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Russian Agricultural and Food Sector in Transition

Meri Virolainen (Pellervo Economic Research Institute, Finland)

Working Paper 06/06

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RUSSIAN AGRICULTURAL AND FOOD SECTOR IN TRANSITION

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Abstract

This paper examines current situation in Russian agricultural and food sector and evaluates forthcoming development. Russia's agricultural production diminished by half at the beginning of the 1990s, and since that the production has hardly grown. In fact, Russia is one of the biggest food importers in the world. Particularly in livestock sector the situation is difficult. Number of livestock has not grown according to expectations and production does not satisfy domestic demand. Crop husbandry, by contrast, has export potential, but fluctuations in export volumes have been great. Furthermore, quality of grain has not always met standards. Russia's food industry has grown rapidly in the past few years, even though Russia has not reached self-sufficiency. Foreign investments have improved quality level of Russia's food industry. However, food imports will continue in the next ten years in bulk food products. For example current meat import volumes will remain more or less unchanged. Moreover, import demand of more specialised production inputs will grow.

Keywords

Russian agro food sector, dairy sector, meat production, crop husbandry, food industry.

1. INTRODUCTION

Russia is one of the largest food importers in the world and it has become a significant, growing market area for food exporters. The rapid economic growth in recent years and the increase in the real incomes of the consumers have led to a rapid increase in food imports. On November 6 2003, the EU and Russia have adopted the concept of European Common Economic Area, and have launched discussions on future trade. The EU is the largest trade partner of Russia (40 % of its external trade, to exceed 50 % after the EU enlargement), and these discussions, that aim at promoting and facilitating trade and investment as well as harmonizing regulations are of particular importance.

The future accession of Russia to the WTO will have significant consequences for the EU. This is likely to change the negotiating positions and the alliances formed between the main participants to the negotiations, in a way that is still unclear for EU interest. Russia could emerge as a much more important market for EU products. In addition, Russia's performances, options and strategies about themes like food safety, technical barriers of trade, environmental protection and rural development are still uncertain.

Because Russia is likely to emerge as a much more important trade partner for the EU in the future, it has appeared necessary to consider various issues surrounding the EU-Russia relations regarding agricultural products. This paper concentrates on three main themes. Firstly, development of Russian macro-economic situation is shortly presented. Secondly, Russian agricultural sector is presented in more detail; problems, possibilities and future trends in dairy, meat and grain sector are analysed. Thirdly, the report examines recent development of food sector, and moreover, the magnitude and importance of foreign firms in Russian food sector is discussed.

2. ECONOMIC SITUATION IN RUSSIA

The Russian economy has made good progress in recent years. Economic growth has been a seven per cent in the past few years, current accounts show a clear surplus and there has been significant growth in investments in both manufacturing industries and construction business. Apart from the rise in oil prices, the easement of the restrictions on investments and consolidation of the operating environment have contributed to these positive trends. Economic growth has been rapid in Russia, and it has regularly exceeded the prognoses of international economists. The entry of the Russian economy into a more stable and durable growth path has also stimulated the recovery of the consumer demand for foodstuffs thanks to the increase in real income and improved purchasing power.

While economic growth in the euro-area has stagnated to 2-3 per cent, the more rapid growth in the Russian economy has encouraged western companies to increase their investments to Russia. In view of the figures for the general economic situation alone the opportunities seem excellent. On the other hand, Russian economy continues to be strongly focused on the energy sector and economic reforms are still pending. Thus Russian economy and markets are highly ambiguous, involving both great risks and attractive opportunities.

2.1 Development of the economy: strengths...

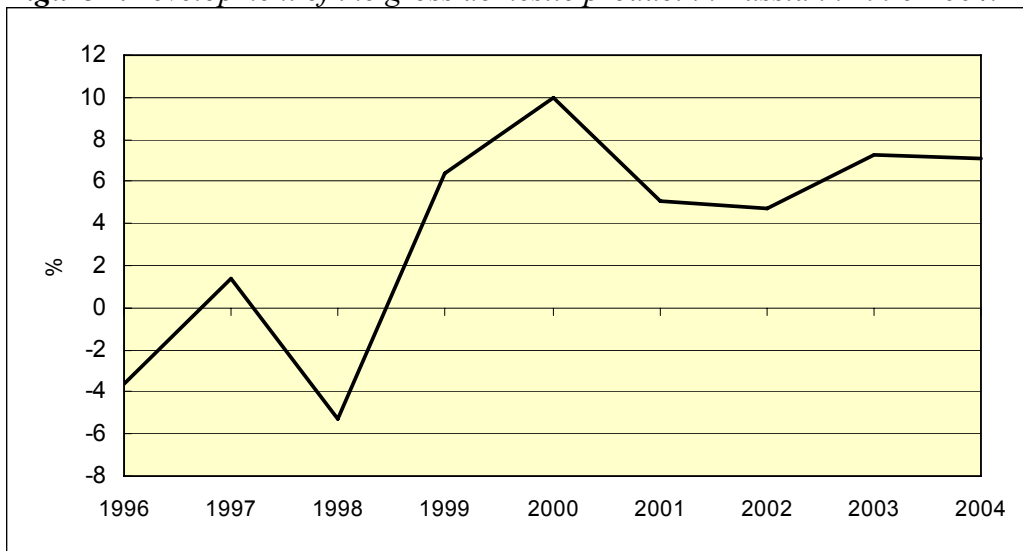
The transition of Russia into a market economy after the collapse of the Soviet Union in 1991 has obviously been a highly significant phase in the economic development of the Soviet Union/Russia. The socialist planned economy fell apart and Russia started to move towards a market economy. By the mid-1990s the total production in Russia fell to about half of the level during the Soviet era. After this, however, the production started to recover, until Russia was hit by a deep economic crisis in 1998. The crisis started as the Russian Government and Central Bank decided to discontinue supporting the exchange rate of the rouble in August 1998, which immediately led to devaluation of the rouble. By the end of the year the rouble weakened by almost to the quarter relative to the American dollar. The crisis had deep impacts on the Russian society and economy: the standard of living of the citizens fell by a third, the banking system ran into chaos and the political leadership suffered a serious loss of prestige as well. The middle class was the most seriously hit by the crisis because their assets were deposited in the banks.

After the crisis the Russian economy has again grown very rapidly, but the difference between the general living standard in Russia and the western countries is still great. The GDP per capita in Russia is only about 10 per cent of that in the old EU Member States. However, in Russia a significant share of economic activity is not yet included in the statistics. The estimates of this shadow economy vary from 20 per cent presented by the Russian authorities to almost 50 per cent suggested by the researchers (Finpro 2004).

Economic growth in Russia after the crisis of 1998 has exceeded all expectations, and the same strong pace seems to continue. In 1999-2003 the average annual growth in the Russian economy was more than 6.5 per cent. According to a forecast by the Russian Government, in the early part of 2005 the growth in the GDP was 5.6 per cent, which is somewhat lower than anticipated. Despite the rapid growth it seems likely that Russia is not going to meet the objective set for the Government by President Putin to double the GDP in a decade (Finpro 2004, Kauppapolitiikka 2005).

The economic growth has been founded on the increase in net exports. The domestic demand also recovered by the middle of the year 1999. In recent years, however, the domestic demand has to an increasing extent been directed to imported products. In 1999 and 2000 the recovery of the Russian industry from the crisis was facilitated by the clear devaluation of the Russian rouble and strong reduction in the domestic energy prices. Economic growth after the crisis accelerated thanks to the industry and construction activity, while the relative significance of the service sector grew especially in 2002 and 2003. Industrial growth has largely concentrated to a few sectors. In 2001-2003 the fuels, colour metals and forest sector represented almost 70 per cent of the growth, while the share of the oil sector alone was 45 per cent. The increase in oil production volume has made a significant contribution to maintaining the economic growth, but Russia has also benefited from the high oil prices (OECD 2004a).

Figure 1. Development of the gross domestic product in Russia in 1996-2004.

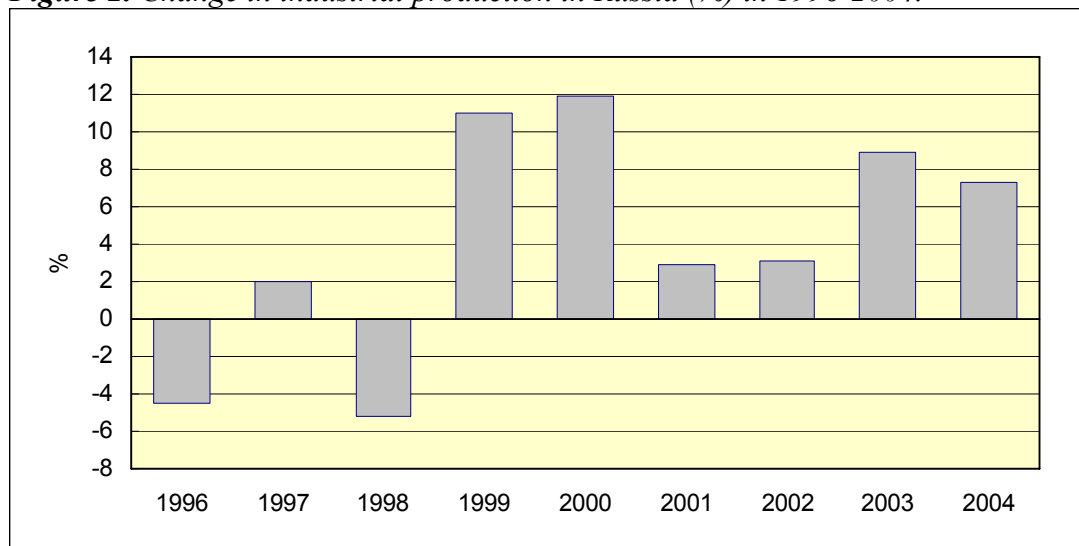


Source: Federal State Statistics, CBR.

Figure 2 illustrates the development of the production of the Russian industry. The economic crisis of 1998, when the production fell by more than 5 per cent from the year before, is clearly shown in the figure. After the crisis the industrial production has increased rapidly. In the beginning of 2005 the Federal State Statistics Service of Russia revised the method of calculating industrial production, as well as updated the production figures for the previous year. The new calculation method corresponds to that used in the western countries. According to the Statistics Service,

industrial production grew by 7.3 per cent in 2004, which is more than in the preliminary data (BOFIT 8/2005). In the early part of 2005 the growth in industrial production slowed down to about 4 per cent, which is lower than during the same period in the previous year (Kauppapolitiikka 2005).

Figure 2. Change in industrial production in Russia (%) in 1996-2004.



Source: Federal State Statistics, CBR.

The growth in industrial production in Russia has concentrated to the traditional, so-called basic industrial sectors. Growth in, for example, the electronics industry has been modest, as can be seen in Table 1. In January-May 2004 industrial production was 7 per cent higher than during the same period in the previous year. Manufacturing industries grew by about 8 per cent, chemical industries by about 10 per cent and the manufacture of construction materials by almost 10 per cent. The production of foodstuffs has, on average, grown at about the same pace as other industrial production.

Table 1. Growth figures for different industrial sectors in Russia (%).

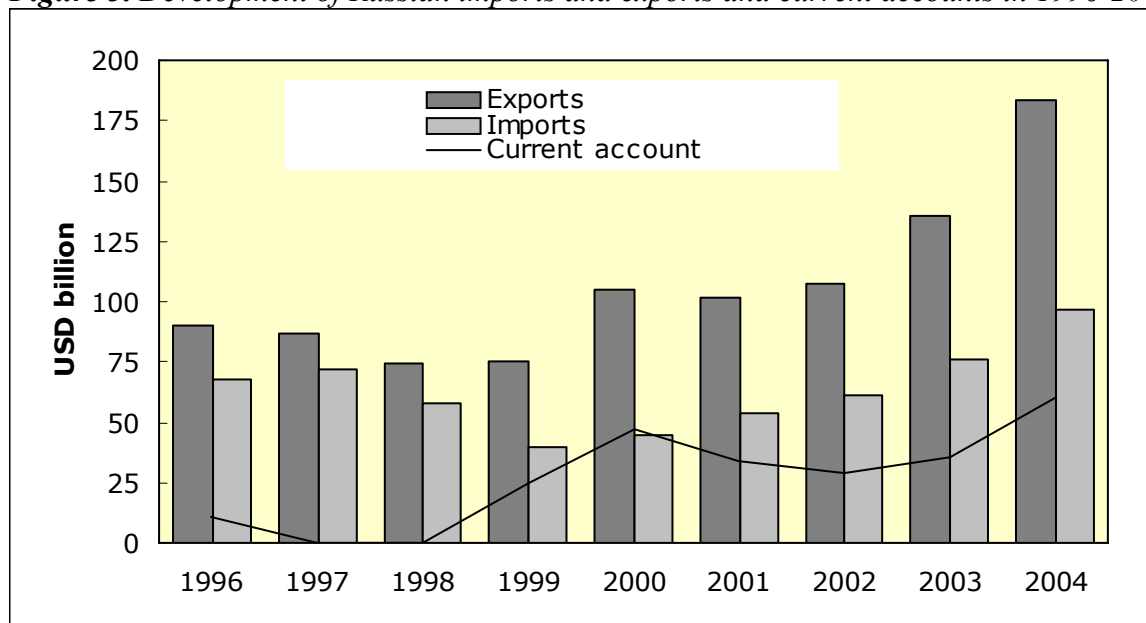
	1999	2000	2001	2002	2003	2004 (I-V)
Non-ferrous metals	10,0	15,0	4,9	6,0	6,2	4,2
Ferrous metals	17,0	16,0	-0,2	3,0	8,9	5,9
Fuel and energy	2,4	5,0	6,1	7,0	9,3	8,3
Wood and processing	18,0	13,0	2,6	2,4	1,5	7,0
Weighted average	9,3	10,4	4,2	5,5	7,8	6,8
Electricity	-1,0	1,8	1,6	-0,7	1,0	0,4
Chemical	24,0	15,0	5,0	1,6	4,4	10,0
Machine building	17,0	20,0	7,2	2,0	9,4	14,2
Construction materials	10,0	13,0	5,5	3,0	6,4	9,8
Light industry	12,1	21,0	5,8	-3,4	-2,3	-2,3
Food	4,0	14,0	8,4	6,5	5,1	7,5
Weighted average	10,6	14,3	6,3	2,5	5,6	8,0

The growth of the Russian economy from the perspective of the supply has been founded on the increase in the productivity, because the labour force is about the same as earlier. However, the level of investments has been low. The growth in the total demand has in turn been based on the increase in the private consumption. Since 2000 the annual growth in the consumption has been more than 8 per cent, while the population decreased in Russia by 3 per cent between 1994 and 2004. The growth in the consumption has been possible thanks to the increase in real incomes and strengthening of the currency. Between 1997 and 2003 the real wages rose by as much as 25 per cent so that in the beginning of 2004 the disposable income of the consumers was almost a third higher than before the crisis. In the beginning of 2004 the average monthly wages of Russians were about 6,000 roubles (about 180 euros) (OECD 2004a). In the early part of 2005 private consumption rose by more than 8 per cent, which is about the same as the increase in the real incomes of the population (Kauppapoliitikka 2005).

The development of Russian exports has also been favourable in recent years. In 2004 the value of exports rose to 183 billion dollars, which is 35 per cent higher than the year before. The structure of the total exports of Russia is still dominated by the products of the traditional, basic industrial sectors, which represent over three-quarters of the exports (OECD 2004). Fuels and energy alone still accounted for as much as 57 per cent of the exports in 2004, when the export revenue from crude oil increased by 48 per cent and that from oil products by 33 per cent, whereas the revenue from gas exports increased by only 12 per cent. The surplus in the trade balance hit a record of 88 million dollars (BOFIT 7/2005). The countries which used to belong to the Soviet Union, the so-called CIS countries (Confederation of Independent States) are significant trading partners of Russia, but the role of the European Union is also growing, especially after the most recent enlargement (Finpro 2004). In 2004 the largest trading partners of Russia were Germany, Belorussia and Ukraine (BOFIT 7/2005).

The current accounts in Russia have been positive for several years. In 2004 the current accounts showed a surplus which represented 10 per cent of the GDP, a total of 60 billion dollars (BOFIT 14/2005). The surplus in the current accounts is founded on the surplus of the balance of merchandise trade, because the balances of services have been negative and the net amounts of interests, profits and dividends paid abroad from Russia have also been higher. Towards the end of the 1990s strong devaluation of the rouble after the economic crisis also contributed to the surplus in the current accounts because of the decrease of imports (Finpro 2004). The favourable development of the oil prices had a strong role in the positive trade balance as well.

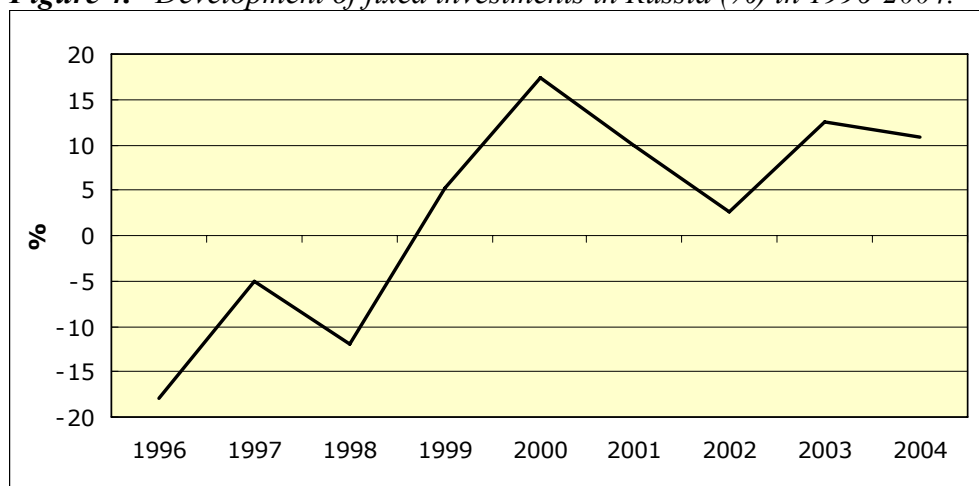
Figure 3. Development of Russian imports and exports and current accounts in 1996-2004.



Source: IMF

Investments to Russia have grown rapidly in recent years. Between January and May of 2004, for example, investments were almost 13 per cent higher than during the same period in the previous year. Most of the investments are still directed to the fuel and energy sector, which accounted for over 30 per cent of the fixed capital investments. The degree of investments in Russia is higher than in, for example, the United States or European countries, but however, below the average among the middle and low income countries (World Bank 2004).

Figure 4. Development of fixed investments in Russia (%) in 1996-2004.



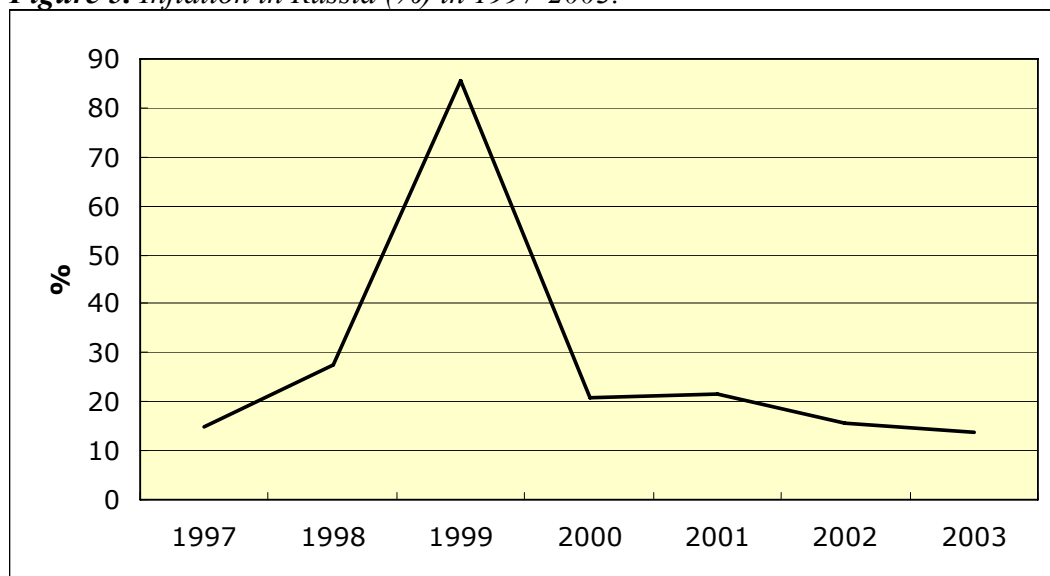
Source: Federal State Statistics, CBR.

In the Russian monetary policy there have been two main objectives which have been difficult to adjust to each other. Efforts have been made to curb inflation, while excessive strengthening of the currency has been controlled to improve competitiveness (OECD 2004a). In the past couple of

years the nominal exchange rate of the rouble has risen relative to the US dollar. In 2004 the rouble strengthened by 5 per cent relative to the dollar, but relative to the euro it weakened by almost the same percentage. Relative to the basket consisting of the currencies of the trade partners of Russia the rouble weakened by about 2 per cent. The Russian Central Bank has operated through currency market interventions to oppose the strengthening of the rouble. This has raised the currency reserve to the record high level of 125 billion dollars, which represents as much as 21 per cent of the GDP (BOFIT 3/2005, 14/2005). At present the currency reserve in Russia is so high that it covers the imports of the whole year, while a six-month currency reserve is considered reasonable for developing countries (Finpro 2004). The International Monetary Fund IMF has urged Russia to give up the policy of opposing the strengthening of the real value of the rouble, because the rate of inflation is likely to stay a little above 10 per cent instead of decreasing in accordance with the objectives (BOFIT 8/2005).

Inflation, i.e. the overall increase in the prices, has slowed down clearly in the past few years. While in 1999 the inflation was as high as 35 per cent, by 2003 it had been reduced to 12 per cent (OECD 2004a). However, in 2005 the rise in the consumer prices did not slow down, and Russia estimated that the inflation would be in the region of 10 to 11 per cent. The high export revenue flowing to the country is one reason for the acceleration of inflation. The Central Bank tries to restrict the strengthening of the rouble by purchasing currency to the reserve, but the means of the Central Bank are not sufficient to control the growth of the amount of roubles circulating within the country. In fact the inflation in Russia is accelerated due to factors which cannot be influenced through the monetary policy, such as rise in the world market prices for energy and high increases in the prices of public services determined by administrative decisions (Kauppapolitiikka 2005).

Figure 5. *Inflation in Russia (%) in 1997-2003.*



Source: IMF.

The state of the public economy in Russia has improved greatly after the economic crisis of 1998. Unlike before the crisis, the State revenue has clearly exceeded the expenditure in recent years (OECD 2004a). In 2004 the State economy showed a record high surplus, which represented 4.4 per cent of the GDP. While earlier a significant share of the budget expenditure went to the interest expenses on debts, now the share of these has fallen to about 8 per cent of the expenditure (BOFIT 11/2005).

As a result of the surpluses of the State economy a so-called stabilization fund was set up in Russia in the beginning of 2004. Its funds have increased more than expected as a result of the favourable development of the oil prices, and by the end of 2004 these funds totalled 522 billion roubles (over 14 billion euros). The share of the funds exceeding 500 billion roubles was used, for example, to pay off foreign debts. The Russian Government estimated that in 2005 altogether 390 billion roubles more would be accumulated to the fund. The funds are estimated to total about 720 billion roubles in the beginning of 2006 (20 billion euros), which represents a little less than 4 per cent of the GDP (BOFIT 3/2005).

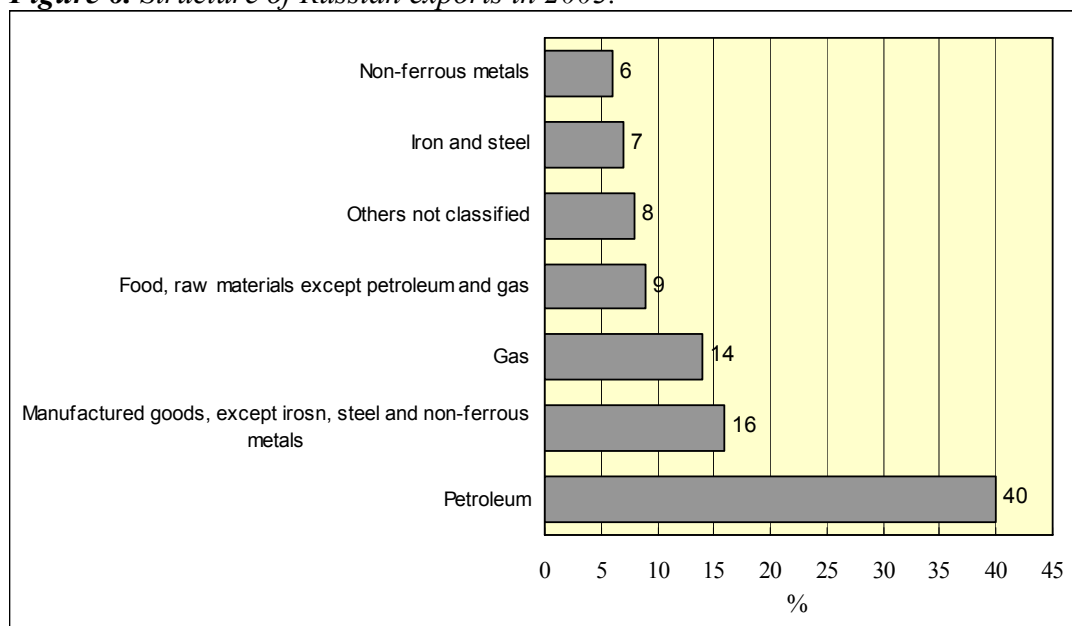
2.2. ...and challenges

Economic development in Russia has been very positive in recent years. However, the World Bank (2004) identifies three major concerns relating to the current economic development in Russia. First, the high world market prices in the oil and natural gas sectors have focused the economic activity too much to these important export-oriented sectors, leading to excessive dependence on these key sectors. Second, efficient implementation of the economic reforms is imperative to maintain the rapid growth. The World Bank sees that there is a need for reform in the finance sector, land ownership, health care, and education. The State monopolies should be reorganised and the public sector should be reformed. Third, the World Bank draws attention to the governance, where clear distinction between the private and public sector is needed.

The World Bank (2004) points out that the high growth figures of the Russian economy should be viewed critically. Domestic consumption and investments alone cannot ensure strong growth in the future, because now the growth has been supported by the high oil prices. We should also keep in mind that in the majority of the neighbours of Russia, i.e. the countries which have regained their independence (states which belonged to the former Soviet Union), the economies are growing even more rapidly than in Russia. The OECD (2004a) also sees certain problems in the economic situation in Russia. Russia is trying to diversify the structure of exports, but the comparative advantage enjoyed by Russia is founded on the natural resources. However, the oil resources are quite limited in Russia, which means other sectors to compensate for the oil should be found. According to the OECD, natural gas could compensate for the oil exports, because Russia has the greatest natural gas reserves in the world. The development of the natural gas sector is difficult due to the monopolised structure of ownership as well as strict regulation. Apart from the export sector,

the OECD sees clear development opportunities in the service sector, which could accelerate the growth of Russia.

Figure 6. *Structure of Russian exports in 2003.*



Source: OECD

The present production and industrial structure, which is heavily dependent on the export of natural resources, makes the Russian economy sensitive to changes. This is why the OECD (2004a) considers that the management of good fiscal and monetary policies cannot be overemphasised to ensure that the favourable economic development continues in Russia. The Russian Ministry for Economic Development and Trade estimates that maintaining the current rate of economic growth is difficult if it is founded on the foreign economic cycles. The Ministry has proposed extensive infrastructure projects, such as the construction and repair of ports, roads, airports, as well as oil and gas pipes. So far investments have been directed to the fuel sector, chemical and metallurgy industries and electricity production, while less than 10 per cent of the investments have been directed to machine construction (Finpro 2004).

The privatisation programme of Russia has for the most part been completed, but the State of Russia still a significant owner in, for example, the energy and communications sectors and banks. In some cases the ministries responsible for certain sectors have delayed the privatisation process, but there have also been difficulties in defining the value of the enterprises to be sold (Finpro 2004). However, the reforms of the structures of the Russian economy have been slow. For example, the major organisational reform of the State administration started in spring 2004 caused difficulties in the activity of the Ministries and agencies and institutes under these, but it seems that the objectives set for the reform will not be reached. The clarification of the structures and division of responsibilities in the public sector is also still under way, and the privatisation and reform of the companies were still far from completed in 2004 (Bofit 1/2005).

The protection of investments and ownership is still insufficient in Russia, and the foreign investment clearly suffers from this. According to the Russian Central Bank, the value of the direct investments to Russia totalled 1.1 billion dollars in 2003, while the value of the investments to Estonia was only a fifth smaller, 0.9 billion dollars (Finpro 2004, World Bank 2004). According to the State Statistical Bureau (Goskomstat), however, the value of the foreign investments which flowed to Russia in 2003 was 6.8 billion dollars. One reason for the difference in the statistics is the fact that the Statistical Bureau reports the direct investments to Russia as gross amounts, i.e. the investments placed abroad have not been deducted from these, while the balance of payments statistics of the Central Bank give the net amounts of the investment flows (Lainela 2004). Direct foreign investments increased clearly in 2004 and they rose to 9.4 billion dollars, which is 39 per cent higher than the year before. Of the total investments about a half were directed to the industrial sector, half of these to the fuel industry. The largest foreign investments came from Luxembourg, Great Britain and Cyprus. It is worth noticing that investments from Cyprus are mostly originated from Russian investors (BOFIT 10/2005).

In recent years imports to Russia have grown at least on the same pace as the disposable income. As the standard of living is rising thanks to the economic growth, it seems inevitable that the strong growth in the import demand will continue as well. The strengthening of the currency contributes to the increase in the import demand. At present the surplus in the current accounts is considerable, partly due to the current price relations, but the OECD (2004a) estimates that, if the growth of imports in dollars continues at the current pace while exports grow by a moderate five per cent, the surplus in the current accounts will melt away quite rapidly.

In 2004 the average increase in the real income of the Russian population was more than 8 per cent. The real income of the decile with the highest income rose by 12 per cent, while those of the lowest income decile rose by only 6 per cent. The number of people below the poverty level decreased from one fifth to 18 per cent in 2004. On average, however, the poorest people are poorer than before (BOFIT 9/2005). The increased earnings and incomes have led to a clear reduction in poverty in Russia, and the decrease in the rate of unemployment to about 9 per cent in 2003 also contributed to this development (OECD 2004a). The income disparities between the rich and poor have increased considerably in the past decade. While in 1991 the Gin coefficient was 0.26 (indicating equal income distribution, the smaller coefficient the more equal incomes), in 2004 it was as high as 0.4.

State employees earn only 2,000 roubles a month (about 60 euros) and the economic growth has not managed to abolish the class of the so-called working poor, which mainly consists of young adults. Average Russians consider that their economic situation had improved in recent years, and the consumer confidence was also reflected in the increased consumption (OECD 2004a). Even if the consumption has increased the most in the poorest social classes, matters which are not purely economic, such as exclusion from health care and education, have become increasingly acute problems (World Bank 2004).

The risks of the Russian economy do not concern only the dependence of the production on few key sectors or fluctuations in oil prices. Corruption is still common in Russia, and the country had the questionable honour of being ranked number 86 on a list of altogether 133 countries, placing it among the most corrupt countries. In this ranking Finland was the first among the least corrupt countries of the world (Finpro 2004). According to the Prosecutor General of Russia Vladimir Ustinov, for example, the number of crimes involving corruption increased by a fifth between 2003 and 2004, while the number of other crimes increased by only 5 per cent. The Prosecutor General urged Russia to reform the legislation to comply with the conventions of the United Nations and Council of Europe in order to get corruption better under control and to break one important obstacle to the economic growth (BOFIT 6/2005).

The connection between democracy and market economy is often emphasised in the efforts to achieve a balanced progress of the economy. The central position of the so-called oligarchs in the Russian economy slows down the economic reforms as well as the democratisation of the country. The Russian oligarchs control the companies operating in the natural resources sector, which are highly concentrated. However, the companies owned by the oligarchs are more efficient than the companies owned by other Russians. A typical problem in countries that are trying to give up centrally managed governance is that the democratisation of the political system remains half-finished, which means that they end up in the middle of a one-party and multi-party system. Russia seems to form no exception to this. Political democracy usually increases after the liberalisation of the finance sector, facilitation of competition policy and market access and evolvement of the middle class. Among the priorities of the oligarchs and political bureaucrats these matters do not rank very high (Guriev & Rachinsky 2005). Without a significant middle class, there can be no extensive consumer society in Russia.

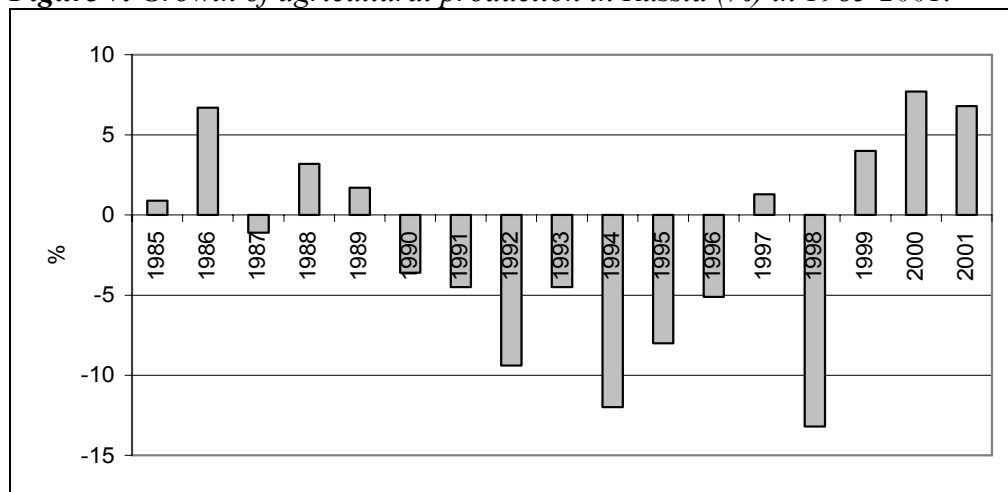
3. STRUCTURE OF RUSSIAN AGRICULTURE AND FOOD MARKET

The reform of the Russian agricultural sector, which got started a little over a decade ago, is still under way. The collapse of the Soviet Union and abolition of the socialist system in 1991 caused great changes in the agricultural sector as well. The reforms initiated in 1992 also signified the privatisation of agricultural land and farms. The employees of the kolkhozes and sovkhozes and pensioners had the opportunity to purchase agricultural land. No specific pieces of land were allocated, but the people received the option to purchase land in a certain region should they wish to do so. Between 1992 and 1994 altogether 12 million of such shares (options) were allocated. About 300,000 household took advantage of the opportunity to leave farm enterprises and start family farming on holdings of their own, while the rest of the rural employees continued to work in the farm enterprises. In most cases the latter relinquished their land (option) to the farm enterprises through a so-called leasing system. (Serova 2005).

Another significant change in the agricultural and food sector was the liberalisation of the prices and significant reduction in price supports. The support paid for foodstuffs, which used to represent as much as 60-80 per cent of the retail price, decreased considerably. For the consumers this meant higher food prices, which led to a clear decrease in the demand for food. The liberalisation of the prices also led to an increase in input prices, which during the planned economy used to be lower than the world market prices. Because in the early parts of the 1990s the market structures of the Russian agriculture and food sector were still undeveloped, the agriculture sector ran into recession. During the planned economy the State steered the whole food chain, but in the early stages of the market economy a corresponding, functioning chain simply did not exist, which means that it was difficult for the producers to get their products to the market. This opened the gates to food imports, which rose to a very high level in the early years of the market economy (Serova 2005).

In the early 1990s it was believed that the privatisation of agriculture and abolition of support would lead to a reduction in the production and increased productivity. Production decreased after the reforms but productivity did not rise as expected. In most production sectors the decrease in the production did not stop until at the end of the past decade (Osborne et al. 2002). There are several reasons for the slow recovery of the Russian agriculture sector. First of all, already during the Soviet era agriculture used to be the Achilles heel of the economy, and compared to the other sectors its transition to the market economy made slow progress. Second, the profitability and productivity of the agriculture sector is weak, and thus it has not managed to attract capital and skilled labour. Because of this the technology is behind the times and the business management skills are also deficient. The interpretation of legal matters (e.g. relating to land ownership) is still ambiguous while the rural areas have suffered from social problems, which is why agriculture has not reached the same kind of growth as the other sectors of the economy (Hockmann & Kopsidis 2005).

Figure 7. Growth of agricultural production in Russia (%) in 1985-2001.



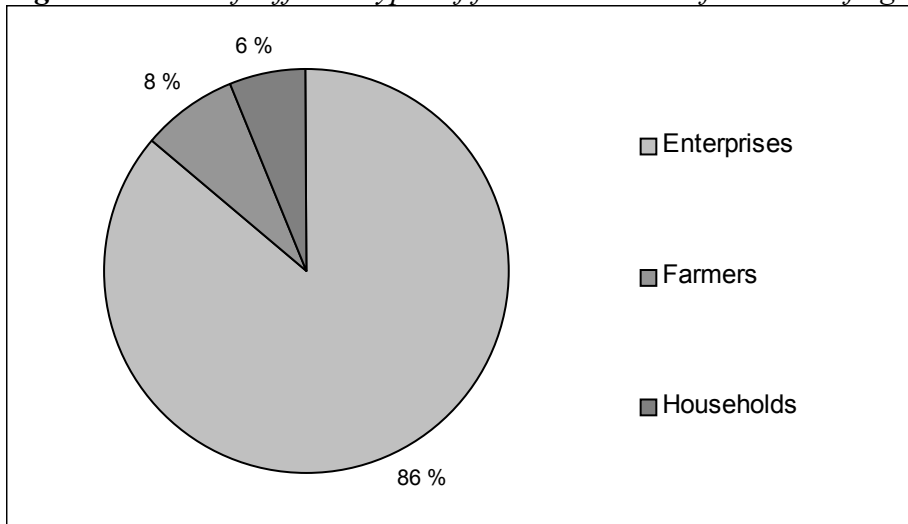
Source: Goskomstat.

One of the greatest problems faced by Russian agriculture is the slow progress of the structural reforms. A large number of farms are making losses and agriculture still employs too large a number of workers whose labour input is quite modest. Farms are still kept going through artificial means (the State does not collect its receivables), which leads to low work motivation and takes resources away from more profitable work. The outdated machinery and implements make it impossible to improve the production efficiency and the need for investments is great. The self-sufficiency thinking disturbs a sensible specialisation between the regions because all regions still strive to produce all the agricultural products they need by themselves. The markets for agricultural products and land cannot transmit current information to the potential buyers and sellers. Problems relating to the economy in general include the deficient infrastructure and undeveloped financing market (Tekoniemi 2003).

Russian agriculture began to grow towards the end of the 1990s. Between 2000 and 2002 the average growth in agricultural production and capital investments in agriculture was about 6 per cent. General economic development was picking up and the competitiveness of Russia was improving, but in addition to this the growth in agriculture was supported by favourable weather conditions. The cultivation area was no longer decreasing and there was some improvement in productivity as well. The economic crisis in 1998 gave a significant impulse to the recovery of domestic production as imported goods became very expensive for the consumers. Later on the growth was supported by the legislative reforms and development of the leasing and credit systems for agriculture. The Russian Minister of Agriculture Alexei Gordeyev has estimated that in the past five years the share of unprofitable farms has fallen from 88 to 33 per cent. The Government has reorganised the loans of farm enterprises for the total of 60 billion roubles. The Minister admitted, however, that the permanent poverty of the rural areas is a persistent problem which is yet to be solved (East Europe 12/2005).

Figure 8 describes the structure of farms in Russia, and Figure 9 shows the shares of different types of farms in agricultural production in 2000. Large farm enterprises possess over 85 per cent of the agricultural land in Russia. Individual farmers own 8 per cent of the farming land and 6 per cent belongs to households. The large farm enterprises are former kolkhozes and sovkhozes. They differ from each other a great deal, and usually they specialise in the cultivation grains, oilseed crops and sugar beets. These farm enterprises account for about 90 per cent of the total production of these crops in Russia (Serova 2005).

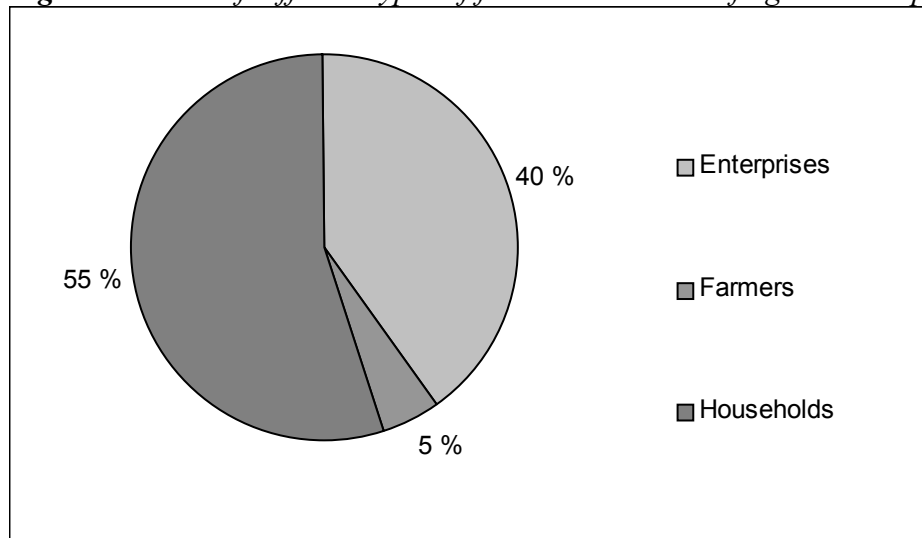
Figure 8. Share of different types of farms on total surface area of agricultural land in 2000 (%).



Source: Serova 2005.

When the production of the different types of farms is compared to the value of agricultural production, the share of households becomes quite high. In 2003 households represented over a half of the value of agricultural production, while large farm enterprises, which possess by far the largest share of the land, account for only 40 per cent of the value of agricultural production. The high production volumes of the plots cultivated for household needs is partly a result of the economic crisis, but it also indicates the insufficient market economy in this sector. One reason why the production of household plots seems higher than it is in reality is the fact that grain prices have risen much more slowly than the prices of livestock products, and the production is very unevenly distributed between the farms. Large farms cultivate mainly grains, while households also raise livestock and cultivate fruits and vegetables (Serova 2005).

Figure 9. Share of different types of farms in the value of agricultural production in 2003 (%).



Source: Serova 2005.

In recent years there has been a rapid, quite fundamental change in the principles for developing agricultural production. Family farm is no longer considered the model to be pursued, like in the early stages of the agricultural reform, but the objective is to set up large, commercial farm enterprises. So-called agroholding companies have been created in the agricultural sector, which may consist of a single farm enterprise or even tens of farms. In most cases these agroholdings belong to some even larger industrial-economic grouping, such as the Alfa group, Interros, Lukoil, Metalinvest or Rusagro. Apart from the economic business objectives the agroholding companies sometimes have certain other objectives, like ensuring the raw material supply of the other companies in the group, improving the stability of the company by diversifying its activity, or ensuring the supply of foodstuffs for the company's employees. The average sales of an agroholding company total about 20 million dollars, while the sales per a single farm enterprise total about 2 million dollars (Serova 2005).

The future of the Russian agriculture sector depends largely on the development of the largest farm enterprises, which cultivate several thousands of hectares. If the production of these farms reaches a favourable development path, Russia may become a globally significant actor in the agriculture sector (Hockman & Kopsidis 2005).

In 2003 agriculture produced 5.2 per cent of the gross domestic product of Russia. The value of fixed capital of agriculture totalled about 1.2 trillion roubles (about 40 billion dollars), which represents 4.4 per cent of the total fixed assets of the Russian economy (Finpro 2004). The total agricultural land area in Russia is about 216 million hectares, which represents 12.5 per cent of the surface area of the country. The cultivated area is about 123 million hectares, which is clearly larger than the total cultivated are in the EU-15, but smaller than the cultivated area in the United States. The area under cultivation has been on the decrease, which means that there is potential to increase the production (Finpro 2004). The transition from the planned economy to market economy has

reduced the agricultural labour force by about a fifth. On the largest farms the number of farm workers has fallen by 60 per cent (Liefert et al. 2005). Agriculture and the food industry employ about 15 million people, which is about 15 per cent of the labour force. In addition to this, it is estimated that about 23.5 million people grow agricultural products for their own use (Finpro 2004).

Table 2. Comparison of the Russian, EU-15 and US agricultural sectors in 2002.

	Agricultural Area (1 000 ha)	Arable Land (1 000 ha)	Agr. population (1 000)
Russia	216 651	123 465	15 271
EU-15	140 987	74 124	16 401
USA	411 863	176 018	6 303

Source: FAO.

Serious efforts are being made to develop agricultural production in Russia. The objectives of the economic programme for 2003-2005 include the improvement of the quality and competitiveness of agricultural production, promoting exports and protection of the domestic food economy by means of customs policy. According to the programme, during the following decade Russia should reach self-sufficiency in the production of milk and milk products, grains, poultry meat, vegetables and potatoes. However, the programme does not specify the products to which the Russian export sector should focus in the future (Tekoniemi 2003).

The development programme for agriculture emphasises the importance of establishing market conditions for agriculture and development of large farms through vertical integration. Large enterprises, which mainly operate in other sectors, have indeed invested in agriculture with the aim of creating a watertight vertical operating chain that they can control from the farms to the retail trade. Such unbroken chains of production and distribution are highly important in countries like Russia, where the production and distribution stages of agriculture are still quite undeveloped. In the economic programme for Russia until 2010 the preconditions for efficient agriculture include the development of private ownership and equal competition. To promote equal competition efforts are made to liberalise the trade flows between regions. The export of agricultural products is supported and protectionist measures are taken "within reason".

Increasing agricultural production and reaching self-sufficiency in certain products in Russia are highly ambitious objectives. Reaching them also depends on the functioning of the input market, issues relating to land ownership and support policy.

The agricultural input sector of Russia suffers from certain structural problems. Various kinds of support programmes, both national and regional, intended to support the farmers in their input purchases inhibit the free functioning of the input market. To receive the support the farmers must select the fertilisers, agricultural machines, etc. from a narrower supply. However, as the State no longer operates directly as an input supplier, new channels for purchasing the inputs are finding their way to the farmers. The functioning of the market is not too efficient as yet, which has

contributed to the creation of the vertical integration in the Russian agricultural and food sector. In addition to the structural problems the farmers suffer from lack of resources, which makes it difficult for them to purchase feed, fertilisers and seed. This is why Russian agriculture is still quite extensive as less expensive production factors, i.e. land and labour, are used to substitute for the more costly production factors (Serova & Shick 2005).

There is an urgent need for machinery and implements in Russian agriculture. The number of agricultural machines and implements has decreased since the early 1990s, because the financing problems have prevented farms from renewing their equipment. The situation is facilitated by the financing aid granted by the State and leasing arrangements. The level of machinery from tractors to working machines is insufficient both qualitatively and quantitatively. In the past 15 years the level of machinery has fallen to a half: the number of tractors is only 46 per cent and that of sowing machines only 41 per cent of their number in 1990. In 2004 there were 564,000 tractors in Russia, while in 2001 there number was still about 800,000. Because now over 70 per cent of the tractors are more than 10 years old, according to expert estimates Russia is soon going to need about 700,000 tractors and at least 100,000 combine harvesters. The Russian manufacturers of agricultural machinery will not be capable of responding to this need even quantitatively (Finpro 2005). The agricultural input industry is highly concentrated in Russia, i.e. both the manufacture and sale of input products are in the hands of a few companies. For example, the five largest manufacturers of tractors hold an almost 90 per cent market share, while Rosagrosnad accounts for as much as 75 per cent of the sales of agricultural machinery. The channels for purchasing inputs have changed. The agroholding companies, for example, obtain inputs from their mother companies, i.e. mainly commercial holding firms whose business strategy comprises agriculture as well (Serova & Shick 2005).

The shortages in the manufacture of domestic implements is compensated for through imports. In 2004 agricultural machinery worth more than 600 million dollars were imported to Russia. In reality, however, the value of imports is estimated to be about a third higher, because the customs clearances do not tell the whole truth. Of the imported agricultural machinery 44 per cent came from Germany. Some foreign manufacturers have also started production in Russia. Because of the financing problems the demand for machinery is still smaller than the need and especially small farms have difficulties in obtaining bank loans. Instead, it is much easier for the large farms to obtain funding from abroad (Finpro 2005).

The use of fertilisers decreased dramatically when Russia shifted to the market economy. The rise in the prices of fertilisers and lack of financial resources reduced the use of fertilisers by as much as 85 per cent between 1990 and 2002. However, as a positive consequence of the higher input prices the inputs started to be used more efficiently than before. Unlike during the old regime, for example, all fertilisers purchased to the farms are actually being used. The use of agricultural machinery has also changed. Earlier the farms had all the necessary machines, but now contracting services are increasingly common in, for example, harvesting (Serova & Shick 2005).

The clarification of the ownership of agricultural land in Russia and legislative reform pose great challenges to the Russian agricultural sector. The impacts of the land reform adopted in October 2001 were for the most part only symbolic, because the reform concerned only 5 per cent of the land area of Russia, while agricultural land was completely excluded. The foundation for the buying and selling market of agricultural land was laid by an act adopted in July 2002 (entered into force on 24 January 2003). The act regulates the legal relationships concerning the possession, use and exchange of agricultural land and allows, for the first time since 1917, the sale of agricultural land to private owners. Foreign operators were still denied the right to own agricultural land in Russia, but they can lease land for the maximum period of 49 years. The new act also gave the farmers the right to use land as security for credit (Finpro 2004, OECD 2004).

Table 3. *Most important agricultural production regions in Russia in 2002. (See map of Russia in Annex 2)*

Region	Gross agricultural output, billion RUR
Krasnodar oblast	66,2
Bashkortostan	44,1
Tatarstan	40,3
Rostov oblast	37,4
Alta oblast	31,8
Moscow oblast	31,6
Stavropol oblast	27,1
Novosibirsk oblast	26
Saratov oblast	25,4
Volgograd oblast	24,6
Others	674,8
Russia total	1029,3

Source: Regiony Rossii 2003(Goskomstat)

In practice agricultural trade is highly dependent on the policy practised by the central government and the supports available to agriculture. The new act grants the regional authorities a great deal of jurisdiction regarding the implementation of the act, including the right to restrict the maximum surface area of privately owned agricultural land within one administrative district. Because of their extensive powers the regional authorities may control the agricultural land market, for example, by postponing land sales and creating various kinds of bureaucratic barriers. At present the risks involved in land ownership are still great, which is why most farmers prefer to lease the land they need.

The value of the supports allocated to agriculture through the budgets represents only one per cent of the gross domestic product of Russia. This is much less than in the other countries. According to the Russian Minister of Agriculture, Russia supports her production by about 10 dollars per hectare, which is only a fraction of the amount of support paid in the EU (East Europe 4/2004). The main problem in Russia is that most of the State assistance (sometimes as much as 80 per cent) goes to

the administrative bodies involved in the agricultural sector, not for supporting the agricultural enterprises. The Russian Government is planning to raise agricultural supports and has also told about this in the context of the WTO negotiations. One special strength of Russian agriculture is that it has shown its ability to survive without State assistance (Finpro 2004).

The production potential of the Russian agricultural sector is great, but the quite optimistic forecasts of the productivity growth have not been realised as yet. The following chapters take a closer look at the situation in different production sectors.

3.1 Milk production sector

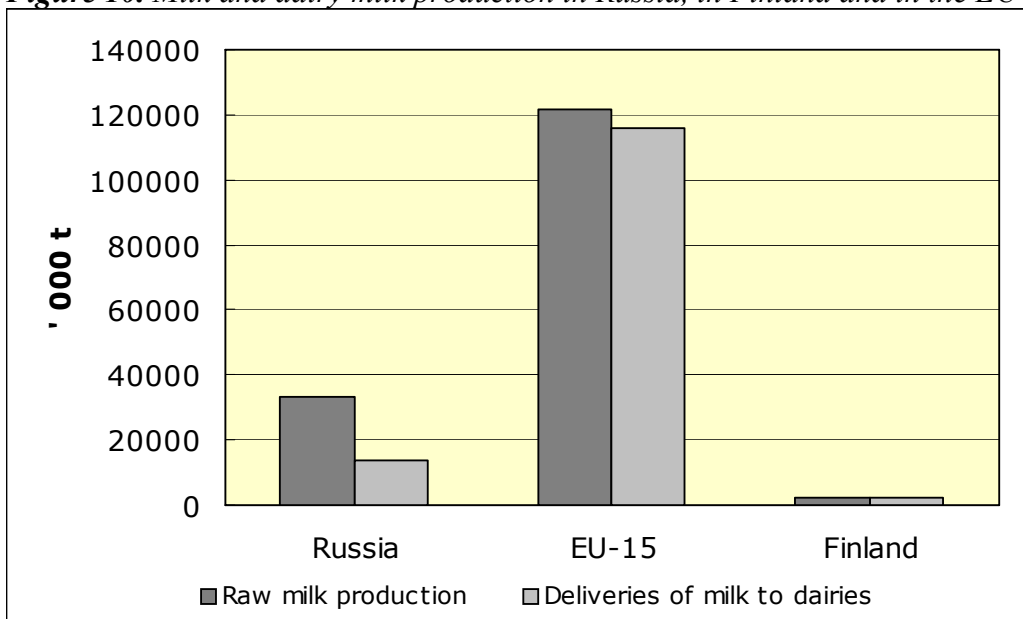
Production

At present Russia produces much less milk than 15 years ago. Towards the end of the 1990s the sector recovered to some extent from the collapse in the beginning of the decade, but since then the trend has not been as positive. The productivity of dairy farms is still weak, while hardly any investments needed to develop the production are being made. During the Soviet era milk production was the leading production sector of agriculture, with an annual production of 55 million tonnes. In 2003 the production totalled only 32 million tonnes and it was estimated to decrease further in 2004. One obvious reason for the decrease in milk production is the reduction in the number of dairy cows to about half from that in 1990 (now about 22 million). For example, in 2003 the number of cattle fell by 4 per cent because of the poor grain crop, which led to a shortage of feed and increased slaughtering of animals (Agra Europe 2.4.2004).

The variation in the milk production costs is great in Russia, from 159 to 831 roubles per 100 kg. The variation is caused by differences in the labour, feed and capital costs as well as in the productivity of the cows and technology used (Mokshina 2005). Today there are two very different kinds of dairy farms in Russia. A smaller share of the farms are highly dynamic and possess the economic potential to introduce new production technology, while for the majority of farms it is quite impossible to make such investments. Foreign companies have contributed to the development of the dynamic farms to ensure that the milk they produce meet the quality requirements of dairies. In practice the assistance has meant, for example, the acquisition of cold tanks to the farms, and the investment costs have been repaid through the milk supplied. These kinds of investments have made a significant contribution to improving the quality of milk. For example, in the Dutch dairy company Campina the share of the milk of the highest quality grade of the total production in Russia has risen from 6 to 55 per cent in the past four years (Dries et al. 2004). However, the dynamics in the Russian dairy sector created by the foreign companies is regionally very limited, because most of these companies are located in the Moscow and St Petersburg regions, which are very different from the other Russian regions (Dries et al. 2004).

Half of the milk produced in Russia still comes from remote private farms, whose milk does not in most cases qualify for industrial processing. It is estimated that less than 15 per cent of the milk produced by small private farms is sold for further processing (Dries et al. 2004). Instead, most of the milk produced on the largest farms is used for processing. This kind of milk represents about 47 per cent of the total milk production in Russia (Agra Europe 2.4.2004). The average yield of cows is very low, less than 3,000 kg, while in the EU-15 the average yield is clearly above 6,000 kg. However, there is also higher-yielding animal material in Russia, but the differences between the production animals are great.

Figure 10. Milk and dairy milk production in Russia, in Finland and in the EU-15 (2003).



Source: ZMP 2004, PTT.

The dairy industry is highly concentrated in Russia. Milk processors located in Moscow and St Petersburg alone produce over 60 per cent of the total value of the production of milk products. Large corporate farms are concentrated to the Moscow region, because this is where financiers for the investments can be found. However, the city of Moscow and the Moscow region cannot produce enough milk, but it must be brought from the other regions. The regional producers are very much willing to market their milk to the processors in Moscow because of the more favourable sales terms (Mokshina 2005). The concentration to the Moscow region has also tightened the competition and quite high prices are being paid for high-quality milk. The price of normal quality milk is about 18.40 cents/litre, while as much as 28.30 cents/litre may be paid for milk that is rated to the highest quality class. Because of the high prices many companies have started to purchase milk at distances as long as 1,500 kilometres. The rise in the producer prices has created great expectations among the producers, but any further improvement in the paying capacity in the future seems unlikely. The packaging and wage costs of the dairy industry are on the increase, but the consumer prices are no longer rising very much (Agra Europe 2.4.2004). Table 4 shows that without the quality supplements the price of raw milk would still be clearly below the price level in the EU-15.

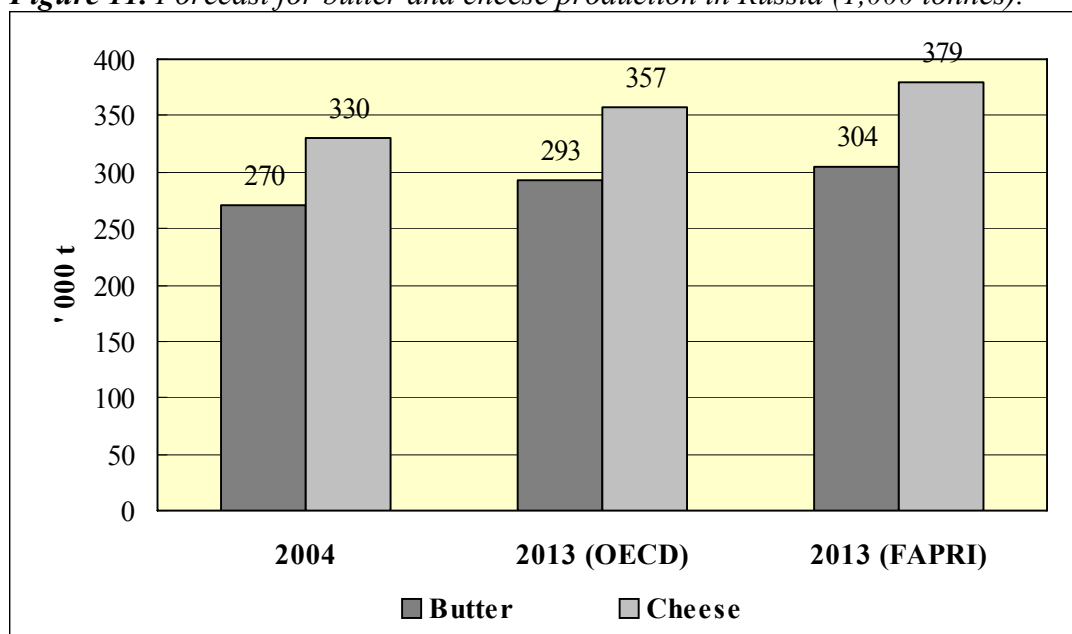
Table 4. Price of milk in Russia, EU-15 and Finland.

Producer milk prices, €/100 kg	2002	2003
Russia	14,8	13,3*
EU-15	29,7	28,6
Finland	35,5	35,3

Source: ZMP 2004, PTT. (*The figure for Russia in 2003 is preliminary information.)

The USDA forecasts that in 2005 milk production in Russia will remain on about the same level as in 2004. The same applies to the production of cheese and butter (Agra Europe 26.11.2004). International estimates of the development of the Russian milk production differ from each other to some extent. According to the ZMP, milk production is going to decrease in the future, which would cause problems to milk processors as well, because they cannot transfer to growing production costs to the consumers. The problems would affect especially the small and medium-sized milk processors, because the producers sell high-quality milk only to dairies which are capable of paying a higher price for it (Agra Europe 2.4.2004). Instead, according to forecasts by the OECD (2005) and FAPRI (2005), by 2013 milk production in Russia is going to increase from the present level by about 10 per cent. Only 55 per cent of the total production would end up in dairies, while at present a little less than half of the total milk production is delivered to dairies. This share is very low compared to the EU countries. Figure 11 presents the forecast of the OECD and FAPRI concerning the change in milk production by 2013. The forecast of FAPRI concerning butter production is slightly more optimistic than that of the OECD, but butter production should rise by about 10 per cent in ten years. The difference in the forecasts for cheese production is greater: according to FAPRI (2005) it should rise by about 15 per cent, while the OECD estimates the increase at only 8 per cent.

Figure 11. Forecast for butter and cheese production in Russia (1,000 tonnes).



Source: OECD 2005, FAPRI 2005.

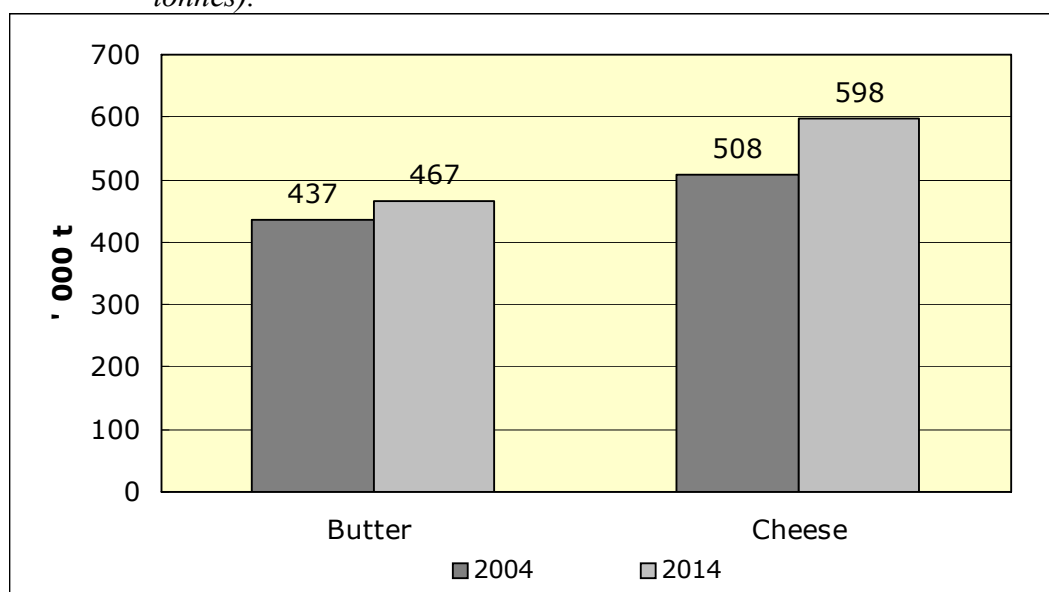
Consumption

The value of the Russian milk product market is estimated at 22-25 billion dollars annually (AgraFood 4/2004). Compared to the Soviet era the consumption of milk products has decreased clearly. In 2002 and 2003 the consumption of milk products in Russia was about 225 kg per capita, while in 1990 it was 360 kg. Thus there is a great deal of growth potential on the Russian milk product market. The Russians consume, for example, the average of only 5.6 kg of cheese per capita per year, while in the EU-15 the average annual per capita consumption of cheese is 18.9 kg (Gallup Food and Farm Facts 2005).

During the Soviet era the consumer basket of milk products was still very different from that in the western countries. In Russia the consumption consisted mainly of cheese, sour cream (smetana), kefir, liquid milk, milk powder and butter, while yoghurt and flavoured milk drinks were completely unknown. The trade of milk products took place either directly between households or in market booths and the like. Since then the milk trade has rapidly moved to supermarkets and the range of milk products has grown to 500-1,000 in supermarkets and as much as 1,000-2,000 in the giant hypermarket (Dries et al. 2004).

The consumption of milk products is expected to rise considerably during the next decade as the standard of living continues to improve. For example, the FAPRI forecasts that cheese consumption should grow to about 590 million kg, which is 15 per cent higher than at present, while the forecast of the OECD is as high as 675 million kg. Butter consumption is expected to rise to about 465 million kg, which would be 7 per cent more than at present. The consumption of powders is also forecast to increase 5 to 10 per cent during the next decade (FAPRI 2005, OECD 2005).

Figure 12. Forecast on the growth in the consumption of milk products in Russia by 2014 (1,000 tonnes).



Source: FAPRI 2005.

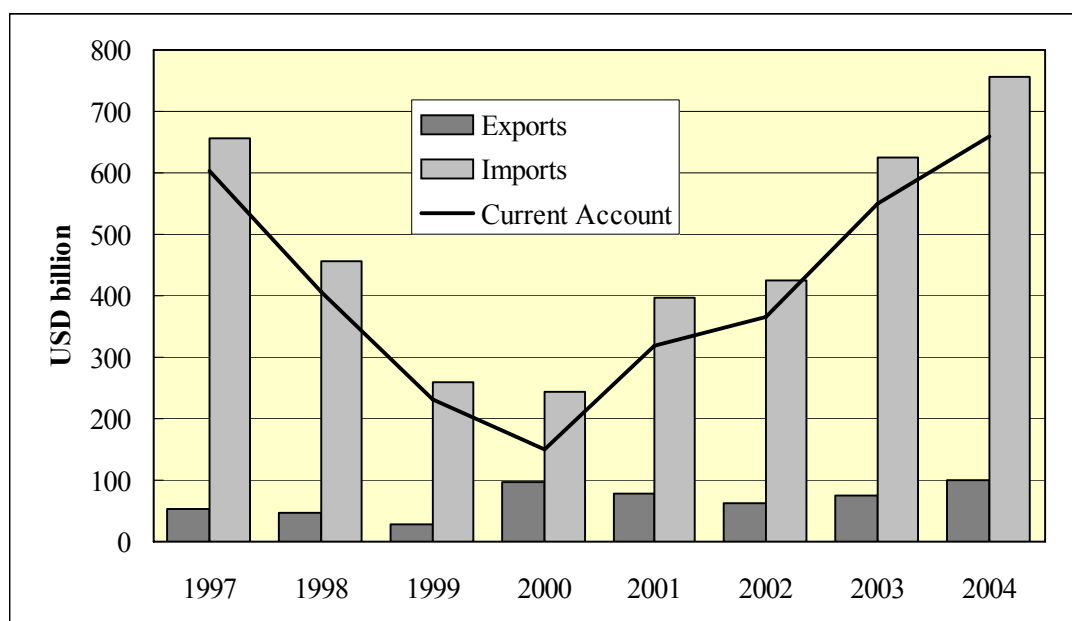
Foreign trade and foreign production activity in Russia

More extensive export of milk products to Russia got started during the perestroika at the turn of the 1990s when many of the barriers to imports were lifted. A second wave in the supply of milk product in Russia came as a result of the economic crisis in 1998 and strong devaluation of the rouble in 1999. As the costs of import rose considerably and tighter border control made import increasingly difficult the companies decided to invest in local operations. At present about 5 per cent of the milk, yoghurt and other traditional milk products sold in supermarkets are imported products. In cheeses the share of imports is higher, 15 to 20 per cent, because the local cheese processing is still poorly developed and the demand for special cheeses has grown among the increasingly wealthy consumers (Dries et al. 2004).

The import of milk products to Russia has grown as the domestic production has been decreasing. For example, in 2003 the cheese imports grew by more than 30 per cent and butter imports by more than 10 per cent (Agra Europe 2.4.2004). Milk products are imported to Russia mainly from Western Europe, but New Zealand is a significant butter importer. Somewhat surprisingly, Belorussia also exports considerable amounts of cheeses, butter and other milk products to Russia (Dries et al. 2004).

In 2003 the cheese imports to Russia totalled 175,000 tonnes, which accounts for about a third of the total consumption. About 160,000 tonnes of butter was imported, which represents about 40 per cent of the consumption. New Zealand was the largest butter exporter to Russia with a share of about a third of total butter imports to Russia, and the share of the largest cheese exporter, Germany, was about the same (Agra Europe 26.11.2004). Figure 13 shows that the foreign trade of milk products in Russia still shows a clear deficit. In 2004 the value of the milk products imported to Russia was a little under 760 million dollars, while in 2000 it was a little less than 250 million dollars. In recent years the exports have grown as well, but the growth has been quite modest compared to imports. The dramatic growth in the import of milk products shows that the foreign investments in Russia have not, at least as yet, substituted for the imports.

Figure 13. Profile of the trade in milk products in Russia in 1997-2004.

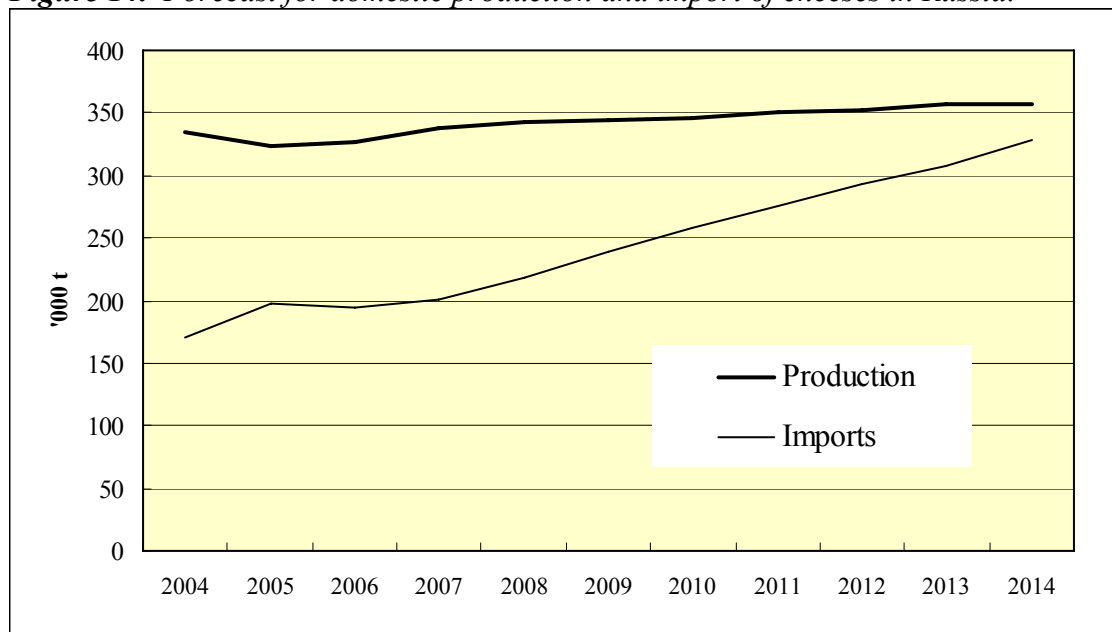


Source: Comtrade.

Many foreign dairy companies have told about their intentions to invest significant amounts to the Russian dairy industry. Increasing exports has also been the goal of many dairy companies, and many of them have also succeeded in this. For example, the Arla Foods told that its butter and cheese exports to Russia had grown by more than a fifth in 2004 (Eurofood 2004). The French dairy company Danone plans to double its milk processing capacity in Russia by 2007. The European Reconstruction and Development Bank has granted 17.5 million euros for the investments in this capacity increase. Danone has operated in Russia since 1992 and at present it owns two dairies in Russia. In the beginning of 2004 Danone was the leader on the Russian milk product market with a market share of about 15 per cent (East Europe 9/2004). Unilever returned to the Russian ice-cream market in 2003 after about two years' absence. The Russian ice-cream market is growing steadily and, for example, Campina set up a third production line in the Moscow region (Euro Food 25.9.2003).

The OECD (2005) forecasts that the cheese imports will be growing in spite of the recovery of the domestic production with the help of foreign companies. The imports are estimated to double from the present level by 2013, which means that the share of imports in the consumption would be a little less than a half. At present imported cheeses account for about a third of the consumption. According to the estimates by FAPRI, cheese imports will not grow quite as much, because the estimate for the domestic consumption is lower than that of the OECD. As the imports of milk products have been growing, the Russian authorities have started to consider various kinds of border protection measures to restrict imports. For example, in the early part of 2004 Russia planned to impose raised duties for imported cheeses. After negotiations with the EU it was finally decided that the refunds for EU exports to Russia were lowered considerably.

Figure 14. Forecast for domestic production and import of cheeses in Russia.



Source: OECD 2005.

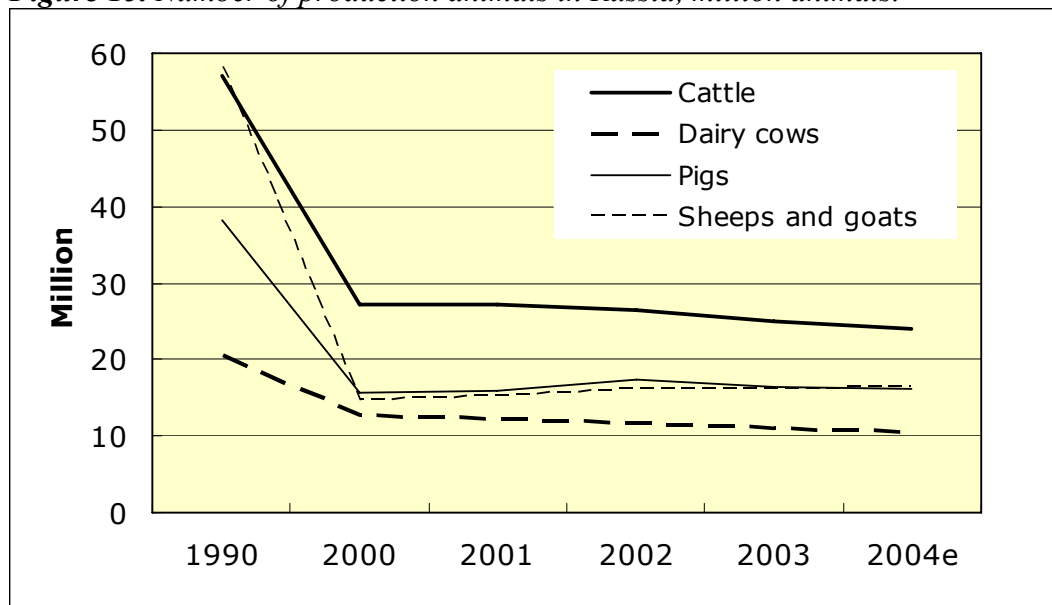
The estimates of the trends in butter imports differ from each other to some extent. The FAPRI estimates that the imports will stay at about the current level, but according to the OECD the butter imports may grow by as much as 70 per cent by 2014. This would mean that the share of imported butter in the total consumption would be 30 to 45 per cent. The imports of skimmed milk powder have been clearly smaller than butter and cheese imports in both absolute and relative terms. The FAPRI forecasts that the imports of skimmed milk powder will decrease during the next decade, while the OECD expects the imports to grow to some extent. The difference is again due to the consumption, which according to the OECD's forecasts will grow more than according to FAPRI (FAPRI 2005, OECD 2005).

3.2 Meat sector

Production

Russian meat production has decreased considerably in recent years as the numbers of animals have fallen. In 2003 the number of production animals was only 40 per cent of that in 1990. The main factor which started the decline in livestock production in Russia was the liberalisation of the prices of agricultural products in 1992, where the quite significant consumption supports were abolished. This reduced the purchasing power of the consumers and the demand for domestic meat fell at the same time when the imports were growing rapidly (Serova et al. 2002). By the beginning of 2005 the number of livestock had fallen to 23.1 million from the 24.8 million the year before. Even if the total number of animals has been decreasing, the number of poultry is on the increase, and there has been some increase in the number of pigs and sheep as well (East Europe 2/2005).

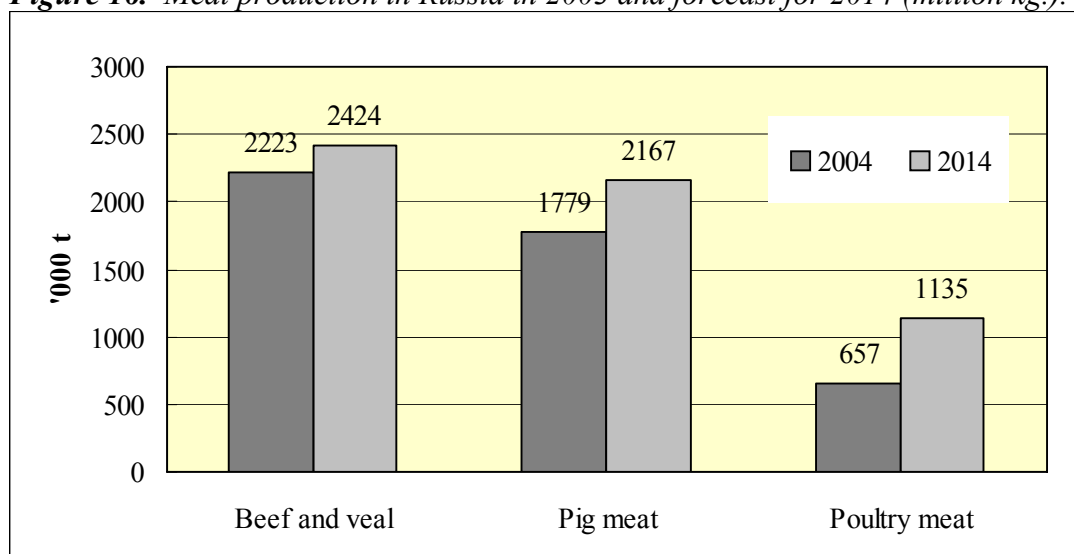
Figure 15. Number of production animals in Russia, million animals.



Source: East Europe 2/2005.

The foreign and Russian estimates on the development of meat production in Russia differ considerably from each other. According to the quite optimistic estimate of the Russian Meat Union, the domestic meat production would grow by more than 40 per cent from 2003 until 2010. However, the meat production would still be about a quarter lower than in 1990, when it totalled 10.1 million tonnes. The focus of meat production seems to be shifting to poultry meat. One of the key areas in the Russian economic programmes has been to ensure self-sufficiency in poultry meat. The Russian Meat Union has suggested that the import duties of all processed meats should be raised to ensure the full utilisation of the domestic production capacity (East Europe 4/2004).

Figure 16. Meat production in Russia in 2003 and forecast for 2014 (million kg.).



Source: OECD 2005.

In recent years a great deal has been invested in poultry production in Russia. The production has doubled in the past three years, and at the end of 2004 it was estimated that the production had grown by almost a fifth from the situation a year before. Apart from the high investments the growth has been founded on the restrictions on poultry imports, which have been successful from the Russian perspective. The objective is that support for the domestic production and restrictions on imports would triple poultry meat production by 2010 (3.23 million tonnes), which would represent more than 40 per cent of all meat production (22 per cent in 2003). At present pork and beef production volumes are still clearly higher than poultry meat production. However, the international estimates of the growth in poultry meat production are far more pessimistic than the three-fold growth by 2010 expected in Russia. According to the OECD (2005) and FAPRI (2005), the production should grow by about 70 per cent.

The views on the development of beef production also differ from each other. According to the OECD (2005), in 2010 beef production will be only a little higher than in 2004, while according to the Russian Meat Union beef production will be about a fifth lower in 2010 than in 2003. The FAPRI (2005) in turn estimates that beef production is going to fall by about 15 per cent by 2014.

Efforts are also being made to increase pork production in Russia. The Russian pork producer organisation even plans to double the production to 3.3 million tonnes by 2010. This target should be reached through lower production costs and by building new pig production units. The prospects for growth in pork production are quite positive, because the demand is growing, there is growth potential in the production of feed grains and import quotas restrict the pork imports (Agra Europe 29.4.2005). However, the international estimates on the growth in pork production are not as optimistic. According to the FAPRI (2005) and OECD (2005), the production would rise by only about a fifth to a little over 2 million tonnes by 2013.

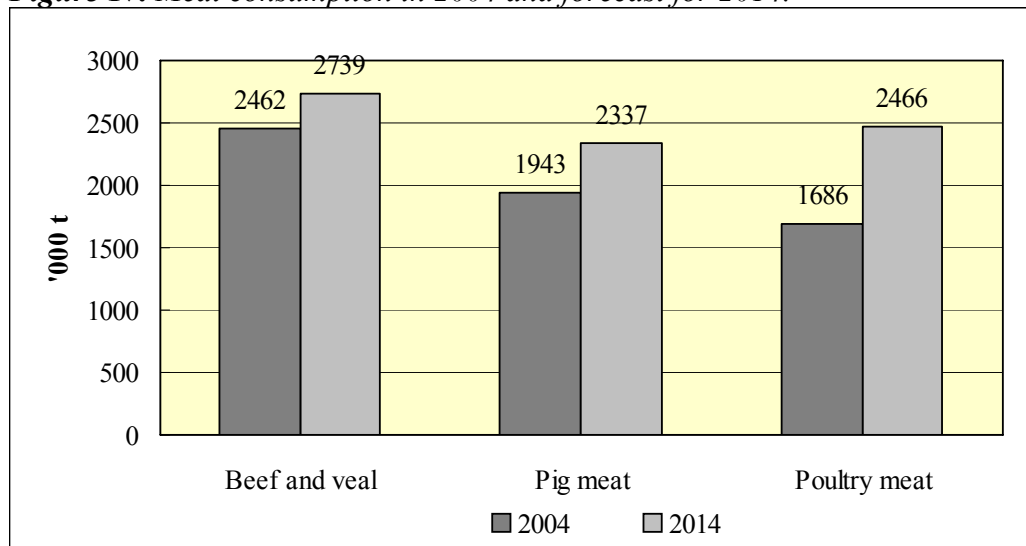
Consumption

The trends in meat consumption should be quite positive in Russia. For example, the OECD (2005) estimates that the consumption of all types of meat will be growing. Beef consumption is expected to grow by about 10 per cent and pork consumption by about a fifth by 2014, while poultry meat consumption should increase by almost 50 per cent. The forecast for trends in meat consumption by FAPRI (2005) is close to that of the OECD for the part of pork and poultry meat, but the FAPRI estimates that there will be some decrease in beef consumption. The FAPRI obviously expects that the growth in poultry meat consumption will substitute for beef.

According to Musheg Mamimokyan, the Chairman of the Russian Meat Union, by 2010 the annual consumption of meat and processed meats would total about 10 million tonnes, while about 2 million tonnes of meat would be imported. Around 2010 the distribution of meat consumption according to types of meat would be such that the share of poultry meat would be 45 per cent, pork 35 per cent, beef 17 per cent and mutton 3 per cent (Pravda 2002). According to the OECD (2005),

however, the annual meat consumption would be only a little less than 7 500 tonnes, which is much lower than the estimate of the Russian Meat Union. The OECD (2005) also forecasts that poultry meat consumption would exceed the consumption of pork only around 2014. Thus the estimates presented in Russia concerning both the pace of the growth and the distribution between the types of meat again differ from the international estimates.

Figure 17. Meat consumption in 2004 and forecast for 2014.



Source: OECD 2005.

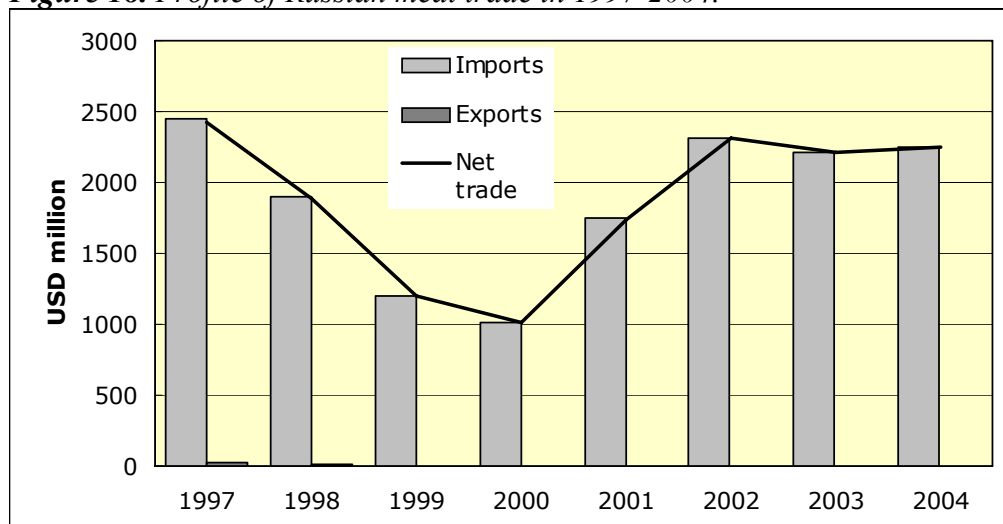
The changes in meat consumption are naturally influenced by the prices of the products. The wholesale prices for meat have risen as the meat imports have been restricted and the domestic production has declined. Between the autumn of 2003 and autumn 2004 the meat prices had risen by several tens of percentage units (East Europe, 12/2004). There are interesting differences in the forecasts concerning the producer prices between the different organisations. The FAPRI expects that the prices will rise only little or they may even decrease, but according the OECD the prices should rise considerably. At present the trend forecast by the OECD is closer to the truth, because the import barriers reduce the imports and the prices are rising. In 2005 the poultry meat prices should stay on about the same level as earlier because of the tight competition, but the prices of beef and pork are expected to rise clearly due to the obstacles to meat imports. In the early part of 2005 the wholesale prices for pork rose by 5 to 10 per cent and the beef prices by about 2 per cent (East Europe 3/2005).

Foreign trade

As the domestic meat production has decreased, Russia has become the second largest net importer of meat in the world. Poultry meat imports are the largest in both absolute terms and relative to the total consumption. In 1999-2003 the annual poultry meat imports totalled, on average, 1,250 million kg, which represents almost 75 per cent of the total consumption. During the same period the average pork imports were a little less than 480 million kg, which accounts for about a quarter of

the total consumption. The average beef imports were a little less than 520 million kg, representing a little over a fifth of the domestic beef consumption (OECD 2005). In 2004 the value of Russian meat imports was about 2.2 billion dollars, which means that it has not yet reached the value of imports in 1997. In fact the value of meat imports decreased slightly between 2002 and 2003, but after that there has again been some increase. Figure 18 shows that Russia exports hardly any meat to other countries.

Figure 18. Profile of Russian meat trade in 1997-2004.



Source: Comtrade.

Russia has protected its meat sector against foreign imports by imposing import quotas for meat. The import quotas applied in 2004 were 447,500 tonnes for beef and 450,000 tonnes for pork, while for poultry meat a quota of 1.05 million tonnes was set for three years (Agra Europe 10.12.2004). Of the import quota for poultry meat the share of the United States was 772,000 tonnes and the quota for the EU was 210,000 tonnes. Towards the end of 2004 it seemed, however, that the quota would not be fulfilled due to administrative reasons, because in the first 11 months of the year the imports had decreased by almost 10 per cent from the same period in the previous year (Agra Europe 21.1.2005). The restrictions on poultry meat imports have made it possible for Russia to increase its own production. However, growth in the poultry sector began before the quota regime. In the poultry sector more attention will also be directed at the quality of the imported meat (Agra Europe 23.12.2004).

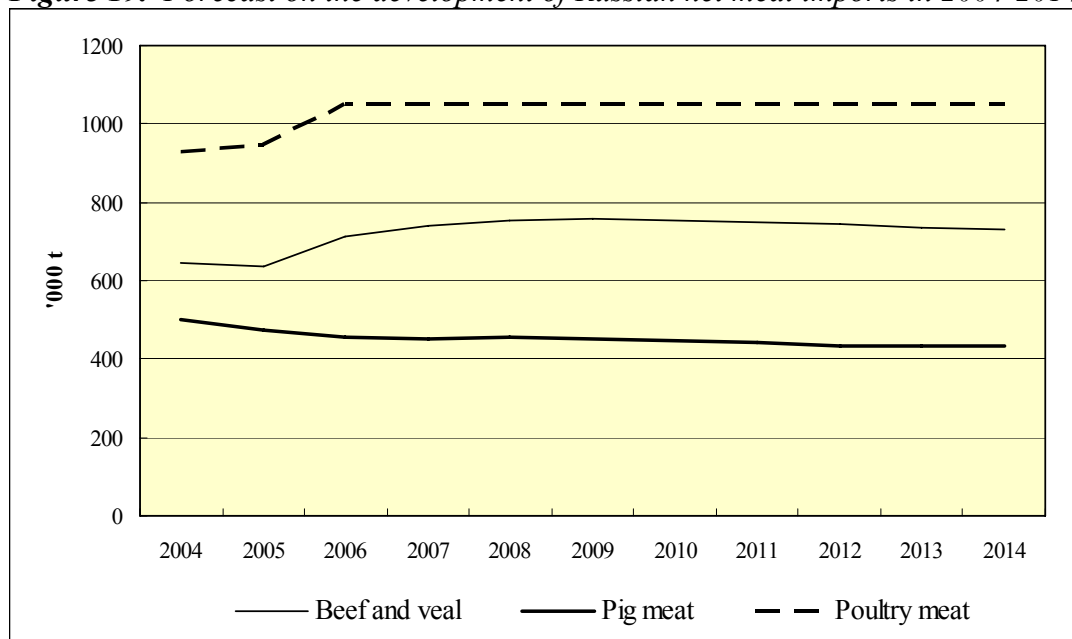
At present Russia is negotiating on raising the meat import quotas. Restrictions on meat imports have caused problems in Russia, as well as in the exporting countries. As the imports decreased more domestic raw material had to be used in Russia, which led to a rapid reduction in the number of animals. This in turn led to an even more acute shortage of raw material. The use of poultry meat has increased as beef has been in short supply (Finpro 2004). The future of the Russian meat industry depends largely on how the raw material problem can be solved. Some companies are trying to solve the problem on their own through vertical integration, i.e. by setting up contract farms of their own to secure their raw material supply.

The EU has suffered from the export problems due to the restrictions on meat imports to Russia. Russia also restricted the import of Brazilian products temporarily because of the foot-and-mouth disease. Brazil is the largest exporter of beef and pork to Russia (East Europe 12/2004). Russia has also threatened the United States and Canada by import restrictions because the conditions of animal transports have not been in proper order. However, in the negotiations between Russia and the United States concerning Russia's membership in the WTO it was agreed that Russia is going to increase its import quota for meat. The import quotas for beef and poultry meat will be raised by about 5 per cent (Agra Europe 10.12.2004, 15.4.2005).

The objectives included in the Russian agricultural programme for 2001-2010 should influence the meat production sector as well. During the programme period Russia strives to reach self-sufficiency in poultry meat and eggs, among other things. The agricultural programme also stresses the need to improve the competitiveness of the domestic pork and meat products, which means that efforts are likely to be made to increase their role in exports. However, it is also possible that the agricultural programme refers to improving the competitiveness of the domestic pork and meat products relative to the foreign imports.

Musheg Mamimokyan, the Chairman of the Russian Meat Union, forecasts that in 15 to 25 years Russia will export annually 2-3 million tonnes of meat and meat products. This estimate is founded on the expectation that feed grain production will stay on a high level (Pravda 2002). However, the international forecasts on the development of agricultural production in Russia do not support this estimate. According to FAPRI (2005), for example, Russia will be clearly a net importer of meat in the next decade. In fact, imports are not likely to decrease, as the import of beef and poultry meat would increase by about 13 per cent while pork imports could decrease by about the same percentage. The OECD's (2005) views concerning the Russian meat market are quite similar to those of the FAPRI.

Figure 19. Forecast on the development of Russian net meat imports in 2004-2014.



Source: FAPRI 2005.

In the first half of 2005 meat imports to Russia increased by almost 15 per cent. The amount of imported mutton grew by over 70 per cent, that of beef by over 40 per cent and poultry meat by about a third from the previous year. Russian authorities have estimated that meat imports will be needed in the future as well. The import of fresh and frozen meat is expected to grow by more than 15 per cent by 2008 compared to the import volumes in 2004 (Agra Europe 19.8.2005)

3.3 Crop production sector

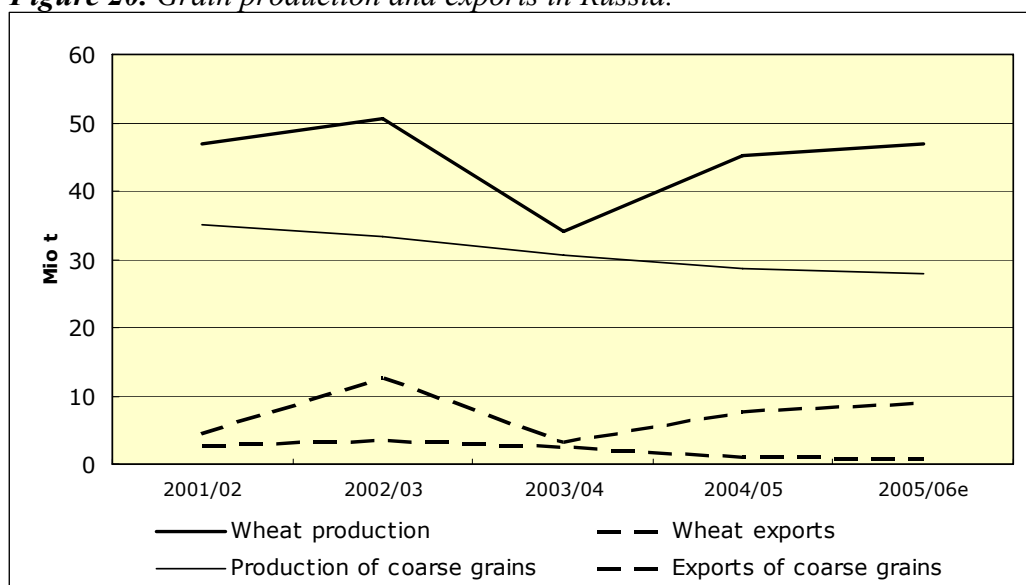
Production

The most important crop products in Russia are grains (mainly wheat), potato, sugar beet and sunflower (Finpro 2004). In the international perspective grain production is probably the most competitive sector of Russian agriculture. Russia has also told that it will be making serious efforts to promote grain production as well as grain exports. There is a great deal of potential in the Russian grain sector, which is also easier to realise over a shorter period of time than in, for example, milk or meat production. The amendment of the legislation to allow relatively free land sales and purchases made a significant contribution to improving the efficiency of grain production in Russia. Extensive vertical integration has also improved the productivity of the sector (USDA 2004b).

In recent years there has been some variation in the total grain crop in Russia. In 2004 the grain crop totalled 74.9 million tonnes, which was about 10 million tonnes more than the year before, when drought and frost damaged the crop (East Europe 2/2005). A good crop, totalling 87 million

tonnes, was harvested in 2002 as well. However, a couple of decades ago during the Soviet era the grain crops could rise to over 100 million tonnes.

Figure 20. Grain production and exports in Russia.



Source: USDA.

The production of oilseed crops has increased clearly in Russia in the past couple of years. The oilseed crop hit a new record level of 5.7 million tonnes in 2004. Oilseed crop production in Russia consists mainly of sunflower, which represents more than four fifths of the total production. The area under oilseed crops grew again in 2005, which means that the production will increase as well. Russia has traditionally exported some sunflower oil, and the exports were expected to double in 2005. The growth in exports is founded on the growth in the production by almost 60 per cent between 2002 and 2004 (AgraFood East Europe, 4/2005, Agra Europe 8/2005).

Table 5. Production of oilseed crops in Russia (1,000 tonnes) in 2001-2004.

	2001	2002	2003	2004	Change % 2003/04
Sunseed	2 685	3 684	4 871	4 801	3
Soybean	350	423	393	555	41
Others	150	163	301	361	20
Total oilseeds	3 185	4 270	5 565	5 717	3

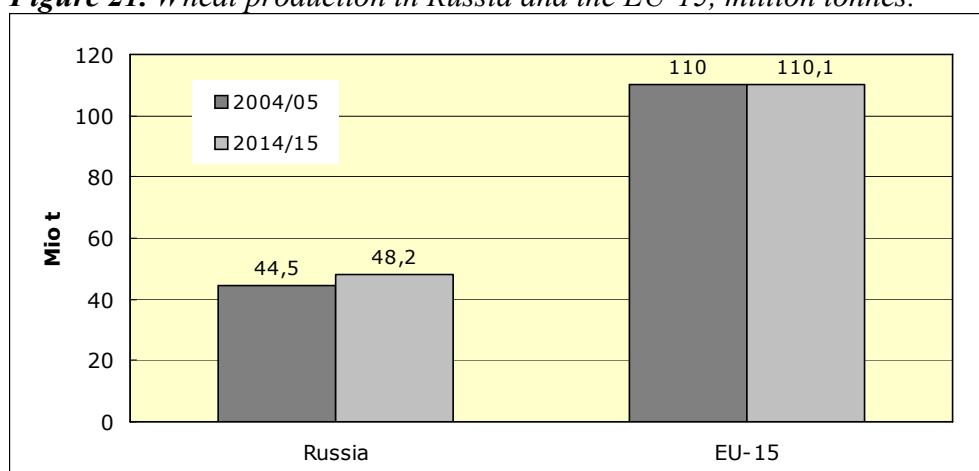
Source: Agra Food East Europe 2005.

The Russian Minister of Agriculture Alexei Gordeyev has told that Russia aims at a significant increase in grain production and exports. In the next couple of years the production should increase to 100-110 million tonnes from the present 76 million tonnes. This objective can be considered feasible, because during the Soviet era the record grain yield was as high as 127.4 million tonnes. Today the largest grain exporters in the world are the EU, USA, Canada, Argentina and Australia. Now Russia is striving to become one of the five largest grain exporters. According to international forecasts, however, this objective is by far too optimistic. According to forecasts by the OECD

(2005) and FAPRI (2005), in the next two to three years Russia will remain clearly short of the objective of 100 million tonnes.

At present the hectare yields of grains are quite modest in Russia. For example, the average yield per hectare of wheat is as low as 1,600 kg and it is only expected to rise to a little less than 1,900 kg by 2013. In the EU-15 the average yield per hectare of wheat is at present a little under 5,800 kg and after 2010 it is estimated to be more than 6,000 kg. This means that there is a lot of unused potential in Russian wheat production. Figure 21 present a forecast of the development of wheat production in Russia. By 2014 this is estimated to increase by about 8 per cent, while in the EU-15 the total wheat production would stay at about the present level (FAPRI 2005, OECD 2005).

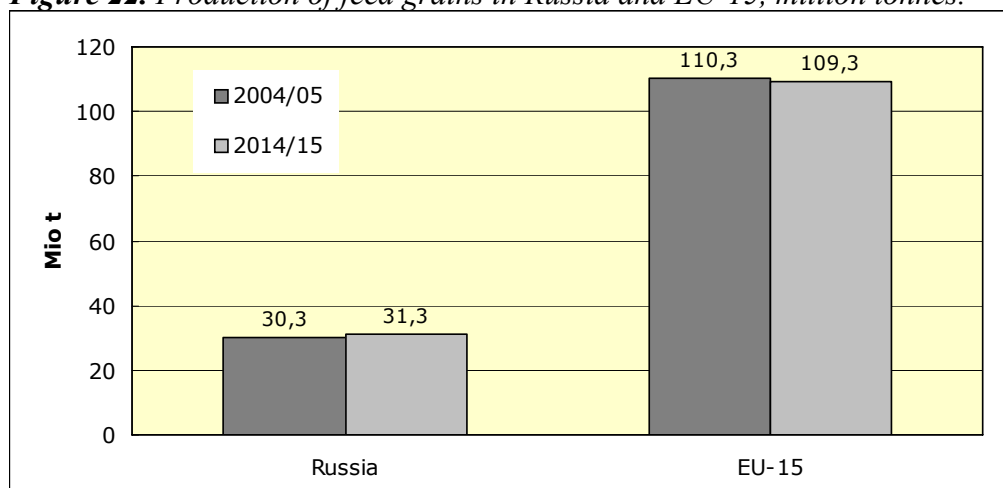
Figure 21. *Wheat production in Russia and the EU-15, million tonnes.*



Source: OECD 2005.

Figure 22 presents the growth in the production of feed grains. The OECD (2005) estimates that in the EU-15 the production of feed grains would decrease slightly, but the production in Russia would grow by a few percentages.

Figure 22. *Production of feed grains in Russia and EU-15, million tonnes.*



Source: OECD 2005.

Foreign trade

The high yields in 2001 and 2002 suddenly made Russia one of the most significant grain exporters in the world. In the market year 2002/2003 Russian grain exports were as high as 17 million tonnes, of which a little over 5 million tonnes went to the EU-25. In the following market year the Russian grain exports totalled about 7 million tonnes, about half of this wheat, and the grain exports to the EU-25 fell to a little over 800,000 tonnes. Because the grain crop of 2003 was weaker than the average, the Russian Government imposed an export fee of 25 euros per tonne as of January 2004. This export fee was collected until the end of April 2004. The purpose of this temporary measure was to balance the prices of bread and bakery products in Russia (East Europe 2/2005, Agra Europe 10/2004, Bank of Finland 2004). However, in practise export tariffs have not stopped growth of the grain prices.

The Russian Ministry of Agriculture estimates that in market year 2004/2005 Russia exported 8 to 10 million tonnes of grains (East Europe 2/2005). The Minister of Agriculture Alexei Gordeyev has told that by 2010 the annual grain exports should total 13 million tonnes (Agra Europe 3.12.2004). However, the international forecasts on the development of the Russian grain exports do not indicate that this objective could be reached. According to the USDA (2004b), there is a lot of unused potential in Russia, but much depends on the rise in the productivity. Table 6 shows a basic scenario which corresponds to the average of grain exports in 1999-2001. The table also shows the impact of weak and rapid productivity growth on grain exports in 2013. If the productivity of grain production remains low, Russia could again become a net importer of grains by a narrow margin. If the productivity improved rapidly, Russia could become a significant grain exporter (USDA 2004b).

Table 6. *Development of Russian grain production and exports in scenarios of low and high productivity (million tonnes).*

	1999-2001	2013	2013
	Base period	Low productivity growth	High productivity growth
Production	66	74	87
Net exports	-1,2	-0,6	15,5

Source: USDA.

The OECD (2005) forecasts a moderate growth in wheat exports. In fact the forecast for net exports in market year 2014/15 (7.2 million tonnes) is slightly lower than Russia's own estimate for market year 2004/05. The forecast by FAPRI (2005) is quite similar to that of the OECD. If the Russian wheat exports grew at the pace forecast by the OECD and FAPRI, the EU would stay clearly ahead of Russia in the export volumes of wheat trade. For comparison, it should be noted that, according to a forecast by FAPRI, the world's largest wheat exporter the United States would export about 26 million tonnes of wheat in market year 2013/14, which is slightly less than at present. For the part of feed grains Russia would be close to self-sufficiency in a little less than a decade. Barley exports

would more than double from the present volumes. The net exports of oilseed crops would almost double as well. Instead, the OECD (2005) estimates that Russia would become a net importer of feed grains by a narrow margin.

Table 7. *Current situation in the Russian and EU-15 grain exports and forecast (million tonnes).*

	2004/05	2013/14	Change 2004/13
Wheat			
Russia: Net exports	4,5	5,7	27 %
EU-25: Net exports	10,9	11,2	3 %
Barley			
Russia: Net exports	1,3	2,9	123 %
EU-15: Net exports	3,1	3,8	23 %

Source: Fapri.

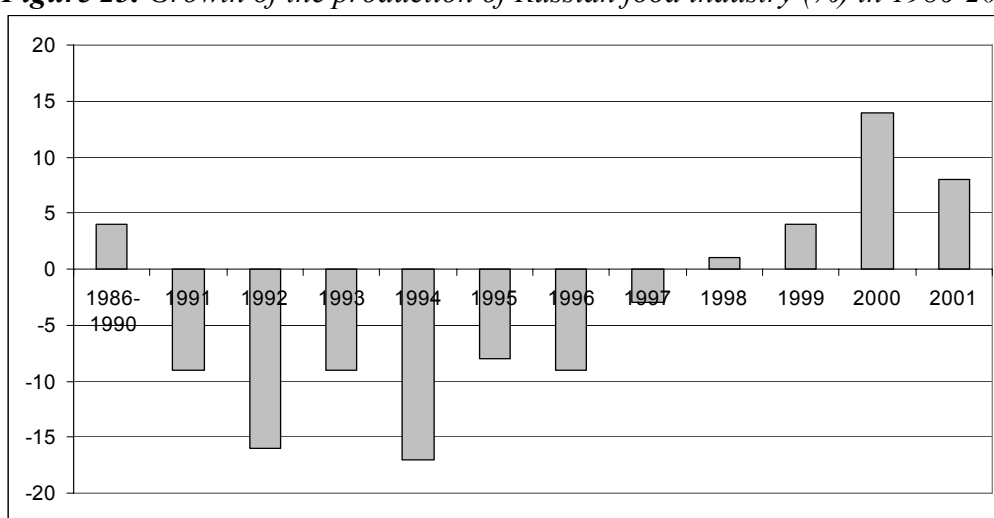
Development of farming technology and renewal of the machinery and implements could make Russia one of the leading grain exporters in the world. Vertical integration improves the efficiency of the food chain and investments of farming corporations increase the yields per hectare. However, in the future the Russian grain exports will be restricted by the tightening competition on the international market and increased domestic consumption. The underdeveloped infrastructure, especially the insufficient capacity of harbours and railroads, causes problems for exports. The quality of the grain may also be a problem, because the varieties grown in Russia differ from those in, for example, the United States. Lower quality influences the price obtained for the grain as well as the demand. The yields vary a great deal and regional and seasonal price fluctuations are remarkable. The domestic purchasing power of grains is weak in the livestock sector and the State's export policy has been inconsistent. Grain exports also suffer from the restrictions on grain imports imposed by several countries and groups of countries (e.g. EU) (East Europe 11/2004, Tekoniemi 2003). However, grain exports from Russia to the EU will increase in the next few years, because in 2004 the EU and Russia signed an agreement on raising the export quota of Russia in the context of the EU enlargement. In 2003 the Russian quota was 600,000 tonnes, but in that year the quota was quite inutile for Russia because exporting to other countries was far more profitable (East Europe 5/2004).

3.4 Russian food sector

Russia is one of the largest food importers in the world and it has become a significant, growing market area for food exporters. The rapid economic growth in recent years and the increase in the real incomes of the consumers have led to a rapid increase in food imports. Russia's own food industry has also recovered in recent years thanks to foreign investments. At present the production of the Russian food industry is well on the increase. Between 2003 and 2004 it grew by a little more than 5 per cent. Food industry has been capable of competing with foreign imports even better than the other industrial sectors (Finpro 2004, World Bank 2004).

Food imports collapsed in 1998 as a result of the economic crisis in Russia. This had two significant consequences. First, the domestic food industry, which up to then had not been very successful, got the very welcome stimulus as the consumers who had got used to the foreign products had to shift back to the domestic supply. The domestic companies in the brewing, dairy and fruit juices industries gained a significant market share, and they have also managed to hold on to this. Secondly, the foreign companies started to buy local companies at reasonable prices to open up the sales channels to the Russian market. High investments have been made to the Russian food industry in recent years. Machinery and implements have been modernised and the quality of the products has improved. Local food companies which have managed to attract investments have developed the quality of their production and differentiated their products (USDA 2004c).

Figure 23. Growth of the production of Russian food industry (%) in 1986-2001.



Source: Goskomstat

The share of raw materials is particularly high in Russian exports, while in the imports the share of processed and high technology products is still large. As the domestic production in Russia has recovered the proportional share of foodstuffs in total imports has decreased, but in 2002 it was still 22.5 per cent (Finpro 2003). In 2004, when the total imports to Russia rose to a record high level, the share of foodstuffs in total imports fell to about 13 per cent. Foodstuffs constitute the second largest group of import articles after machinery and implements. The Moscow and St Petersburg regions import more than half of their foodstuffs from abroad (ERS/USDA 2001).

The demand for foodstuffs is expected to increase in Russia in the next couple of years as the disposable income of the consumers is rising and consumer habits are approaching those prevailing in Western Europe. The consumption of meat, milk, fruits and vegetables is expected to grow in the near future. The consumption of certain products, such as beer, is already close to the consumption level in the western countries. The demand for processed and convenience foods, for example, premixed salads, processed and vacuum-packed fish and noodles will be growing as well (USDA 2004a).

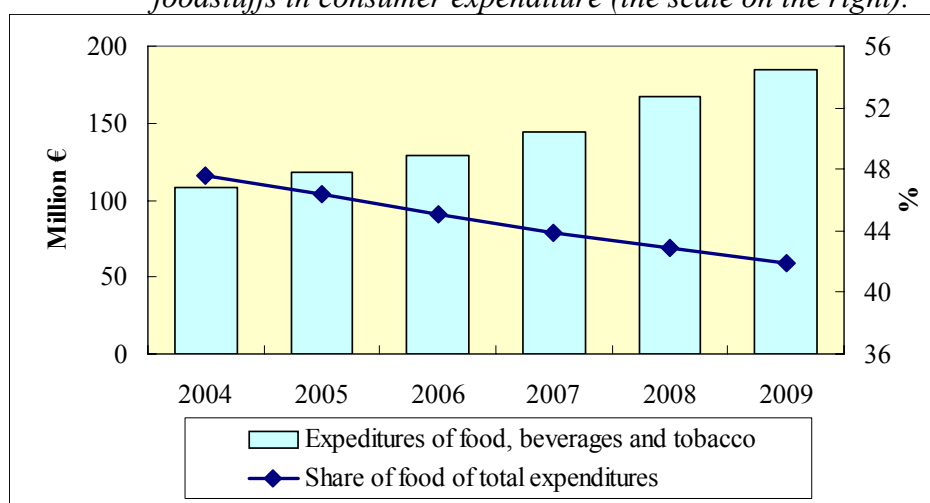
Table 8. Forecast of the development of the food and drink market in Russia.

	2003	2004	2005	2006	2007	2008
<i>Food consumption per capita kg/year</i>						
Meat	49,2	51,1	52,7	54,1	55,7	57,2
Milk	155,7	159,8	163,2	166,1	169,2	172,2
Fruits	41,9	43	43,9	44,7	45,5	46,2
Vegetables	94,7	96,5	97,9	99,2	100,3	101,9
Coffee	2,2	2,3	2,3	2,3	2,4	2,4
Tee	1,1	1,1	1,2	1,2	1,2	1,2
<i>Total consumption, billion litres</i>						
Alcohol beverages	9,9	10,2	10,5	10,7	10,9	11,2
Soft drinks	4,6	4,9	5,2	5,4	5,7	5,9
Confectioners (tons)	2 147	2 210	2 272	2 343	2 415	2 485

Source: Economist Intelligence Unit.

The disposal income of the Russian consumers has increased rapidly during the past decade. About 10 years ago the average disposable monthly income of the consumers was only 20 to 30 dollars, but since then it has risen ten-fold to about 300 dollars a month. The consumer expenditure on foodstuffs has also grown. The food sector is estimated to grow very strongly in the next decade. The monthly expenditure on food and drink is expected to almost double from the present 70 dollars to 130 dollars by 2012, while the turnover of the sector increases from the present 130 billion dollars to 220 billion dollars (Finpro 2004).

Figure 24. Consumer expenditure on food, drink and tobacco (the scale on the left) and share of foodstuffs in consumer expenditure (the scale on the right).



Source: Economist Intelligence Unit.

The growth in the disposable income of the consumers is estimated to benefit especially the retail traders and food manufacturers. According to the Katchalov & Partners market research institute, each of the following groups represents 15 per cent of the expenditure on foodstuffs: confectionary, alcoholic beverages and fresh meat, while the share of milk products, sausages and other meat products, vegetables and fruits is about 8 per cent each. The market research institute estimates that the period of strong growth in Moscow should slow down around 2012-2014, when the average

monthly expenditure on foodstuffs will be about 350 dollars per capita. In the whole country the consumption is not likely to slow down until 2022-2024, and the average monthly expenditure on food would be 240-280 dollars (Finpro 2004).

3.4.1 Food production in Russia

Even if Russia is not self-sufficient in foodstuffs, the Russian food industry is a dynamic and growing sector. The value of food production almost doubled between 1999 and 2002, when it was close to 26 billion dollars. During the same period the net profit of the sector rose by 50 per cent. The growth has been particularly strong in the dairy and brewing industry, confectionary industry and production of various kinds of sauces. The growing purchasing power of the consumers and increased consumption of the higher quality products have led to a rapid growth in direct investments in the food sector. For example, in the first six months of 2003 the investments grew by 63 per cent more than during the same period in the previous year (USDA 2004a).

Table 9. *Indicators for the development of the food industry in Russia.*

	1999	2000	2001	2002	Change % 01/02
Number of businesses (thousands)	22,9	25,4	24,7	23,3	-5,7
Value of food production (billion US\$)	14,6	18,7	22,8	25,9	13,6
Net profit (billion US\$)	1	1,2	1,5	1,5	
Bread/bakery products (million tons)	9,2	9	8,6	8,3	-3,5
Pasta products (thousand tons)	707	704	764	831	8,8
Confectionery (thousand tons)	1509	1628	1793	1952	8,9
Meat, incl. offals(thousand tons)	1113	1193	1284	1390	8,3
Sausages (thousand tons)	948	1052	1224	1443	17,9
Dairy products (million tons)	5,6	62	6,7	7,5	11,9
Canned/preserved foods (million tons)					
* vegetables, ex. Juices or tomato prod	322	386	417	489	17,3
* fruit juice	340	705	1419	2199	55
* fruits and berries	193	114	118	153	29,7
* dairy products	538	620	677	714	5,5
* canned fish/seafood	486	531	610	598	-2
Mineral water (million deceliters)	74	98	122	157	28,7
Wine, grape (million decaliters)	18	24	27	32	18,4
Beer (million decaliters)	445	516	637	702	10,2

Source: Goskomstat.

According to a study carried out by the Expert RA in autumn 2004, there are as many as 48 food companies among the 400 largest companies in Russia. The largest one was Wimm-Bill-Dann, which with the sales of about 940 million dollars held the 38th position. The second largest food company was the Baltika brewery (sales about 735 million dollars), the third largest was the agroholding company Razguljai-Ukros (sales about 675 million dollars) and the fourth largest was agricultural company Karavaj Pljus (sales about 665 million). These are all among the 50 largest companies in Russia (Finpro 2005).

The development of the Russian food sector can be summed up into a few main trends. First of all, the vertical integration is proceeding rapidly and new large agricultural and food sector companies are being set up. Vertical integration increases in all production sectors. Second, agricultural production grows and develops, albeit slowly. It is going to take years before the local farms can produce at least most of the inputs needed in the local food processing industry. Third, foreign companies continue to invest in Russia. Fourth, reorganisations and mergers of companies will continue, which means that the Russian buyers are placing bigger and bigger orders. Fifth, the demands for higher quality have increased among the consumers in recent years and brand awareness has also grown. Products of the highest quality category are sold to the middle class, but the production is still focused on the low-priced product segments and the consumers are very price-sensitive (USDA 2004a).

Food industry in Russia is concentrating to the agricultural region of the Leningrad oblast around St Petersburg. Food industry is the largest individual sector in St Petersburg, which in 2003 represented about a third of all industrial production in the city of St Petersburg. The brewing, tobacco, meat processing and dairy industries now constitute the backbone of the food industry. The largest company in the St Petersburg region is Baltika brewery. However, the local agricultural production is not capable of satisfying the demand for raw material in the St Petersburg region in terms of either the quantity or quality of the products, which is why the food industry in the region is highly dependent on imported raw material. At the moment, however, the domestic production is capable of meeting the demand of the bakery and milling industry (Research Institute of the Finnish Economy Etna 2002).

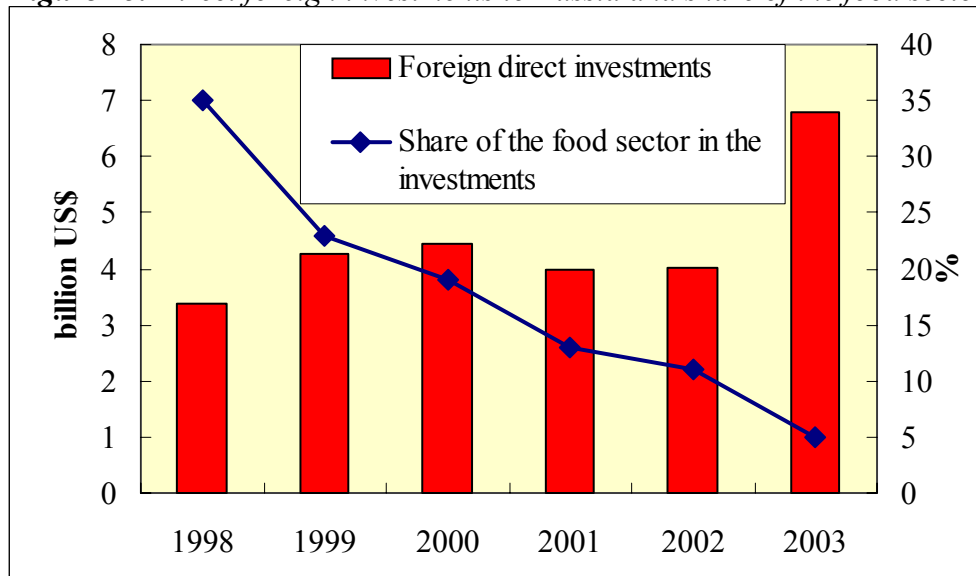
The investments to food industry in the St Petersburg region totalled about 6.7 billion roubles in 2001. About 80 per cent of these investments came from abroad, and most of them were directed to beer and tobacco production (Suomenlahden kasvukolmio 2003). The development of the food industry increases the demand for technology needed in agriculture in the St Petersburg region (Saarinen & Pirilä 2003). This creates markets for machinery, implements, fertilisers, feedingstuffs and plant protection products.

One of the strengths of the food sector in St Petersburg is that almost all processors are using modern technology and equipment and the local administration supports the development of the food sector. Agricultural production as well as the storage and distribution network have made significant progress in recent years. The Russian consumers also favour domestic products. However, the problems inherent in the food chain are still numerous. The productivity of the sector is not very high and the quality of the products should be improved. One problem is that the raw materials and equipment needed in the processing largely come from abroad. The weaknesses in the food sector also include problems relating to taxation and education (Suomenlahden kasvukolmio 2003).

3.4.2 Foreign operators in the food sector

Investments into the Russian food sector have dwindled from the peak level reached in 1998. In 2003 the direct foreign investments to Russia rose to 6.8 billion dollars. Foodstuffs, drinks and tobacco account for about 5 per cent of these investments, while in 1998 this sector represented more than a third of all direct investments. At present the industrial sector attracts about a half of the investments, trade about a quarter, building less than 5 per cent, and the share of agriculture is only about one per cent (Liuhto, Pelto & Lipponen 2004). The boom in the investments of foreign companies which related to the economic crisis in 1998 obviously raised the investments in the food sector to an unusually high level. Since then the investments have decreased, but they are still quite high.

Figure 25. Direct foreign investments to Russia and share of the food sector in the investments.



Source: Goskomstat.

The investments flowing to the Russian food sector, even though they are diminishing, show that the foreign companies trust in the growth of the domestic demand in Russia in the next few years. Today it is almost impossible to talk about the Russian food industry without mentioning foreign investments and foreign companies in general. Foreign investments directed at the food industry as well as improving the primary production have made a significant contribution to the modernisation of the sector. The success of agricultural production in Russia is naturally reflected in the food industry and vice versa. At present there are two very different kinds of agricultural production, because some of the farms are thriving and investing while others are declining. Successful farms manage to attract investments and skilled labour. In agricultural production, however, the geographic location is also important. Companies located in the Moscow region and close to other major cities and regions are doing much better than farms operating in the peripheral regions. This is quite natural, because the food companies are investing in operations located close to the large

centres. This also promotes agricultural production in these regions, which in turn makes them more attractive for the food industry.

In the past couple of years the interest of foreign companies to invest in Russia seems to have picked up again. In fact the companies seem to consider that production in Russia is indispensable in order to stay on the market. In 2005 many of the giant foreign food companies told that they were going to increase their investments to Russia. For example, the Heinz Group based in the United States bought the majority share of Petrosojuzist in St Petersburg, which is one of the largest manufacturers of ketchup, mayonnaise and butter spreads in Russia. Many foreign companies are also starting or increasing the production of vegetable preservatives in Russia. In the beginning of 2005 the Coca-Cola Company and HBC bought almost a quarter share of the Russian juice manufacturer Multon. The PepsiCo is also planning company purchases in Russia. Foreign investors have been particularly interested in the brewing industry (Finnpro 2005). Table 10 presents the largest food industry companies in Russia according to the production sectors. The list contains local companies as well as large international companies, such as Nestle and Danone.

Table 10. *Largest food industry companies in different production sectors in Russia.*

Confectionary, cakes, cookies	Sales (\$ Mil)	Meat	Sales (\$ Mil)
SladCo	119	Cherkizovsky	350
Babyevsky	180	KamposMos	130
Krasny Oktyaber	126	Omsky Bacon	120
Rot Front	174	AIG Mikhailovsky	50
Rossiya	90	Golden Rooster	350 000 birds/wk
Mars	100	Elinar	250 000 birds/wk
Odinstovo	36		
Bolshevik	52 '000 t		
Kraker	20 '000 t		
Ice cream	Mio kg	Dairy	Sales (\$ Mil)
Altervest	8	Wimm-Bill-Dann	825
Ice-Fili	15	Prodimeks	500
Nestle	17	Ostankinsky	120 '000 t
Russkiy Holod	27		
Servis Kholod	9		
Fruit juices	Mio ltrs	Yogurt	Mio kg
Multon	325	Campina	56
Lebedyanskiy	325	Danone	70
Nidan-Ecofruit	170	Ehrmann	70
Brewery	Sales (\$ Mil)		
Baltika Beverage	425		
Sun-Interbrew	413		
Ochakovo	220		
AO Vena	320		

Source: USDA.

The quality of the domestic production is improving rapidly, which also tightens the competition among the food exporters. However, the increase in the domestic production creates new kinds of import needs in the food sector. For example, the demand for various kinds of additives and semi-processed products will be growing (USDA 2004a). In 2002 the import of bulk products to Russia

decreased by 16 per cent in the Russian food sector, but the import of semi-finished products grew by 30 per cent from the year before to 1.5 billion dollars. The import of, for example, fish and crustaceans (most of these for further processing) grew by more than a third to 382 million (USDA 2004c).

In certain product segments the efficiency of the domestic production has already improved considerably. For example, the domestic supply of grains and edible oils is already substituting for some of the imports. However, despite the growth and improved quality of the domestic production the total imports do not seem to diminish, and in some cases the need for imports is actually growing. First, local companies cannot produce sufficient amounts of various kinds of inputs which would meet the quality requirements. Second, the food processing companies are growing and modernising their production, which means that they need more of various kinds of special inputs, such as certain additives, which cannot be supplied locally. Third, through the company mergers the financial basis of the local operators has become more solid and they are capable of placing larger orders (USDA 2004a). In additions, Russia continues to import various kinds of staple foodstuffs such as soybeans, food oils, meat, poultry meat products and milk products, because the reform and reorganisation of the agricultural sector is only getting started. The USDA (2004a) estimates that the following products continue to possess good sales potential on the Russian market:

- Poultry/beef/pork trimmings and offals
- Fish and seafood products
- Quality prunes, raisins, and other dried fruit
- Quality almonds, pecans, other tree nuts, and peanuts
- Flavor enhancers for processed meat products
- Functional soy concentrates and isolates
- Lactose
- Quality textured vegetable protein
- Gluten Powder
- Dextrin and other modified starches
- Preservatives and food colours
- Essential oils
- Seasonings/spices/flavorings

The USDA (2004a) has also listed products which should have sales potential in the future but which as yet are not available on the market in significant quantities:

- Frozen and soft pasteurized fruits
- Various specialised food ingredients
- Certified organic/natural ingredients
- Kosher and halal-certified ingredients (for Jewish population and Moslem consumers).

Table 11. *Development of food imports to Russia in 2000-2002 (million \$).*

	2000	2001	2002	% Change
Snack food (exl. nuts)	215	263	252	-4 %
Breakfast cereals & Pancake Mix	10	18	11	-39 %
Red meats, fresh/chilled/frozen	619	935	1 414	51 %
Red meats, prepared/preserved	65	65	64	-2 %
Poultry meat	366	756	816	8 %
Dairy products (exl. Cheese)	184	230	188	-18 %
Cheese	64	166	235	42 %
Egg & products	4	8	12	50 %
Fresh fruit	559	595	742	25 %
Fresh vegetables	202	162	224	38 %
Processed fruit & vegetables	349	317	380	20 %
Fruit & vegetable juices	57	85	131	54 %
Tree nuts	20	27	23	-15 %
Wine & beer	248	340	361	6 %
Pet foods	14	18	22	22 %
Fish & seafood products	158	280	382	36 %

Source: USDA.

Table 11 shows the development of the imports of certain foodstuffs to Russia in 2000-2002. The import of, for example, meat, cheese and fruit juices has increased rapidly in the past couple of years. The demand for fish and crustacean products has also grown considerably. The Russian food import market is divided between several countries. Brazil is clearly the number one meat exporter, but the market shares of the USA and EU are also significant (see Annex 1).

In 2004 the value of Russian food imports was about 12.8 billion dollars. The largest group of countries is the EU-15, whose share in the total Russian food imports is a little less than a third. The market share of Brazil is about 12 per cent and that of the new EU Member States a little less than 10 per cent. Individual countries with significant market shares are the USA (6 per cent), Ukraine (6 per cent) and China (4 per cent). The Russian food trade will be studied in further detail in the subsequent section of the research project.

The operations of companies investing and exporting to the Russian food market suffer from certain weaknesses in the Russian economy and society. The customs and duties are highly complex, taxation system is unstable, storage and transportation systems are still quite weak and the distances are long. The corrupted bureaucracy and especially the ambiguities in the right to land ownership cause problems (Vaknin 2003). Often the credits available from the local agents are quite expensive, which makes it difficult to purchase higher-quality raw materials for the production (USDA 2004a).

Companies operating on the food market must also take account of the retail sector, where significant progress has been made in recent years. The State Statistical Bureau of Russia (Goskomstat) estimates the value of retail trade in Russia at a little over 131 billion dollars. The share of the city of Moscow about 36 billion dollars, which is more than a quarter of the total value of retail trade. The value of the retail trade volume in St Petersburg is less than 5 billion dollars. The

quite significant difference between Moscow and St Petersburg is partly due to the population of the two cities (in Moscow more than double that of St Petersburg), as well as the disposable income of the consumers. In Moscow the gross domestic products per capita is more than 6,500 dollars, in St Petersburg it is only a little more than 2,000 dollars. In Moscow the per capita GDP is clearly above the average in Russia, which is 1,900 dollars per capita. The higher income of the residents of Moscow is reflected in the retail trade also in that the share of foodstuffs in the value of the retail trade volume is only a little more than 40 per cent, which means that most of the income is already spent on something else than food (Liuhto et al. 2004).

In 2003 about 15 per cent of the sale of the Russian food market took place in so-called modern retail outlets, i.e. organised chains with supermarkets, hypermarkets and department stores. According to an estimate by AcNielsen, in 2004 about a fifth of the retail trade in foodstuffs took place in the modern outlets. This means that a significant share of the food trade is still carried out outside the modern retail chains (Kaipio & Leppänen 2005).

Retail trade has grown in Russia thanks to the positive economic development. However, it is not always easy for the food companies to gain access to the market, because the structure of the retail trade is not fully developed as yet. The Russian market is still waiting for the entry of the American and European retail traders on a broader front (Lorentz 2004). The foreign chains are interested in the markets of only the ten largest cities in Russia, which means their impact on the food market of the whole of Russia would be limited. In 2004 the trade in perishables and retail trade in Russia were characterised by mergers and expansion to new regions, while the non-organised retail traders were losing their positions. The increased mergers lead to a decrease in the number of retail chains, while the remaining chains are growing rapidly. The Finnish food companies estimate that the organisation of retail trade into chains makes the business increasingly professional. The competition between the chains is also growing, which highlights the role of brand products (Kaipio & Leppänen 2005).

Certain trends in the Russian retail trade are very well known in western countries. The market power of retail outlets in the food chain has grown relative to the food suppliers. The growth in the size and purchasing volume of retail trade increases its negotiating power in the chain. In the future there will be more and more negotiations on the production of the retail brands. In addition to the growth of trade, another significant trend in this sector is the differentiation of the retail outlets. Consumer preferences are becoming increasingly diversified as their incomes are growing. The production chains are getting shorter and more efficient thanks to the improved logistics (Lorentz 2004).

The share of the chains in the total value of retail trade is growing especially in areas such as Moscow and St Petersburg. Regional chains as well as chains extending to the whole country are also evolving in Russia. From the perspective of food producers this gives the opportunity to offer their products to a broader range of buyers. According to Lorentz (2004), food companies would

benefit if they could find a good partner on the local market. The possibilities for cooperation with retail trade improve if the company maintains the high quality of the products, the distribution works, and the company invests in the presentation of the product and offers volume discounts. The company can also reinforce its brand, which improves the position of the product on the market.

4 CONCLUSIONS

The Russian agricultural and food sector has been faced with major changes for some time. In many sectors agricultural production has dropped to about half from the volumes at the turn of the 1990s, which is why Russia is one of the greatest food importers in the world today. However, Russia has set as an objective to reach self-sufficiency in most agricultural sectors during the next decade. This is a highly ambitious objective, because the share of imports in the consumption of foodstuffs is still very high. The very big agricultural enterprises engaging mainly in grain production constitute the most competitive element of Russian agriculture. In the other extreme there are the household plots used for cultivating e.g. potatoes and vegetables and for keeping domestic animals. These plots account for only 6 per cent of the agricultural land in Russia, but their share in the value of the production is about a half. One reason for the significant share of household plots in the value of production is the rapid increase in the prices of livestock products.

Crop production is the most competitive sector of Russian agriculture. Russia is a net exporter of grains. In recent years the average annual grain exports have been about 10 million tonnes, which is about 5 per cent of the total grain exports in the world. The exports from Russia are much smaller than those of the five largest grain exporters in the world. Russia is striving to become one of the five largest exporters, but at present this seems quite unrealistic. The Russian grain sector suffers from weaknesses such as quality problems, relatively low yields per hectare and problems in the logistics. However, there is also a great deal of potential in the sector. Investments in agricultural corporations increase their vertical integration, which is reflected on the farm level as higher quality inputs and more modern technology.

The problems in livestock production appear to be quite serious. Milk production has not increased much from the level where it fell in the early 1990s. Less than half of the raw milk produced ends up in dairies for further processing. According to the forecasts, in the next decade milk production in Russia should grow by about 10 per cent and only a little more than half of the production would be sent to the dairies. This is still very low compared to the EU countries. Even if the production in Russia will be growing, significant quantities of milk products will continue to be imported. For example, the import of cheese is expected to almost double during the next decade and butter imports should grow as well. In the future cheese imports would account for about half and butter imports for about 40 per cent of the total consumption.

Meat production in Russia has also decreased dramatically from the levels about 15 years ago. Russia is making serious efforts to increase especially the poultry meat production considerably by 2010. The objective is to triple the production, but according to international estimates the production would grow by about 70 per cent. There is likely to be some decrease in beef production. Russia aims to double pork production, but the international forecasts estimate that it will grow by about a fifth. At present Russia is clearly a net importer of meat. For example, imports represent clearly more than a half of poultry meat consumption. Imported beef represents about a

fifth and imported pork about a quarter of the consumption. Meat imports are likely to stay high in the future. In fact, according to the forecasts the volumes of meat imports should stay on about the same level as they are at present. The domestic production is growing, but imports are needed to satisfy the growth in the consumption. The share of imports in the total consumption is going to decrease slightly.

The production of foodstuffs has grown quite well in Russia at a steady pace of about 7 per cent a year. However, Russia is far from being self-sufficient in foodstuffs, but it is the largest food importer in the world. Foodstuffs represent about a fifth of the total imports. Food imports collapsed as a result of the economic crisis in 1998, but in 2001 they were again growing. In 2004 the value of the food imports to Russia totalled about 12.5 billion dollars. Of the different countries or groups the share of the EU in the food imports to Russia is the largest, about 40 per cent.

Today it is almost impossible to talk about the Russian agricultural and food sector without mentioning the foreign companies and their investments. While food exports to Russia are growing, the investments of both foreign and domestic food companies have made a significant contribution to the development and modernisation of the local industry. It seems that, in fact, most foreign companies consider that concentrating only on export operations is insufficient. There is also a need to produce locally to secure the market position. Investments are not only directed to the food industry but also to the whole food chain all the way to the farm. For example, the French dairy company Danone gives out loans for purchasing cooling tanks on farms and offers instruction in milk production to obtain high-quality raw material. This is why the investments have very concrete impacts on the farm level as well.

The growth and improvement in the quality of the domestic production does not necessarily reduce the need for imported raw material. In certain sectors the need for imports may even grow as the local companies are not capable of producing sufficient quantities of certain special inputs and additives. The reform and reorganisation of basic agricultural production is still far from being completed, which means that basic foodstuffs such as meat will have to be imported in the future as well.

Foreign and domestic investments are highly important for the development of the Russian agricultural and food sector, but obviously these do not cover the whole country. In fact, most of the investments are directed to the Moscow and St Petersburg regions. Thus there is a great deal of agricultural and food production in Russia which has not been influenced by the foreign investments. Because of this there are two very different types of agriculture and food production in the country: certain companies invest and attract investments, while the prospects of the others are quite gloomy.

Today there is a kind of race under way on the Russian market, as the foreign companies are striving to get their share of the growing market. The Russian agricultural and food sector has taken

important steps forwards, but there are still serious challenges to be faced. It is in the interest of the food industry to find raw material from nearby, but at least during the next decade high quantities of imports will also be needed.

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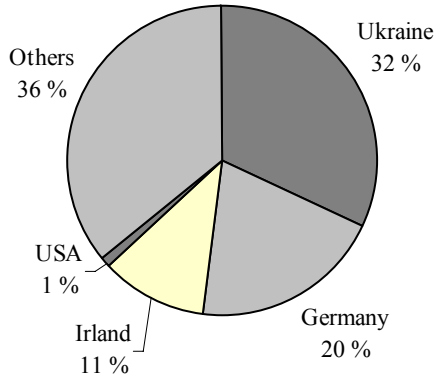
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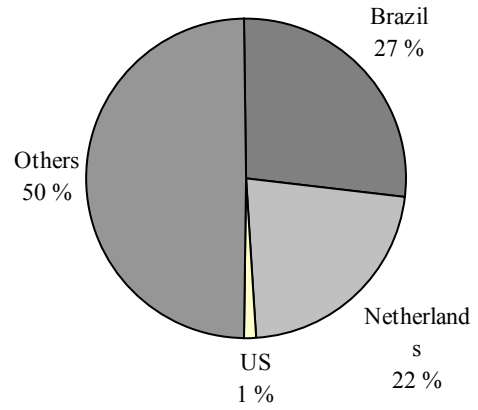
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Annex I. Imports of certain foodstuffs to Russia.

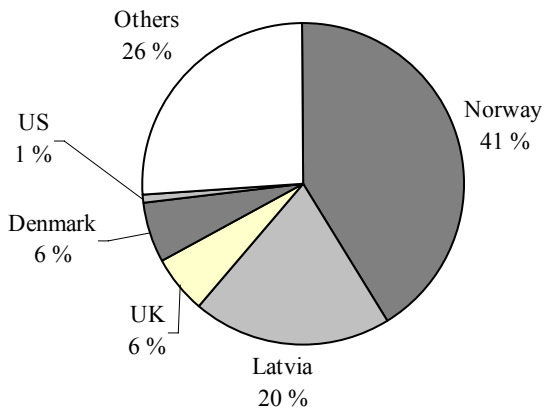
Beef



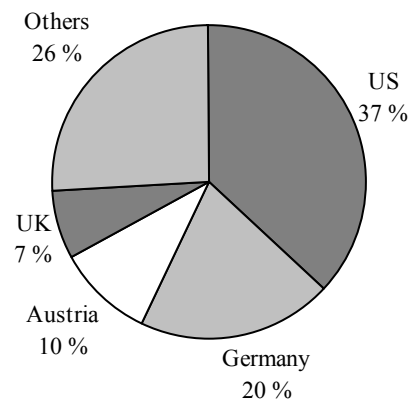
Fruit & concentrates



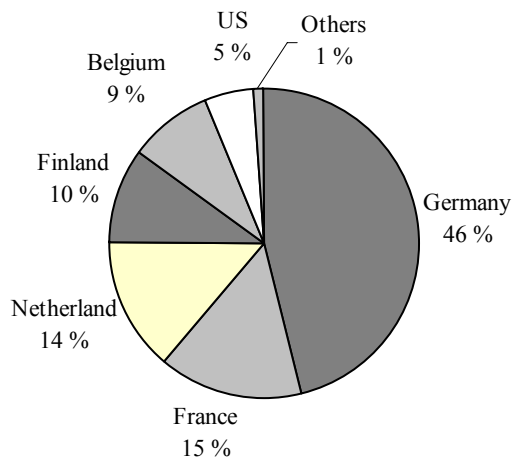
Fish & seafood



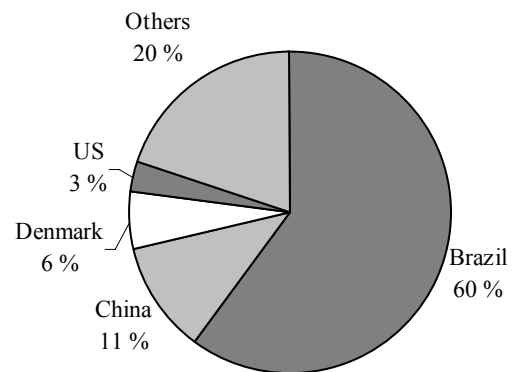
Essential oils



Potato flakes, flour and meal



Pork



Annex 2. Russia's map.

