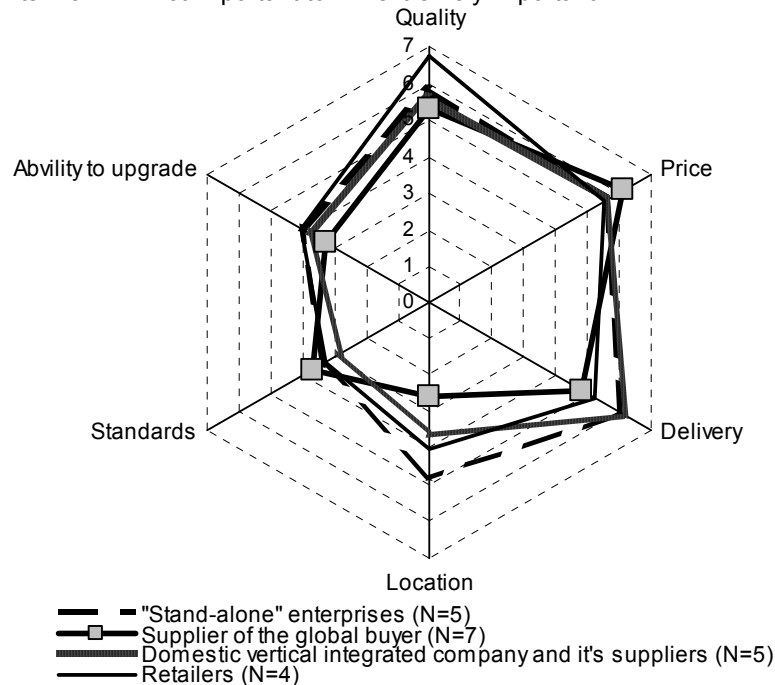


Source: Prices in Russia-2002; Prices in Russia-2004, author's calculations)

4.2. Types of value chain, opportunities and incentives to upgrade

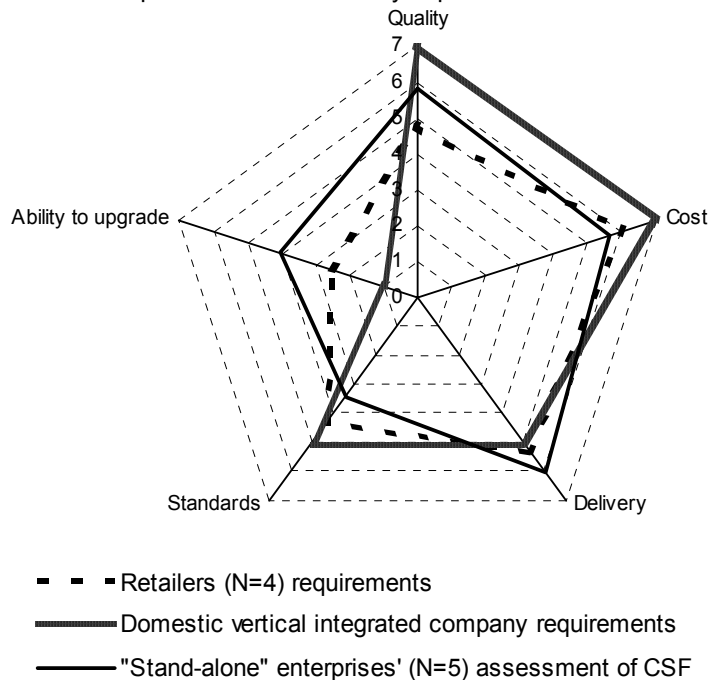
As far as overall estimations of crucial success factors are concerned, different types of market participants are almost unanimous (figure 8). The estimates received highly correlated with the ones presented by Kaplinsky [Kaplinsky et al., 2002]. Quality and delivery are most important; the ability to upgrade is of medium importance. The only serious difference is that standards, according to market participants, are not so important in Russia in comparison with international practice.

Figure 8.. Crucial success factors for producers in perception of different groups of market participants: from 1 – not important to 7 – extremely important



But the situation changes if we compare the perception of crucial success factors by market participants with the requirements of buyers – retailers and domestic vertical integrated company (figure 9). We can see that the ability to upgrade for one-shop retailers is of modest importance. Instead, the price is more important for them than furniture producing companies are expecting. Formally retailers assessed the quality of products high enough, but the spirit of interview as a whole was that, from the perspective of retailers, Russian producers should compete for the market segment with low willingness to pay and a low level of consumers' expectations about quality. Domestic vertically integrated company is even stricter to its suppliers: price, quality and certification are of primary importance, but ability to upgrade is not interesting at all.

Figure 9. Crucial success factors in perception of producers and requirements of one-shop retailers: from 1 – less important to 7 – extremely important



Interviews with producers also give an impression that Russian retailers and vertical integrated companies put pressure on furniture producers to cut prices but definitely don't assist them in upgrading, to the contrary of international evidence, presented by Kaplinsky [Kaplinsky, 2003]. Questions to furniture companies about their relationship with suppliers showed that they implement the same type of practice for their own suppliers: there are no special attempts to provide suppliers with specifications or any standards and to support them to achieve the goals set up by buyers. According to market participants, in the context of extremely fierce competition the very threat of breakup of delivery contract should provide incentives for suppliers.

Ideally, the incentives to upgrade in relationships with retailers should be high. In fact, the structure of incentive is shifted towards cost minimization. Considering the trade-off between price and quality, all the retailers were sure that their target consumers prefer lower quality at a lower price. If buyers are not prepared to pay premium on certification or ability to upgrade (in terms of product variety, quality etc.) the cost reduction becomes the main track of development. As a result, domestic producers can compete with the foreign ones (first of all, the Chinese) only in the lowest price segment, and that tendency is obvious for the great part of industry

during the last fifteen years. Our information about the retailing in Russian domestic furniture market confirms the impression made by interviews. Most specialized retailers (except the global buyer of course) are small and unable or reluctant to provide furniture producers any services which would help them to upgrade. Besides, it is important that retailers usually do not compose the bundles of furniture produced by different enterprises; they just display the furniture items for sale as they arrived from the producers. That is why almost all furniture producers, including very small ones, indicated operations inside the enterprise include marketing and advertising. That is why enterprises still use *sales at the factory* as important channel of product distribution. One respondent said: *"To sell at the factory... to sell in a furniture shop... It's just a trade-off between number of consumers (who may not arrive at the factory) and discount to retailer"*. From the value chain perspective, it is not the domestic specialized retailers who govern the value chain, but instead, furniture producers who perform the role of retailers themselves.

Recently several big furniture retailing centers have opened in Moscow and other big cities (*"Tri Kita"*, *"Grand"* and others), but till now the most difference between them and small retailers is that furniture of large number of producers (including domestic and foreign ones) are presented there. Up to now these centers have served mostly as exhibition places, as most consumers first choose furniture there, and then buy it directly from the producer with discount about 10-15%. To conclude, domestic retailing companies do not govern value chain in an appropriate way, do not give producers impulses to improve, and therefore, independent retailers are hardly competitive in the long run.

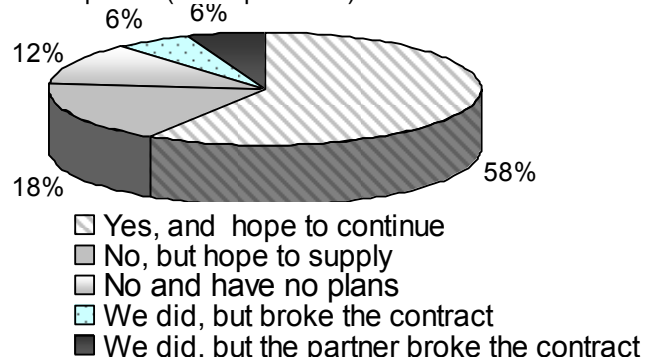
There are two alternatives to the market governance in the Russian furniture market: modular and vertical integrated. Comparing the relationships between the global buyer and the suppliers in Russia, on the one hand, and in international context (according to [Kaplinsky, 2003]), on the other, we can find similarities as well as differences. Like in international practice, the global supplier promotes the process upgrading more actively than product upgrading. More precisely, the only way of product upgrading provided for furniture producers by the global buyer is the specifications of products supplied. In some cases, according to the respondents, they were important enough to increase the quality of the product produced. At the same time, comparing with the evidence presented by Kaplinsky, the global buyer in Russia is far from implementing all the devices to promote upgrading by the supplier.

Among the basic tools (which are specified as “work with suppliers”, “set targets and comply”, “provide finance”, “provide training” and “promote supplier cooperation” [Kaplinsky et al., 2003]) in our sample we found only two ones. Of six respondents which are or used to be suppliers of the global buyer, four pointed out that the buyer worked with them actively and set very hard but provoking to upgrade targets. No one pointed out that the buyer provided finance and training program for them while almost all (five out of six) said that they derived a lot from “learning-by-doing”. Several respondents have heard that the global buyer provided credit to Russian furniture producing companies but none of them is presented in our sample.

As for certification which is an important part of upgrading strategy, suppliers of the global buyer have advantage over the rest of the respondents, but at the same time their success is modest. All the six respondents had only quality standards (ISO9000), four of them introduced labor standards. They also meet standards of forest using, many of them are obligatory for the Russian industry participants, but very few keep them. For instance, suppliers of the global buyer demand that their own suppliers of wood should have cutting certificates to confirm the legality of timber cutting. All the companies pay for all the stages of certification themselves.

Like in international practice elsewhere, the global buyer protects its control of the key resources, first of all, of brand name and design. Products supplied to the global buyer, similar parts and products of similar design can not be sold to other market participants. As international practice, all furniture supplied is sold under the brand name of the global buyer. In exchange to relatively high amount of supply, profit margin is set on the level about 2-4 percent which in the period under consideration was substantially lower than average. Only one respondent indicated that the profit margin in the contract with the global buyer was on the same level with other contracts.

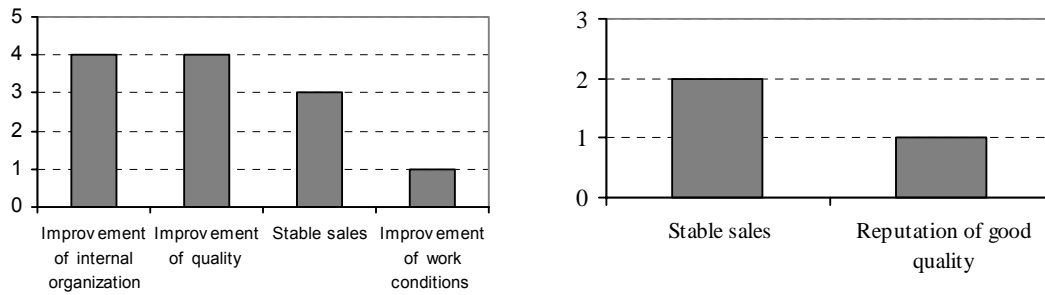
Fig.10. Answers to the question: Do you supply to global retailer and/or domestic vertical integrated companies (17 respondents)?



Nevertheless, almost all furniture producers in the sample prefer to be included in modular and/or vertically integrated relationships. Of seventeen producers interviewed only two said that they had no plan to become a supplier of the global buyer or a domestic vertical integrated company (figure 10). Suppliers indicated specific types of gains they derived supplying to the global buyer (figure 11). In relative terms, the advantages are the highest for medium-size and narrow specialized companies. Two respondents with higher employment said that the improvement of internal organization, certification, quality, etc. was achieved independently of their contracts with the global buyer. On the contrary, suppliers with up to 500 employers highly appreciated the contribution of the buyer to their restructuring.

Vertically integrated companies in Russia historically started with production of furniture and then develop retail and marketing segment. Strategy of vertical integration is implemented consistently, with few exemptions (timber-felling is an example). The biggest vertical company's assets include two furniture factories, a chipboard factory and a trading house. The company only purchases timber for chipboard production, hardware, adhesives, paintwork materials, accessories, and uses the services of several transport operators. Two major suppliers account for over one third of primary goods and material purchases. There is no particular governance towards suppliers: none of the suppliers of vertically integrated company indicated that the buyer promoted upgrading, except the control over quality. So typical gains from the supplying to vertical integrated company are stable and relatively high amount of sales and the reputation of a high quality producer for other buyers (figure 11).

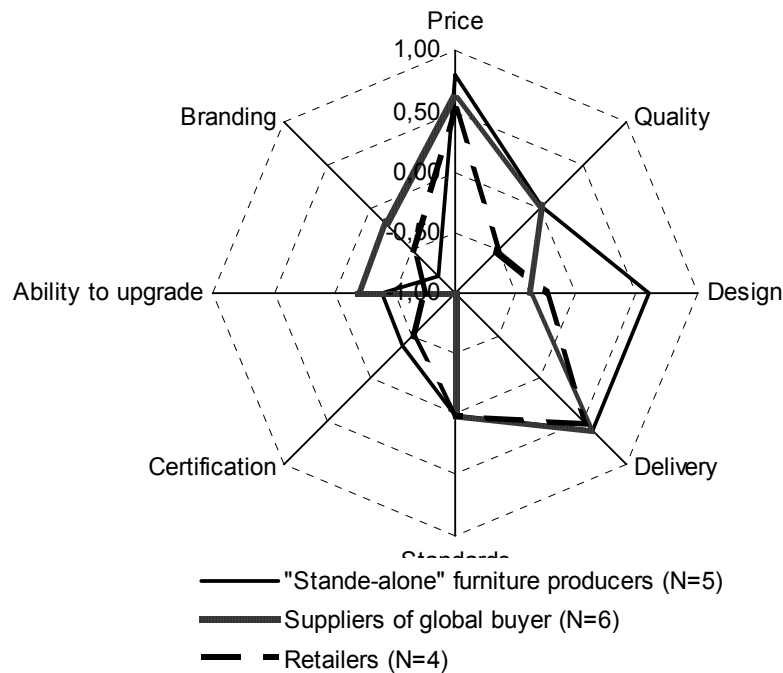
Figure 11. Gains from supplying to the global buyer (left, 6 respondents) and domestic vertical integrated company (right, 4 respondents)



Vertically integrated companies also try to establish more tough control over the final link in the value chain. It is indicative that the biggest vertical integrated company during a short period of fast growth relied upon the network of retailers-franchisee but is currently restructuring the system of product distribution shifting from franchisee to the company's own retailing. This process was initiated in spite of clear understanding that it will lead to slowing down of sales growth and can result in deterioration of overall financial performance within the next few years.

Integrated companies relying on upgrading through repositioning in the value chain focuses on the product renewal and aggressive market strategies. At the same time, according to the results of the interview, insufficient attention is paid to the optimization of the production process and cost management issues. Headquarter of the company do not only failed to pay great attention to cost-saving, but also often lacked sufficient information on the level, structure and major determinants of final product costs. By the time of the interview, the company had not introduced system of product costing.

Figure 12. Competitive advantages of domestic furniture in comparison with imported one by the enterprises not supplying to the global buyer and domestic company (enterprises 1), suppliers of the global buyer and retail companies



Note: 1 – domestic producers are more competitive; - 1 – domestic producers are significantly less competitive.

In order to discuss how the governance within value chains influences on the incentives and abilities of furniture producers to upgrade, we have first to present which directions of improvement managers feel necessary. Two types of questions were posed during the interviews. One was about competitiveness of Russian producers in comparison with the foreign ones, and the other was about the plans of the company to improve competitiveness. Figure 12. presents the answers of different types of respondents to the first question. We can interpret them in such a way that managers feel it necessary to improve the product characteristics, in which domestic producers are least competitive. A number of interesting conclusions can be drawn from the answers. There is difference between furniture producers, not involved in the global value chain, suppliers of global buyers and one-shop retailers. First group assesses their comparative advantages in price, delivery and even design high enough. They feel their problems are in the sphere of standards, certification and especially branding. The suppliers of the global buyer agree that they are good enough in quality, delivery and standards, but they are more unpretentious as far as design is concerned and see they are in serious disadvantage with certification. The retailers' assessments of domestic industry competitive advantages are lower than those of furniture producers almost at every point, exceptions are delivery and standards.

These data let us draw the only simple conclusion. Retailers don't ask producers to comply with standards more than they do now. Retailers are sure that Russian furniture is of poor quality and design. Furniture producers feel that their quality and design are good enough for the (low) prices, but they seem to overestimate their price competitiveness. Both retailers and furniture producers feel branding to be extremely insufficient, and producers are more anxious about that. Suppliers of the global buyer regard design and certification as the most important problem for them.

Now let's look at the plans of furniture producers to improve their business (figure 13, figure 14). First of all, the plans about internal structure of companies are interesting. Thought almost all the producers, as we have seen before, seem too diversified and integrated, very few respondents look for outsourcing and, on the contrary, most of them try to integrate. We can see (fig.12) that there are no plans for outsourcing even if respondents feel that inside their companies there are operations which don't bring profit to the company as a whole. On the part of integration, half of the respondents feel necessary to integrate downstream, and one quarter – upstream.

Figure 13. Plans to upgrade internal organization by outsourcing (16 respondents) and integration (12 respondents)

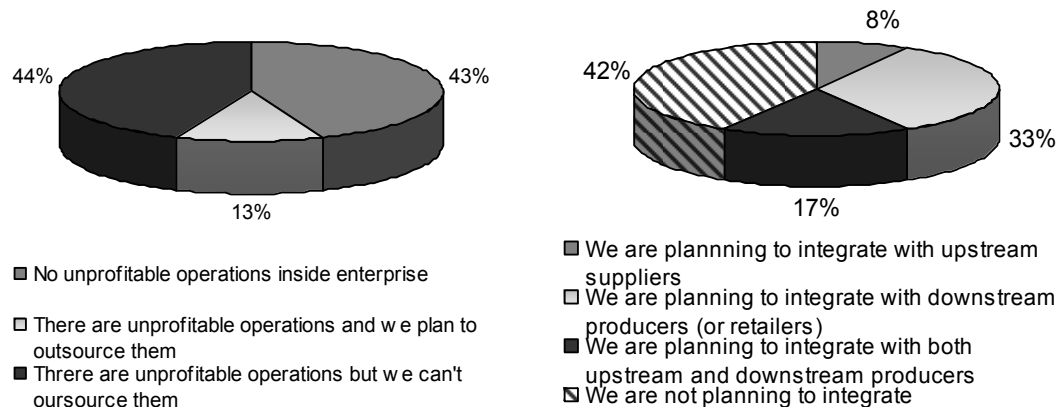
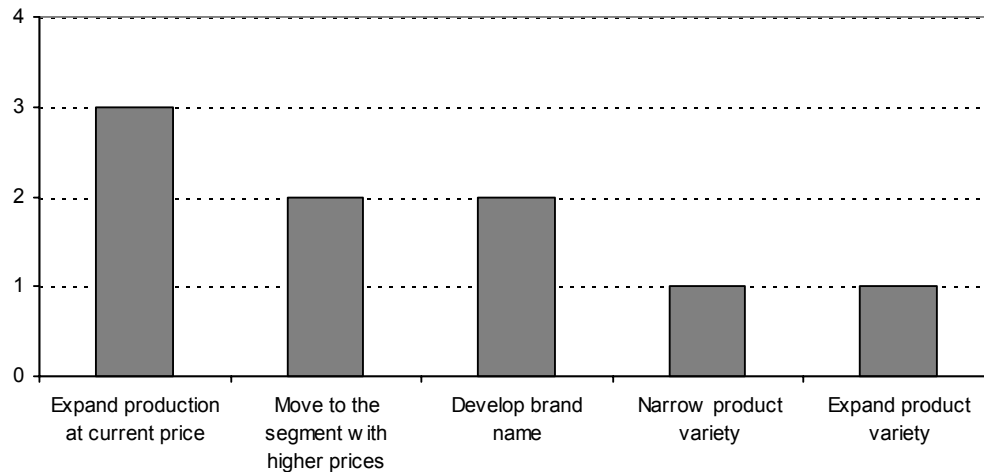


Figure 14. Directions of upgrading as planned by furniture producers: the number of answers (out of 6 respondents).



As for other plans to improve their businesses (the question was put as requiring free answers), half of the respondents felt it necessary to expand the sale of items produced at current prices, one third reported they wanted to move to the segment with higher prices, one third of the respondents said they wanted to develop their own brand name. As for product variety, only one third of the respondents are going to adjust product variety: one company considers it necessary to narrow product variety and others – to expand it.

We can draw several conclusions assessing plans of the companies. First, many companies feel unsatisfied with their positioning inside value chain. It seems understandable because most part of value added is located at the final stages of value chains – marketing, wholesaling and retailing (fig.3). There are links with plans to develop brand name and to integrate with retailers: of six respondents who are planning downstream expansion, four consider they already have a trade mark known by customers and two intend to develop it. Assessing this profile of upgrading, we have to mention immediately that it is available for a very small portion of 2500 Russian furniture producers. And even if available, there are no guarantees that it will be successful. Evidence shows that fast growth of integrated company at the beginning of the century is replaced by slowing down. From the conceptual point of view, upgrading inside vertical integrated chain includes substantial risks. There are common risks associated with diseconomy on vertical growth – losses due to decreasing incentives to improve efficiency, due to coordination failures inside company etc. Modular type of governance should have an advantage of flexibility over vertical integrated one. In Russian context high risks are connected with governance at the final stage of value chain. Domestic vertical integrated company in

the course of restructuring of retailing decreased the number of dealers from 500 in 2002 to 150 in 2004. The immediate cause for that was the *free-rider* [Goldberg, 1984] problem: franchisee retailer tried to sell furniture of unknown enterprises under the company's brand name or at least use the brand name of the company to attract customers while the share of the company's furniture in the whole stock was negligible.

At the same time vertical integration gives a company a chance to participate in the profit accumulated at the final stage of value chain that is in marketing and retailing. Weak development of specialized retailing, on the one hand, and inherited from the Soviet past integrated and diversified internal organization, on the other, make this type of development attractive.

An alternative way of upgrading is market or modular type of governance. But looking at the directions of upgrading proposed by a furniture producer we should come to an ironic conclusion: it seems that restructuring actions proposed could prevent but not promote competitiveness. If these plans realize, companies will be more integrated and more diversified and their ability to control their costs will decrease. Why are many market participants reluctant to upgrade as a part of modular chain, while they want to become a supplier of the global buyer?

The answer seems to be connected with the distribution of rent within the chain. Incentives for upgrading in value chains under modular and market governance may be even higher (due to higher toughness of competition in perception of furniture production), but resources for upgrading are more scarce, since furniture production is the least profitable link in value chains. The global buyer and especially retailers are not ready to pay to furniture producers rent on quality improvement and brand development. Without upgrading by means of repositioning in the value chain, domestic producers of furniture are forced to pursue upgrading that is almost exclusively aimed at cost minimization.

For domestic furniture producers circumstances become worse because the global buyer today is the only customer for the kind of product it needs (standardized product of a specialized producer). In the market with high competition on the part of supply specialized producer faces the *hold up* or *quasi-rent extraction* [Klein et al., 1978] problem. The price of goods produced using specific assets tends to the

second-best level that is quite low for a specialized furniture supplier. Other authors also discover this kind of problem in the network of the global buyer: “*The Russian supplier interviewed explained that the fear of losing existing orders from other clients and the decreasing variety and complexity of products made him cautious about prioritizing Ikea before other clients*” [Tarnovskaya et al., 2005]. The results of our interviews show that the situation is even more dramatic: there are no other clients for specialized suppliers without brand name and service facilities.

So many Russian furniture producers are at the crossroads now: following two alternative ways of upgrading potentially they are expected to occupy quite different positions in the value chain. Both are associated with specific gains and specific risks. Trying to upgrade by means of vertical integration, there is an extremely high need for resources and extremely high competition at the final stage, discouraging the investments of newcomers. Upgrading in the framework of modular governance, furniture producers have to concentrate on the stage of value chain with the lowest profit margin and to lose margin that they have as a diversified and vertical integrated companies.

Many market participants did not make their choice yet. That is why vertical integration, diversification and scale of Russian furniture producers remain high enough, and managers of *IKEA* in Russia are reporting that their demand is much greater than the Russian industry can cope with [Tarnovskaya et al., 2005]. As for international evidence, success of furniture sector development in former socialist Eastern European countries was driven by outsourcing of MNCs and large retailers, accompanied by the process of production fragmentation [Kaminski, Ng, 2001] and corresponding producers’ specialization. To what extent this development path is available for Russia – time will show.

5. Conclusion: challenges of enterprises' upgrading in Russian furniture industry

The results of the interview presented in this paper demonstrate the problems Russian domestic furniture producers face with. Almost all of them need restructuring in order to enhance competitiveness; managers and owners of enterprises understand that very well. The problem is however, that from the value chain theory's point of view, we cannot speak about the competitiveness out of value chain context. To be competitive, a company should first of all be included in the competitive value chain and then should fit the requirements of governance in specific chain.

Weak specialized domestic retailing and inability of retailers to govern value chain in efficient way make it necessary for furniture producers to choose between two alternative ways of upgrading, i.e. downstream integration and entering into the chain of global specialized retailer IKEA. These two ways imply two opposite directions of restructuring. Following one, it is necessary to diversify, to expand product variety, to turn core business from furniture production to furniture retailing. Following the other, it is necessary to specialize, to narrow product variety, to pay much more attention to product costing, etc. Two alternative ways of upgrading are perfectly substitutable: the same feature of furniture producer is an advantage on the one way and disadvantage on the other one. So, the main question Russian furniture producers have to answer is '*To specialize or not to specialize*'. The choice in favor of specialization is difficult because it would be a little exaggerated to say that in domestic market there is only one specialized retailer which is able to govern value chain efficiently. Recent tendencies of furniture industry development allow to suppose that both ways of development will be presented in Russia.

In its turn, lack of restructuring of market participants influences scale and directions of investments in domestic furniture market. Though Russian market is large today and has all the premises to exhibit high growth rates in the future, up to now significant investments have been made either in the stages of production, which can be included in other value chains (for instance, wooden chipboard and fiberboard production) or in a small number of integrated downstream companies. Enlargement of IKEA is an important exception and it shows that needs for investments are high but payback period is very long. It is remarkable that IKEA reported losses in Russian market during several years.

It is worth noting that the Russian furniture company's problem '*To specialize or not to specialize*' and investor's problem '*To invest or not to invest*' are highly interrelated. For domestic producers specialized on items with rich domestic resources (wooden and board furniture, for instance), or, alternatively, for a domestic vertically integrated company with efficient organization of retailing it would be possible to attract investments. On the other hand, the development of efficient specialized retailing in Russia would make for relatively small furniture companies to choose the way of narrow product specialization.

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