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**N:o 85 (December 2006)**

**IMPLICATIONS OF CHANGES IN THE RUSSIAN  
AGRO-FOOD SECTOR AND EFFECTS OF RUSSIA'S  
LIKELY MEMBERSHIP OF THE WTO ON FINLAND**

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**Abstract.** For Finnish agricultural and food exports, Russia is by far the most important destination. Nearly 20% of Finnish food exports go to Russia. Russia attracts interest nowadays not only as a destination for food exports, but also as a possible target for foreign direct investments. In the interviewees conducted for this study, the Finnish food companies considered that the share of local production will increase in Russia in the future, but the firms seemed to have rather diverse picture of the Russian investment climate. Those firms with little experience had more negative attitudes towards the Russia food markets. There were some main obstacles behind the negative investment decisions like mature markets, lack of raw material, problems in infrastructure etc., but then, lower costs, growing market prospects and good profits were seen as an advantage. Russian agrarian trade policy has been characterised by growing protectionism during past couple of years. The aim of certain import restrictions was to reduce the amount of foreign food coming into the Russian market, in an attempt to improve domestic production and move towards a greater self-sufficiency rating. Russia's market access system can be simply characterised by the following idea: Russia's tariffs are relatively low, but customs procedures may be long and unpredictable, constituting a significant import barrier. According to the interviewed Finnish food companies, the unpredictability of Russian customs procedures and time-consuming bureaucracy are nowadays the biggest problems in the market access system. The forthcoming Russia's WTO accession is expected to enhance openness, transparency and predictability in Russian trade policy. Most of the interviewees estimated that WTO accession will probably have some positive effects, but the Finnish firms relied more on their own knowledge, for example concerning market access operations, than on the WTO agreement.

**Keywords:** Russia, agro-food sector, investments, market access

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**Tiivistelmä.** Venäjä on tällä hetkellä Suomen tärkein elintarvikkeiden vientikohde, sinne viedään lähes 20 % koko viennistä. Venäjä kiinnostaa suomalaisia elintarvikeyrityksiä yhä enemmän myös sijoituskohteena, eikä vain viennin kohdemaana. Tutkimuksessa haastateltiin suomalaisia elintarvikeyrityksiä ja heidän näkemyksiään investointimahdollisuuksista Venäjällä. Tutkimuksessa selvisi, että yritykset uskovat kotimaisen tuotannon lisääntyvän Venäjällä tulevaisuudessa, mutta yritysten näkemykset investoinneista poikkesivat toisistaan. Yritykset, joilla oli vähän kokemusta Venäjän markkinoista, suhtautuivat penseämmin Venäjän markkinoihin. Yritykset näkivät Venäjälle investoinneissa tiettyjä ongelmia, kuten kypsä markkinatilanne, raaka-aineiden puute ja ongelmat infrastruktuurissa. Toisaalta alhaisemmat kustannukset, kasvavat markkinat ja hyvä tuotto houkuttelivat yrityksiä myös. Venäjän kauppapolitiikka maataloussektorilla on muuttunut viime vuosina protektionistisemmaksi. Venäjä yrittää kehittää kotimaista tuotantoaan ja nostaa omavaraisuusastettaan, mikä vuoksi elintarvikkeiden tuontia haluttaisiin vähentää. Venäjän markkinoillepääsyjärjestelmää voisi luonnehtia siten, että tullit ovat suhteellisen alhaiset, mutta tullimuodollisuudet ovat aikaa vieviä ja ennakoimattomia, mikä muodostaa tuonnin esteen. Haastateltujen suomalaisyritysten mukaan mutkikkaat ja pitkät tullausjärjestelmät ovat tällä hetkellä suurin markkinoillepääsyn ongelma. Venäjän tulevan WTO-jäsenyyden on arvioitu lisäävän markkinoiden avoimuutta, läpinäkyvyyttä ja ennustettavuutta Venäjän kauppapolitiikassa. Useimmat haastatellut yritykset arvioivat Venäjän WTO-jäsenyydellä olevan myönteisiä vaikutuksia. Toisaalta yritykset luottivat kuitenkin omaan osaamiseensa enemmän esimerkiksi markkinoillepääsy asioissa kuin WTO-sopimukseen.

**Avainsanat:** Venäjä, maa- ja elintarvikesectori, investoinnit, markkinoillepääsy



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## TIIVISTELMÄ

### **Suomen elintarvikekauppa Venäjän kanssa säilyy ylijäämäisenä**

Venäjä on tällä hetkellä Suomen elintarviketeollisuuden suurin yksittäinen kauppakumppani. Noin viidennes Suomen elintarvikeviennistä suuntautuu Venäjälle. Elintarviketeollisuutta houkuttavat ennen muuta suuret markkinat; jo pelkästään Pietarissa on saman verran asukkaita kuin koko Suomessa. Elintarvikkeiden vienti on piristynyt selvästi vuoden 1998 Venäjän talouskriisin jälkeen, mutta kriisiä edeltäneestä viennin tasosta ollaan silti selvästi jäljessä. Vuonna 2005 Suomen elintarvikeviennin arvo Venäjälle oli 175 milj. euroa, kun tuonti jäi noin 9 milj. euroon.

Suomi vie Venäjälle etenkin maitotuotteita, maltaita, lihaa ja viljatuotevalmisteita. Suomeen Venäjältä tuodaan lähinnä viljaa ja hedelmätuotteita. Tulevaisuudessa yritykset vievät Suomesta entistä enemmän pitkälle jalostettuja tuotteita, sillä suomalaisten elintarviketeollisuuden yritysten suunnitelmissa siirtävät investoinnit paikalliseen tuotantoon Venäjälle, jolloin alemman jalostusarvon tuotanto siirtyy sinne. Kauppa Venäjän kanssa säilynee kuitenkin selvästi ylijäämäisenä, sillä Venäjä on pääsääntöisesti elintarvikkeiden nettotuojaa, ja Venäjän uudet potentiaaliset vientituotteet löytävät markkinansa todennäköisesti muualta kuin Suomesta.

### **Suomen suorat sijoitukset Venäjälle vielä vähäisiä**

Suomen suora sijoituskanta Venäjällä oli vuonna 2005 noin 1 075 miljoonaa euroa. Tämä oli noin 1,6 % Suomen koko ulkomaisesta sijoituskannasta. Asiantuntija-arvioiden mukaan sijoituskanta Venäjälle on kuitenkin moninkertaisesti suurempi, etenkin jos mukaan otetaan suomalaisten yritysten ulkomaisten tytäryhtiöiden sijoitukset Venäjälle. Elintarviketeollisuuden sijoituskanta Venäjälle oli vuonna 2005 noin 61 miljoonaa euroa. Tämäkin luku on asiantuntija-arvioiden mukaan todellista pienempi tilastollisten ongelmien vuoksi. Tutkimuksessa haastateltujen elintarviketeollisuuden<sup>1</sup> ja muiden Venäjänkaupan asiantuntijoiden mukaan investoinnit Venäjän elintarviketuotantoon ovat kuitenkin selvässä kasvussa, ja ne korvaavat tulevaisuudessa osittain vientiä Venäjälle. Investoiminen Venäjälle on houkuttelevaa monestakin syystä. Yritykset arvioivat hyödyksi tuotannon läheisyys itse markkinoista, edullisemmat raaka-ainekustannukset sekä markkinoillepääsyyn ja rajanylitykseen liittyvien ongelmien poistuminen. Lisäksi venäläiset kuluttajat arvostavat jälleen paikallisia tuotemerkkejä.

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<sup>1</sup> Tutkimuksessa haastateltiin sellaisia suomalaisia elintarviketeollisuuden yrityksiä, joilla on jo liiketoimintaa Venäjällä.



## **Investointi Venäjän kasvaville markkinoille kiinnostaa, mutta riskejäkin on**

Toisaalta investointipäätöksiä hidastavat kuitenkin monet seikat. Suomalaisten elintarvikeyritykset ovat kansainvälisesti katsoen melko pieniä, jolloin niiden riskinsietokyky on muita pienempi. Tutkimuksen asiantuntijahaastattelut osoittavat, että elintarvikeyrityksen Venäjää koskevissa investointipäätöksissä on eroja. Varovaisuutta korostavat yritykset arvioivat, että joillakin toimialoilla markkinat ovat jo niin kypsät, ettei uusille tulokkaille ole enää tilaa. Joissakin yrityksissä johto olisi puoltanut aktiivisempaa toimintaa Venäjän markkinoilla, mutta omistajat olivat varovaisempia. Paikallisen raaka-aineen laatu ja toimitusvarmuus sekä infrastruktuurin toimivuus Venäjällä askarruttivat myös elintarvikeyrityksiä.

Toiset yritykset suhtautuivat puolestaan hyvin myönteisesti Venäjän kasvaviin markkinoihin. Haastatteluissa elintarviketeollisuuden yritykset arvioivat, että Venäjällä menestymisen avaimia ovat korkealaatuiset tuotteet, hyvät henkilösuhteet paikallisiin toimijoihin ja oikeiden paikallisten partnereiden valinta. Nämä tekijät korostuvat etenkin Venäjän markkinoilla, joissa asioita hoidetaan korostetun johtajavetoisesti. Lisäksi korostettiin pääsyä suurten kauppaketjujen tuotevalikoimaan, jotta tuotteet pääsevät laajan asiakasjoukon ulottuville. Myös lakien ja hyvien toimintatapojen noudattamista pidettiin tärkeänä.

## **Yritykset hallitsevat melko hyvin Venäjän markkinoillepääsybyrokratian**

Venäjän kauppapolitiikan suunta maa- ja elintarviketaloudessa on kääntynyt viime vuosina protektionistisemmaksi, ja markkinoillepääsybyrokratiaa on pidetty raskaana. Suomalaiset elintarviketeollisuuden yritykset eivät kuitenkaan kokeneet markkinoillepääsybyrokratiaa erityisen hankalana. Vientiin liittyvä byrokratia on yhtä raskasta myös muihin kolmansiin maihin viedessä. Vaikka muuttuvia säädöksiä ja byrokratiaa pidettiin valitettavana, niin opetteluun jälkeen rajaylitys sujuu yleensä mutkitta.

Venäjän WTO -jäsenyys on jo melko lähellä, sillä Venäjä on saanut päätökseen tärkeimmät bilateraaliset neuvottelunsa. Venäjän WTO -jäsenyyden on arvioitu helpottavan rajanylitykseen liittyviä yllättäviä muutoksia ja parantavan Venäjän kauppapolitiikan ennustettavuutta ylipäättäen. Haastatteluissa Venäjän WTO -jäsenyyttä pidettiin myönteisenä asiana, mutta toisaalta sen ei arvioitu muuttavan merkittävästi Venäjän kauppapolitiikan linjaa lyhyellä tähtäimellä. Yritykset luottivat enemmän omaan osaamiseensa ja kokemuksiin kuin kansainvälisiin sopimuksiin.

## 1. INTRODUCTION

The Finnish food industry has traditionally had keen trade relations with Russia. After the collapse of the Soviet Union, Finnish food exports to Russia experienced a deep recession, but recovered quite quickly. Finnish food exports to Russia peaked in 1997, but then collapsed again by nearly 50% as a result of the Russian rouble crisis. Trade has since grown, but the pre-crisis level has not been reached. Nowadays, Russia serves not only as a destination for food exports, but also as a possible target for foreign direct investments (FDI). Numerous foreign food industry companies have already invested in the growing Russian food markets, and although Finnish firms have shown considerable interest in these markets, only a few have started local production in Russia.

Goods traffic from Finland and from the EU in general to Russia is currently characterised by several bureaucratic procedures. One major issue in Russian trade policy is the unpredictable custom regulations, which have direct effects on Finnish food exporters to Russia. The forthcoming WTO membership of Russia is one tool that could improve trade policy legislation in the country. As a result of WTO membership, Russian trade legislation will become more harmonised with the WTO countries. It is assumed that the predictability of Russian trade policy will improve and investments in the food industry will also increase.

In the first part of this research project (Virolainen 2005), the current situation in the Russian agro-food sector was analysed and forthcoming development was discussed. The results of the first report were that the 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 considerable. Russia's food industry has grown rapidly in the past few years, even though Russia has not reached self-sufficiency, and food imports will continue in the next ten years in bulk food products and in more specialised production inputs.

This research report continues with the same theme, but concentrates on the implications of the changes in the Russian agro-food sector for the Finnish food sector. First, Russian agro-food trade is analysed in more detail in this report. The study examines the changes in Russian food trade in general, but particularly from the perspective of Finland and the EU. Second, the study considers foreign direct investments in the Russian food industry, and more specifically, the opinions of the Finnish food industry concerning FDI in Russian food markets. Third, the Russian market access system and Russian customs procedures are described. Finally, the current situation and likely implications of Russian membership of the WTO for the agro-food sector are also discussed.

The study is based on published domestic and foreign literature and several statistical sources have also been applied. Interviews were also conducted with managers of such Finnish food firms, which already have made business in Russia, and with Russian trade policy experts to obtain a broader view of the research topic.

## 2. RUSSIA'S FOREIGN TRADE

Russia experienced a large shift in the levels and structure of external trade during the transition from central planning to a market economy. A significant structural change in Russian trade occurred in the early 1990s, particularly on the export side. Machinery exports declined, but semi-processed goods and the shipment of energy experienced an expansion. This was due to changes in the geographical composition of trade, but also because market-based pressures pushed downwards on negative value-added activities. The majority of Russian foreign trade occurred with the former socialist economies in the early 1990s. Russia directed approximately 64% of total exports to the Commonwealth of Independent States (CIS), but their share was less than 15% in 2002. Exports to the European Union constituted over one-third of total exports in 2002 (Lissovolik & Lissovolik 2006).

Fuels and energy nowadays have a great deal of importance in Russian exports, comprising 57% of total exports in 2004. Metals and metal products accounted for approximately one-fifth of total exports, while more processed goods make up only one-sixth of Russian exports. This suggests that the total exports of Russia are still highly dependent on natural resources. Table 1 shows that machinery comprised 40% of total imports and that food products had an approximately 20% share of total imports in 2004. In other words, food imports still make up a considerable proportion of Russian imports (BOFIT 7/2005).

**Table 1.** *Russian foreign trade in all product groups in 2004.*

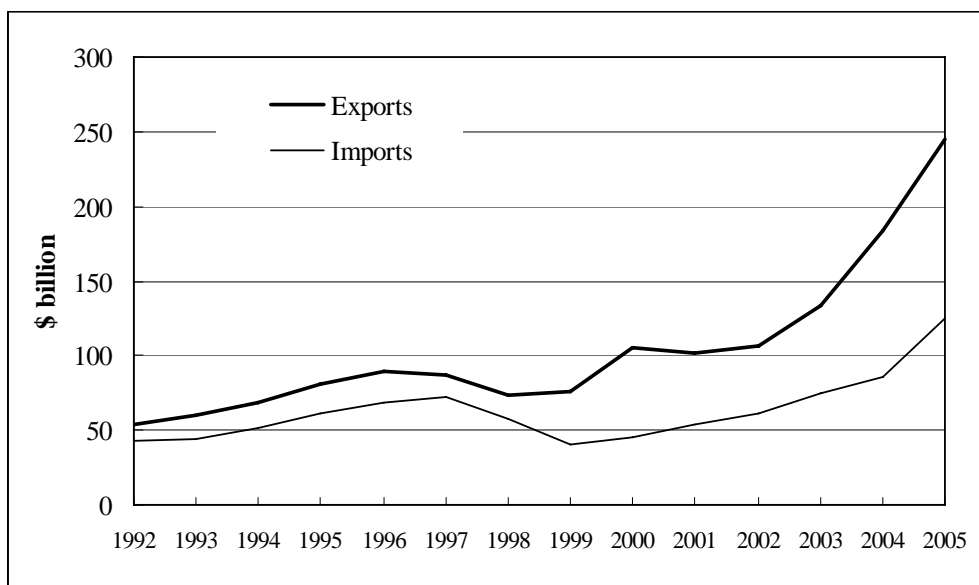
<b>ALL GROUPS OF PRODUCTS</b>	<u>Export (%)</u>	<u>Import (%)</u>
Food Products and Agricultural Raw Materials	0.9	17.9
Mineral Goods(Gas, Oil, Petrol, Ores, Coal etc.)	60.4	1.0
Chemical Products and Rubber	6.0	17.6
Leather Raw Materials, Furs and their products	0.1	0.3
Wood, Timber, Pulp and Paper Goods	4.0	4.0
Textiles and Footwear	0.4	3.7
Precious Stones and Precious Metals	4.2	0.4
Ferrous and Non-Ferrous Metals and Products	17.6	5.2
Machinery, Equipment and Transport Equipment	5.5	45.7
Other goods (which are not mentioned above)	0.9	4.2

Source: NAG Consulting Co.

Russia's foreign trade balance has developed very positively during the past decade. The growth has mainly originated from the increase in exports to Western European countries, because world prices for the exported goods and prices of resources developed well and the rouble-dollar exchange rate was favourable for Russia. For example, the boom in world market prices for oil and petrochemicals in the 2000s has resulted in a rapid growth in Russian exports. In fact, the increase in the value of Russian exports of oil and fuels in 2000

was 71%, accounted for by the increase in prices. Only 5% of the export growth originated from increases in the actual volumes of the exported material (Chistokhvalova 2003). Russia's foreign trade balance was strongly positive in 2005; total exports reached \$245 billion, while the value of total imports was around \$125 billion. The trade surplus reached a record level of \$120 billion.

**Figure 1.** *Development of Russia's merchandise trade flows in 1992-2005 (\$ million).*



Source: Bank of Finland.

## 2.1 Trade structure: Main trading partners and products

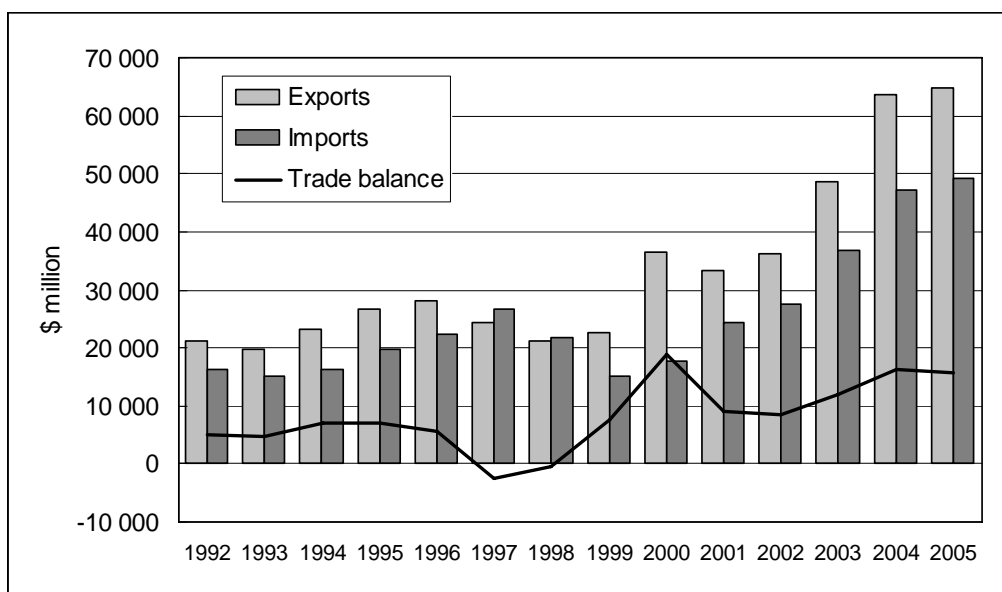
Russia's foreign trade can be divided into trade with the CIS countries and the non-CIS countries, the latter of which can be interpreted as trade with Western companies. The non-CIS countries accounted for around 85% of Russia's total imports in 2002, while 90% of Russian exports were directed to non-CIS countries. The EU is Russia's main trading partner, accounting for over 50% of its total trade. China is playing an increasing role in Russian foreign trade; in fact, China has more intensive trade relations with Russia than with the US. The US proportion of Russia's total trade is surprisingly small, and the US's trade value with Russia only slightly exceeds the corresponding value with Finland (Liuhto, Pelto & Lipponen 2004).

It is worth examining the regional distribution of trade with non-CIS countries. Moscow, St. Petersburg, Moscow Oblast and Kaliningrad Oblast, in this ranking order, are the most important import destination regions for non-CIS countries. Moscow and St. Petersburg import over half of Russia's total imports from non-CIS countries. However, these regions

are important re-distribution centres and do not consume half of the total imports from Western countries (Liuhto, Pelto & Lipponen 2004).

Russia represents approximately 5% of the EU's overall trade. Russia is the EU's fifth biggest trading partner after the US, Switzerland, China and Japan. Since the emergence of the market economy, bilateral trade between the EU and Russia has grown. Following the Russian economic crisis in 1998 the value of trade dropped, but soon recovered, and in a couple of years exceeded the pre-crisis level. The trade structure closely reflects the comparative advantage of both exporters; Russia exports fuel and primary products while the EU concentrates on the export of finished industrial and consumer goods (European Commission 2004a). Russia's trade balance with the EU is clearly positive; in 2004 Russia exported over €80 billion worth of goods to the EU while it imported goods worth over €45 billion (European Commission's Delegation 2005). The main reason behind this large trade surplus is the high price of oil.

**Figure 2.** *Russia's bilateral trade with the EU-15 (\$ million).*

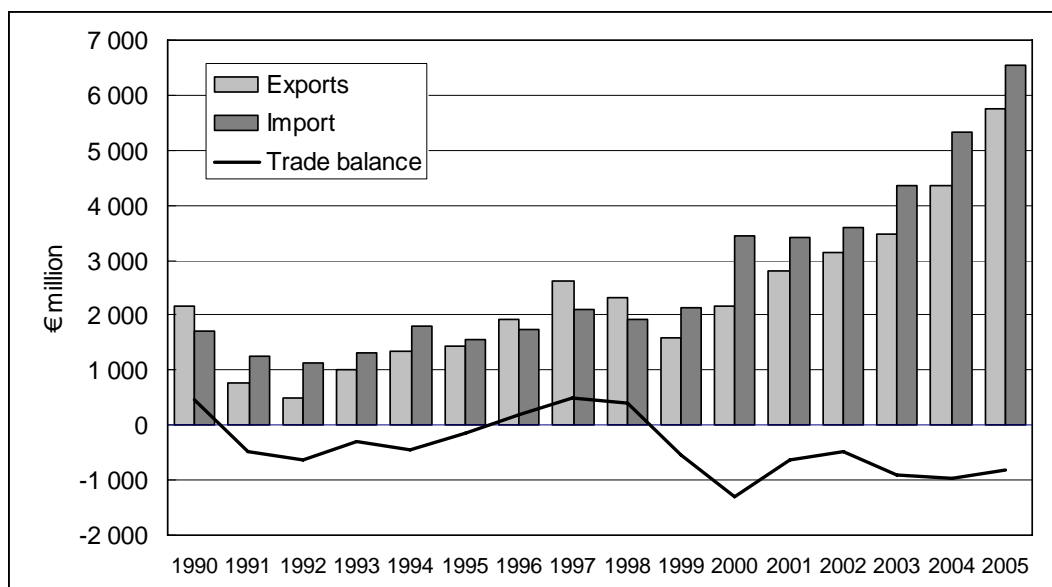


Source: Comtrade.

The EU and Russia constitute two rather different trading partners; the size and structure of their economies differs considerably. Russia's economic size matches well with that of the EU's new member states combined. The energy, construction and agricultural sectors constitute a significant part of the total factor income in Russia, while in new EU member countries trade and other industrial sectors form a major part of the total factor income (Sulamaa & Widgrén 2005). The EU is relatively dependent on fuel imported from Russia. In fact, Russia provides over 20% of the EU's needs for imported fuel. Energy and oil currently comprise a significant part of the bilateral trade, but trade in services will undoubtedly increase in size and importance in the future (European Commission's Delegation 2005).

Finland has a relatively small economy, but is Russia's tenth largest trade partner, having 3% share of Russian foreign trade (Liuhto, Pelto & Lipponen 2004). Finland's trade balance with Russia is negative: Finland imported goods from Russia with worth of 6.5 billion euros in 2005, while it exported goods to Russia worth 5.7 billion euros. Russia became the biggest source of imports in 2005 as a result of the sharp rise in the oil price. Finland's bilateral trade with Russia experienced a sharp decline at the beginning of the 1990s when Russia became a transition economy. Trade started to grow again in 1993, and by 1997 it exceeded the 1990 level. However, trade declined again in 1999 as a result of the Russian crisis. Strong devaluation of the rouble boosted Russian exports and the trade balance turned positive in 1999, and has remained positive since then due to the high price of oil. Finland's negative trade balance with Russia improved in 2002 when the world market price of oil sank, but the deficit started to grow again a year later when oil price returned to an upward trend.

**Figure 3.** Finland's foreign trade with Russia in 1990-2005 (Million euros).



Source: ETLA.

Finland's exports to Russia consist of machinery products, chemicals, and paper, while Finland imports oil and oil products, natural gas and timber. As much as 68% of Russian exports to Finland consist of mineral fuels. Crude materials are the second biggest import group, with a 15% share of total imports. The majority (62%) of Finnish exports to Russia consist of machinery and transport equipment. Food exports comprise approximately 3% of total exports.

**Table 2.** *Structure of the Finnish bilateral trade with Russia in 2005.*

	<b>Imports, million €</b>	<b>% of total imports</b>	<b>Exports, million €</b>	<b>% of total exports</b>
Food and live animals	8.7	0 %	175.2	3 %
Beverages and tobacco	0.2	0 %	12.2	0 %
Crude materials, ex.fuels	975.3	15 %	41.4	1 %
Mineral fuels	4433.4	68 %	116.6	2 %
Animal and vegarable oils and fats	0.1	0 %	2.2	0 %
Chemicals and related products	491.6	8 %	697.5	12 %
Basic manufactures	508.9	8 %	796	14 %
Machinery, transport equipment	98.1	1 %	3539.1	62 %
Miscellaneous manufactured articles	30.8	0 %	362.8	6 %
Goods not classified elsewhere	0	0 %	0	0 %
<b>Total trade</b>	<b>6547.1</b>		<b>5743</b>	

Source: ETLA.

Nearly 4 000 Finnish companies export to Russia. Small and medium-sized enterprises (SMEs) account for a major proportion of these firms. Four firms out of five exporting to Russia are classified as SMEs, but their share of the total export value is less than 30%. Large companies, on the contrary, dominate Finland's imports from Russia. They have an approximately 90% share of Finland's total import value from Russia. This is due to the import structure; natural resources are commonly executed by large companies (Liuhto, Pelto & Lipponen 2004).

## **2.2 *Russia's trade in food products with the world, with the EU and with Finland***

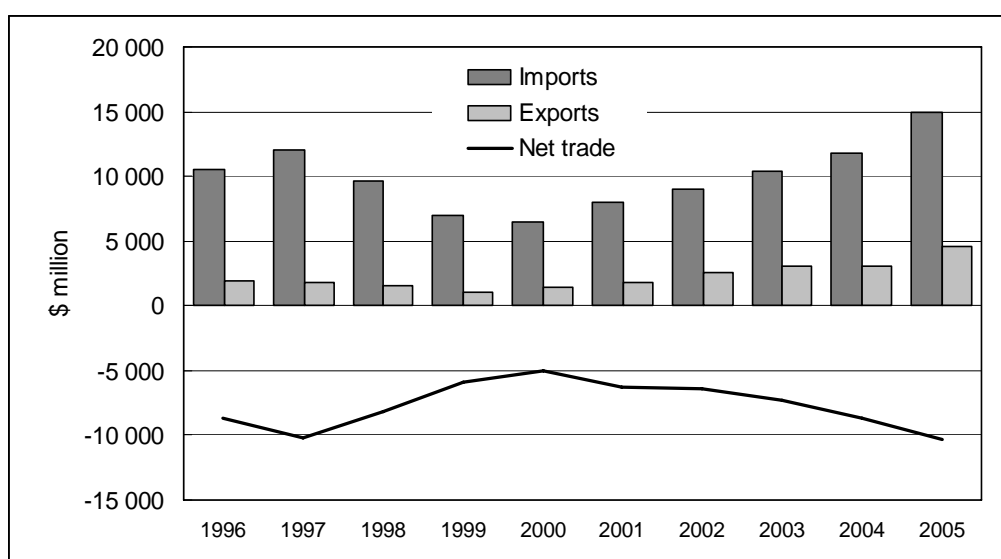
The structure of Russia's food trade has changed quite dramatically during the past 15 years. Thirty years ago the Soviet Union (the USSR) imported grain, soybeans, and soybean meal to increase livestock production. The USSR was not self-sufficient in animal-feed production and the amount of imported feed was impressive. At the beginning of the 1990s the situation started to change. As a result of price liberalisation, 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 and decline in agricultural production. Furthermore, the underdeveloped market structure contributed to the slowdown in the agricultural sector. Producers were unable to sell their products to the markets, which caused massive food imports (Serova 2005, Zadorozhniy 2002).

As a consequence of dramatic decrease in meat production, the need for imported grains also declined from 37 million tons only to a few million tons. At the same time, imports of meat naturally rose due to the slowdown in livestock production and grain was massively exported in 2001-2003. In fact, it became the main exported agro-food item, followed by

fish and sea products, alcoholic beverages and sugar. Imports of highly-processed foods, fruits and beverages, by contrast, started to grow in the 1990s. Vegetable oil, dairy products, macaroni products and dried milk are currently typical imported food products (Serova 2005, Zadorozhnyi 2002).

The main part of Russian foreign food trade is still with non-CIS countries. The share of non-CIS countries in the total Russian food trade over the past few years has been about 80% (Serova 2004). Russia has been a net food importer during the past ten years. Trade statistics before 1994 are not reliable, but according to expert estimations, the Soviet Union/Russia did not reach self-sufficiency in food production. Russia experienced an economic crisis in August 1998 that led to a drop in food imports, but imports of food and agricultural products recovered to the pre-crisis level in 2003 (Zadorozhnyi 2002). According to Virolainen (2005), food imports will remain at a high level as the incomes of Russian consumers increase. However, Russian food exports grew by over 80% from 1998 to 2003. The increase in food exports was mainly stimulated by the devaluation of the rouble.

**Figure 4.** Russia's total food and agricultural trade, \$ million, in 1996-2005.



Source: Comtrade.

Figure 5 shows that the Russian economic crisis that began in August 1998 caused a deep slowdown especially in meat imports to Russia. Meat imports declined by nearly two-thirds from the original level. Imports of alcohol and soft drinks and vegetables also experienced a significant drop as a result of the economic crisis. Imports of sugar and confectionary, by contrast, faced only a minor slowdown in imports. Meat imports have not yet exceeded the pre-crisis level, but imports of vegetables and fruits as well as sugar and confectionary have already passed the pre-crisis level.



**Figure 5.** Development Russian imports of the main food and drink products.



Source: NAG Consulting.

Meat and meat products have a nearly 20% share of the total food imports to Russia, forming the biggest imported food category. Fats and vegetable oils, fruits and vegetables, sugar, dairy products, sunflower seeds and cereals are the next most important imported food products (Serova 2004). The EU and the US are two major food importers to Russian markets. However, Brazil, Ukraine and Belarus are also important sources of food imports and are taking the market share from traditional industrial countries. Brazil is the biggest sugar exporter to Russia, but it also has a leading position as a meat and edible meat by-products exporter. Ukraine and Belarus, by contrast, dominate in exports of milk and cereal end-products as well as meat and fish end-products. It seems that industrialised countries have lost their market share to cheaper production countries, which have created an incentive to start local production. However, the lack of raw materials in Russia has pushed industrial countries to transfer production to other cheap production countries such as Ukraine (Kaipio & Leppänen 2005).

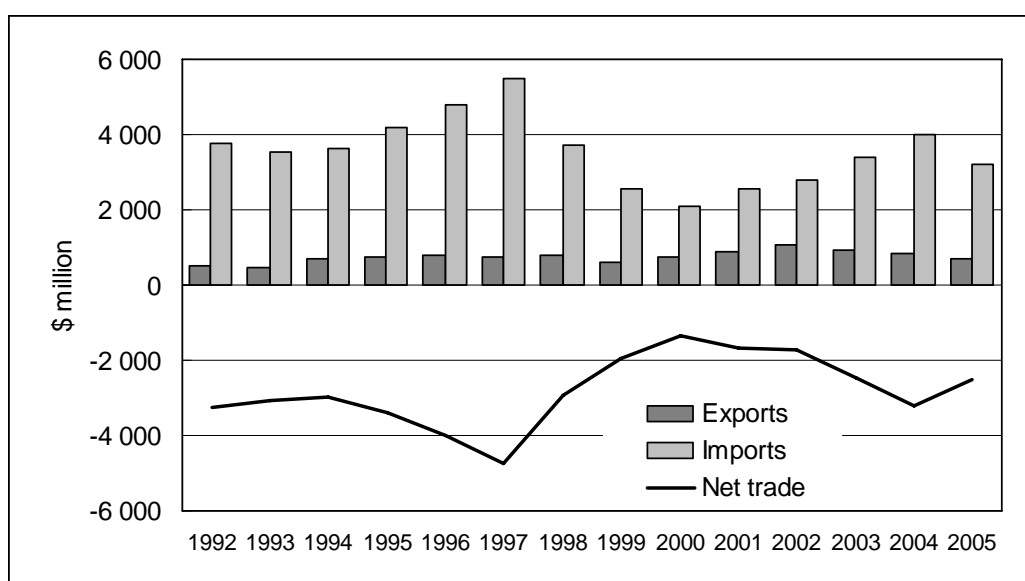
**Table 3.** The most important food importers to Russia and their share of imports, per cent.

	Meat and edible meat by-products		Meat and fish end-products		Milk products		Milk and cereals end-products
Brazil	28.3	Belarus	33.2	Belarus	28.7	Ukraine	11.6
U.S.	19.9	Latvia	18.7	Ukraine	18.4	Poland	11.5
Ukraine	10.1	Chile	9.4	Germany	15.4	Germany	11.0
	Sugar and sugar confectionaries		Fruits and peanuts		Animal and vegetable fats		Beverages
Brazil	38.9	Ecuador	21.5	Malaysia	18.9	Moldova	22.3
Belarus	14.3	Turkey	7.8	Ukraine	18.8	France	17.4
Cuba	13.3	Argentina	6.8	Indonesia	11.1	Ukraine	11.2

Source: Russian Customs (Kaipio & Leppänen 2005).

Figure 6 shows that Russia's food trade balance is clearly negative with the EU-15. Although the Russian crisis considerably lowered the food deficit, since 2001 the deficit has grown again. The EU-15's food exports to Russia have not reached the pre-crisis level for several reasons. First, Russia's domestic production has recovered as a result of growing domestic and foreign investments in the Russian food industry. Second, Russia's trade policy has slightly changed during a couple of years. Russia consistently protects domestic production; for example, quota systems and new sanitary regulations for meat imports have lowered the EU's exports to Russia. Third, export competition in Russian markets has grown. As the second biggest food importer in the world, Russia has become an interesting marketing area for the main food exporters.

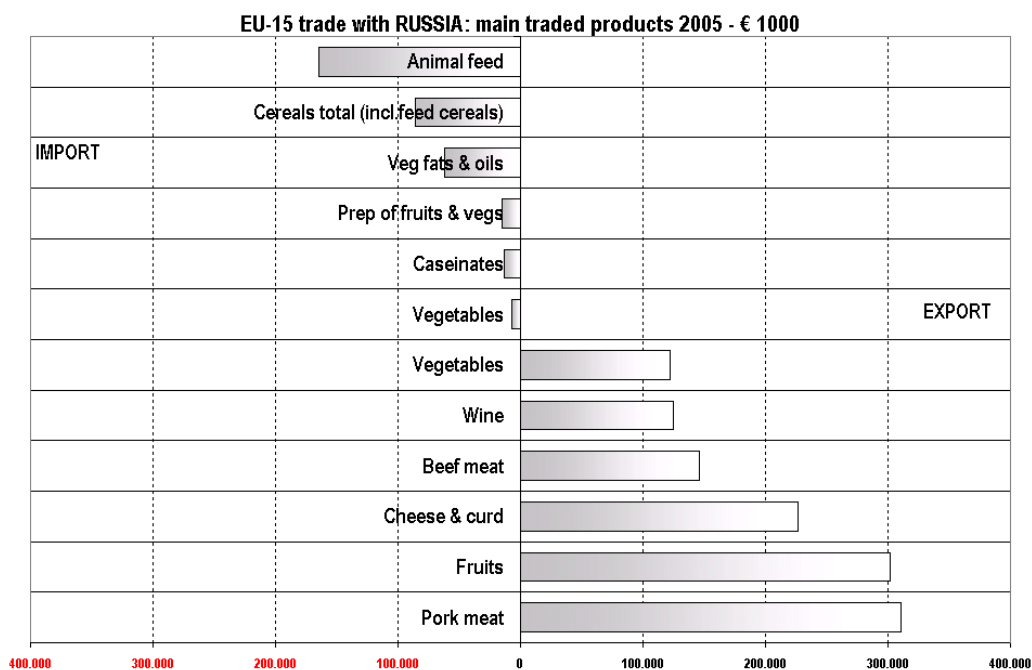
**Figure 6.** Russia's bilateral food and agricultural trade with the EU-15 during 1992-2005 (\$ million).



Source: Comtrade.

The EU25 countries exported farm products worth of € 4.971 billion to Russia in 2005, while agro-food imports from Russia totalled € 2.440 billion (Eurostat). Figure 7 presents the main traded agro-food products in EU-15-Russian trade. Pork was the EU-15's most important exported product to Russia in 2005 but fruits, cheese and beef were also significant items. Export revenues of pork were worth approximately € 300 million. Russia's food exports to the EU-15 consist almost entirely of animal feed and cereals. Vegetable fats and oils are also exported to the EU-15, but their importance is clearly less than that of the previously mentioned products. Animal feed was imported to the EU-15 from Russia to the value of under € 200 million. It is worth noting that the EU exports more processed and diversified products to Russia, while Russia exports less processed products such as animal feed and cereals. As far as trade volumes are concerned, cereals and animal feed are also the most traded products in trade between the EU-15 and Russia (see Annex 2).

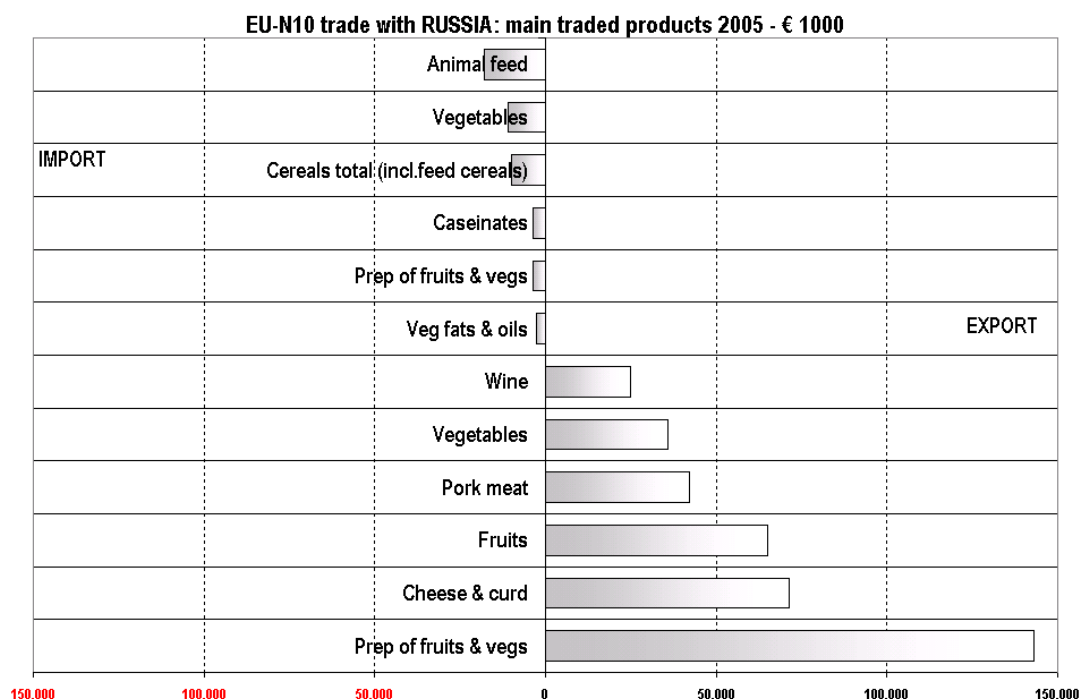
**Figure 7.** The main agro-food products traded between the EU-15 and Russia in 2005, (€ 1000).



Source: European Commission.

The structure of Russian food trade with the new EU member countries (EU-10) differs from trade with the old EU countries. Preparations of fruits and vegetables are the most important items imported to Russia. Cheese, pork and cereals also constitute a significant part of the total imports. Russia, by contrast, exports animal feed, vegetables and cereals to the EU-10. It should, however, be borne in mind that the EU-10 trade with Russia is only a fraction of the EU-15-Russian trade value. However, Russia's food trade deficit with the EU-10 is relatively even greater than with the EU-15. Russian trade with the EU-10 is also presented in volume terms in Annex 3.

**Figure 8.** The main agro-food products traded between the EU-10 countries and Russia in 2005 (€ 1000).



Source: European Commission.

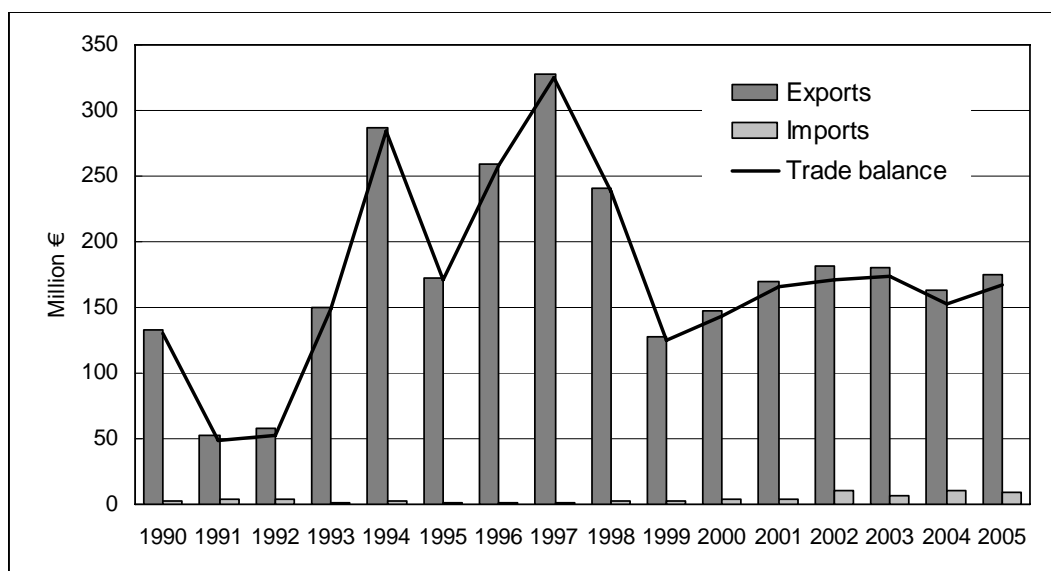
The current situation and prospects of Russia's agro food sector have already been discussed in the first part of this study (Virolainen 2005). One of the main conclusions of the study was that Russia's food imports of bulk food products will continue to grow during the next ten years, and moreover, the import demand for more specialised production inputs will also grow. This will provide good prospects for Finnish food firms to export to Russian markets. Although it is assumed that the growth of foreign food imports will continue in the future, the attraction for foreign products is diminishing. In fact, foods imports will remain at high level due to the lack of certain domestic raw materials rather than because of enthusiasm for foreign goods in itself. The Finnish food companies interviewed for this study assumed that Russians nowadays have a greater appreciation for their domestic food products than before. Foreign products are no longer regarded as special, as they were at the beginning of the 1990s when they symbolised wealth and status.

According to the interviewed Finnish experts, the competitiveness of the Russian agro-food sector seems to be quite good in some emerging economies, but western markets are probably too difficult for most Russian firms to enter. In fact, Central Asia, Ukraine and Northern Africa are the most promising marketing areas for Russian products. This suggests that the EU's food trade balance with Russia will remain highly positive, and it seems very unlikely that Russia will significantly increase its food exports to the EU. In fact, grain will

probably be the most significant exported product in the near future, but Russia may place some emphasis on use the grains as an input for the Russian livestock sector.

For Finnish agricultural and food exports, Russia is by far the most important destination. Approximately 20% of Finnish food exports go to Russia. As a neighbouring country of Russia, freight costs are low and transportation times are shorter compared to many other countries. St Petersburg is located only approximately 250 kilometres from the Finnish/Russian border, and it has become a centre of the Russian food industry, although agricultural production is not concentrated in this area. Finland's total food and agricultural exports to Russia amounted to € 175 million in 2005, although they still account for only a small fraction of the total imports. Russia's economic development has also had implications for Finnish bilateral food trade. The transition to a market economy at the beginning of the 1990s caused a collapse in food imports from Finland, but Finnish food exports experienced a rapid growth after that. The Russian crisis caused another sharp drop in Finnish food exports in 1998 and 1999. Food exports have grown steadily since then, but have not yet reached the pre-crisis level. In fact, the value of food exports to Russia in 1997 was around twice that in 2004. Food imports from Russia grew by nearly 200% from 2000 to 2004, but are modest compared to the food exports in value terms.

**Figure 9.** Finland's food and agricultural trade with Russia, million €.



Source: Bank of Finland.

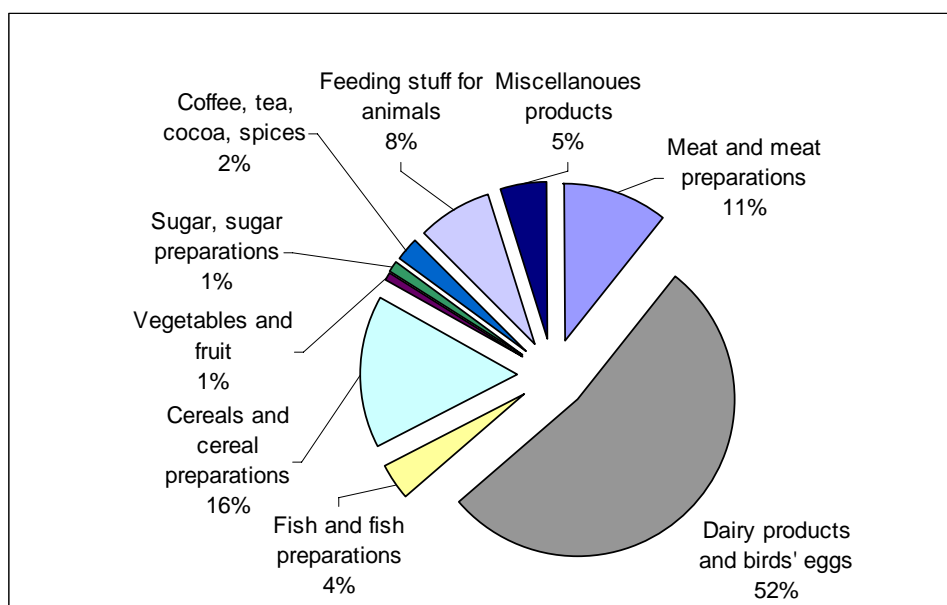
Kaipio and Leppänen (2005) reported that the crisis of 1998 was a watershed in the Russian food markets. Those firms that stayed in Russia through the crisis are nowadays quite pleased with their success. The present study confirmed this finding. The opinion of the Finnish food industry in general seems to be that it would have been a perfect time to invest

in the Russian markets before or during the crisis in 1998. Those who left Russia in 1998 afterwards realised that they had made a mistake.

The structure of Finnish food trade with Russia has experienced some significant changes during the past ten years. Ten years ago, Finland's food exports to Russia consisted of many product groups, but the economic crisis changed the patterns. During the crisis, consumption habits turned to cheaper (local) products and some of the Finnish food companies also started local production in Russia. For example, margarine and chocolate accounted for approximately 20% of the total food export value to Russia ten years ago. Cheese and curd, butter and other milk derived fats, cereals and flour preparations constituted nearly two-thirds of total exports to Russia in 2004. Chocolate and margarine, by contrast, had only a 3% share of total exports (Kaipio & Leppänen). The Finnish margarine producer Raisio started local production in the Moscow region, and thus it has replaced exports to Russia. However, it should also be borne in mind that Finland was an important exporter of coffee, tea, cocoa and spices in the middle of the 1990s due to transit trade, but transit trade practically ended in 1998.

Figure 10 depicts the structure of Finland's food exports to Russia in more detail in 2005, and shows that the structure food exports is heavily concentrated on one group. Dairy products represent over a half of total food exports. Butter and cheese are the key export products to Russian markets. Cereals and cereal preparations are the second most important export group, accounting for 17% of food exports. The majority of the exports consist of malts. However, it is worth noting that the milling industry has faced problems in exports to Russia and imports from Finland experienced a sharp drop in 2005 due to the growing supply of malt on the world market and declining prices. In fact, malt exports had a considerably greater share of total exports in 2004. Meat and meat preparations account for over 10% of total food exports to Russia, while feedstuff for animals, fish and fish preparations and miscellaneous products have a smaller share of total exports. It seems that bulk products still comprise a considerable share of food exports Russia. However, according to the interviews conducted for this study, food exports will concentrate on more processed products in the future and bulk production will be increasingly replaced by domestic production in Russia.

**Figure 10.** The structure of the Finland's food exports to Russia in 2005.



Source: Finnish Customs.

Although Finland plays a minor role in Russia's total food imports, in some food categories Finnish products have a significant market share. Finland was the fourth most important dairy products importer to Russia in 2001-2003, having an approximately 10% market share. Nearly 4% of total milk and cereal end-product imports originated from Finland in 2003. Table 5 shows that no major changes have taken place in Finland's markets shares in past ten years (Kaipio & Leppänen 2005). However, it is worth noting that the development of total food imports to Russia has varied between product groups.

**Table 4.** Changes in Finland's share in Russian food markets, per cent.

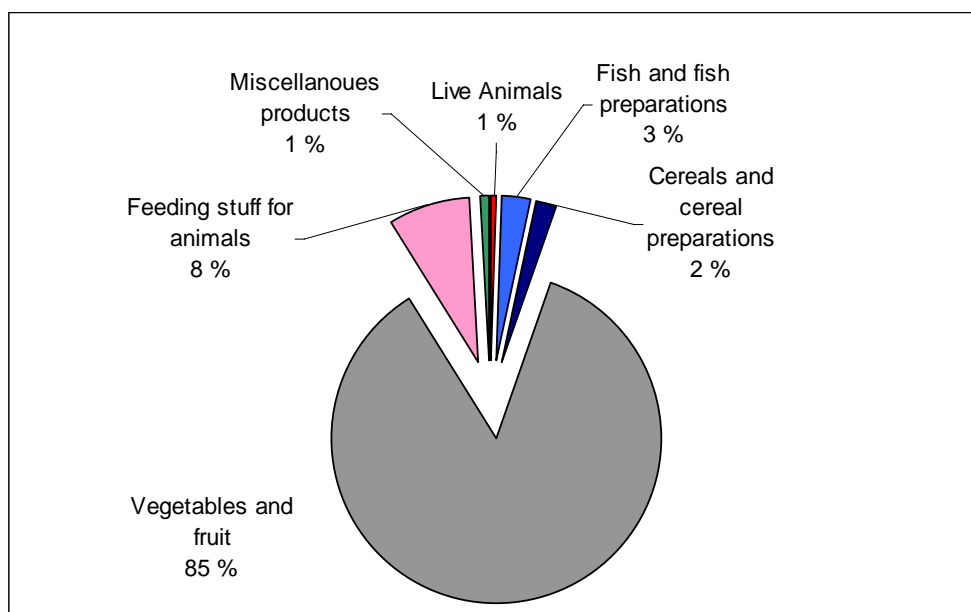
	Meat and meat by-products	Milk products	Animal and vegetable fats	Meat and fish end-products	Sugar and sugar confectionaries	Milk and cereals end-products	Beverages
1996	0.5	7.2	2.3	2	0.3	4	1.5
2000	0.2	4	1.9	0.8	0.4	2.4	1.3
2003	0.5	10.7	1.4	0.3	0.5	3.9	0.9

Source: Russia's Customs (Kaipio & Leppänen 2005).

Kaipio & Leppänen (2005) found that Finland's food exports to Russia are not likely to increase very much in the future due to the fierce competition in Russian markets. According to the interviewed Finnish food producers, food exports to Russia will not necessarily increase in the future, because almost all the firms had made some plans to start local production in Russia, which would replace exports from Finland. However, there were some differences in the aims and magnitude of local production between the separate lines of businesses. This will be discussed further in the next chapter.

Edible fruits and nuts comprise a vast majority of food imports from Russia to Finland. This group accounted for 85% of the total food import value in 2005, while feedstuff for animals was the second important group, with an 8% share of total imports. Cereals were the second most important imported group in 2003, representing 10% of total food imports, but since then cereal exports to Finland have completely ended due to weaker harvests in Russia. Other products play a less significant role in Russian trade. Table 6 suggests that the degree of working up of imported commodities is rather low, which partly reflects problems in the Russian food industry.

**Figure 11.** *The structure of Finland's food imports from Russia in 2005.*



Source: Finnish Customs.

Export subsidies are still used in food exports to Russia. In fact, approximately a half of the total Finnish export subsidies are applied to Russian exports. The vast majority of the subsidies go to the dairy sector, which accounted for over 85% of the total supported exports to Russia. It should, however, be borne in mind that dairy export subsidies have been cut by 50% during the past couple of years: export subsidies were worth 72 million euros in 2003, while their total value was only 36 million euros in 2005. In the interviews conducted for this study it was confirmed that export subsidies have no role in Finnish food exports to Russia, except in the dairy and grain sectors. However, the importance of export subsidies is diminishing in these two sectors.



**Table 5.** *Total export subsidies of Finland and Russia's share of the export subsidies in 2005.*

	<b>Total Support to Exports (€)</b>	<b>Support to Russian Exports (€)</b>	<b>Russia's share of total, per cent</b>
Processed products	3 843 068	906 485	24
Eggs	2 955		
Dairy	59 007 141	36 165 145	61
Beef	756 763		
Pork	1 448 425	1 275 890	88
Poultry	126 502	125 223	99
Sugar	15 677 079	3 122 859	20
Grains	3 767 300	184 548	5
Fruits and vegetables	248 335	48 482	20
<b>Total</b>	<b>84 877 567</b>	<b>41 828 631</b>	<b>49</b>

Source: Ministry of Agriculture and Forestry.

The Finnish interviewees had a clear view that Finnish products have a very positive image in the Russian food markets. Finnish food products are considered as high value quality products, and they are clearly more expensive than, for example, domestic local products. According to the interviewed actors, foreign products (imported or produced in Russia) are the main competitors for the Finnish products. However, some of the interviewed actors also mentioned domestic products as important competitors in their sector, because the quality of Russian products has improved.

The opinion of the Finnish food industry in general seems to be that Russia is the most important or one of the most important export markets for their companies. Most the interviewed food actors mentioned that they are pursuing growth in Russian exports, but surprisingly many of the actors had no clear strategy for the Russian markets. In other words, some of the Finnish food firms had only decided to follow the development of the Russian markets without any specific agenda. Very few of the actors said that the Russian markets have only little importance for their business and the situation will probably remain unchanged in the future. There were some significant differences between separate lines of business. This issue is closely related to the investment decisions concerning the Russian food markets, and thus this issue will be discussed in more detail in the next chapter.

### **2.3. The role of St Petersburg and (Moscow) in Finnish food exports**

It is not perhaps surprising that the Central Federal District plays a central role in Russia's foreign trade. Moscow and the surrounding Moscow Oblast are the dominant regions in the Central Federal District, which accounts for a vast majority of the district's foreign trade. This region accounts for a third of total exports, and a half of imports. Moscow and the Moscow Oblast are the centre of foreign trade in Russia. This is partly due to fact that

headquarters commonly locate in Moscow, but Moscow also re-distributes goods to other regions. Therefore, other regions have a less important position. For example, St Petersburg and the Leningrad Oblast account for only 4% of Russian exports and 14% of imports (Liuhto, Peltonen & Lipponen 2004).

**Figure 12.** *Federal Districts of Russia.*



1. Central Federal District
2. Southern Federal District
3. North-western Federal District
4. Far Eastern Federal District
5. Siberian Federal District
6. Urals Federal District
7. Privolzhsky (Volga) Federal District

St Petersburg plays an important role in Russian foreign trade. Exports from Western countries are typically first conducted to St Petersburg. The foreign trade turnover of St Petersburg increased by nearly 30% in 2004. Exports increased by 45%, while imports grew by 20%. Despite the growing exports, St Petersburg's trade balance is still negative, even though it is gradually decreasing. Foodstuffs are still the most important imported commodity group, having a 36% share of total imports in 2004. Machinery and equipment comprise the second largest import group (30% of total imports) and the third largest group is chemicals (14%) (ETLA 2005). Germany and Finland are St Petersburg's most important trade partners. According to Petrostat statistics, Germany is the biggest trade partner, having a 14% share of total trade. Finland is in second position, representing nearly 12% of total imports. It is worth noting that China is in third position, before the EU, although the EU countries have geographically closer contacts with the North-western Federal District of Russia.

**Table 6.** *St Petersburg's main trading partners in 2004.*

<b>Main Export Partners</b>	<b>Export Share, %</b>	<b>Main Import Partners</b>	<b>Import Share, %</b>
Germany	14.1	Germany	14.1
India	11.8	Finland	11.6
Finland	8.2	China	6.6
China	7.4	USA	6.6
The Netherlands	5.3	Italy	4.5
Spain	4.7	France	4.2

Source: Petrostat.

The Finnish food producers interviewed for this study had a clear strategy in their food exports to the Russian food markets: Business was first started in the markets of St Petersburg, because of their close geographical proximity to the Finnish border, and because St Petersburg is a significant single marketing area. However, once business in the St Petersburg markets had been established, firms moved to Moscow. This was the most common solution among the interviewed Finnish food firms. Moscow and St Petersburg comprise a significant part of the Russian food markets, and the majority of the Finnish food firms therefore had no great ambitions to expand their business to the whole of Russia. Taking into consideration the relatively small size of Finnish food firms, this seems to be a very reasonable solution. In fact, the firms were focusing on a certain geographical area (like St Petersburg) or a certain consumer segment (high income upper class or middle class). Finnish food firms simply do not have sufficient resources to produce massive volumes of food.

It is worth noting that retail business is no longer concentrated on certain geographic areas. International and local Russian retail chains do not have stores only in Moscow or in St Petersburg, but in all big cities in Russia. These chains naturally do not cover the whole of Russia, but a considerable part of the increasing purchasing power of Russian consumers is clearly concentrated in the big cities. All this means that the geographical area is no longer the most crucial question in penetrating Russian food markets. It is extremely important that a company's product has a place on the shelves of retail chains. In fact, it seems that Moscow is becoming an increasingly important place for Finnish food firms, because strategic decisions in the retail sector are made in Moscow.

The strengthening role of the retail sector is expected to have mostly positive implications for Finnish food producers. Actors in the retail sector are professional and their storage systems are generally reliable. Some of the interviewed food actors mentioned that their Russian sales had grown by dozens of per cent once their products had been accepted on the store shelves of big retail chains. It is very unlikely that Finnish food firms would be able to distribute their products all over the Russia as efficiently by themselves.

The Finnish food producers had some common problems in their export business in St Petersburg (or in Russia in general). There is a lack of a reliable and a well-organised storage system and deliveries of food products are unsatisfactorily organised. In fact, some products are at risk of losing their best quality, for example because a cold storage chain cannot be guaranteed due to unsatisfactory storage and delivery systems. These points were raised in almost all of the interviews. It was also pointed out that problems in market access and cumbersome customs procedures have impeded exports to Russia markets. This will be discussed further in chapter 4.

## **Conclusions**

### **Russia is a net importer of food**

Russia's trade balance is highly positive due to growing prices of energy and increased exports of it. Russia's exports are highly concentrated on exports of mineral fuels. In agro-food sector, by contrast, Russia is a net importer. Russia imports especially meat, dairy products, vegetable oil, fruits, and vegetables, but grain is currently Russia's main exported agro-food item. Decreased demand of grain in domestic markets and partly renewed cultivating methods has boosted grain exports.

### **The EU's food exports to Russia has developed well, but challenges are faced too**

The EU is Russia's main trading partner, accounting for over 50% of its total trade, but Russia represents approximately 5% of the EU's overall trade. EU is clearly a net exporter of food to Russia, and the exports to Russia have grown again after the Russian crisis, but it has not reached the pre-crisis level for several reasons. First, Russia's domestic production has recovered as a result of growing domestic and foreign investments in the Russian food industry. Second, Russia consistently protects domestic production; for example, quota systems and new sanitary regulations for meat imports have lowered the EU's exports to Russia. Third, export competition in Russian markets has grown as well.

### **Finland exports dairy products, grains, and meat**

Finland's total food and agricultural exports to Russia amounted to € 175 million in 2005, while imports were only a small fraction of the exports. Dairy products represent over half of the Finnish food exports to Russia. Cereals and cereal preparations, meat, animal or vegetable oil and fats and waste from food industries are also exported to Russia.

### **Food exports will be partly replaced by domestic production in Russia**

According to the interviewed Finnish food companies, Finland will be a net exporter of food products to Russia, but the Finland's food exports to Russia are not likely to grow much in the future. In fact, local production will partly replace food exports. Russia, by contrast, will remain a net food importer in the next few years, and their growing export markets are located in Central Asia, Northern Africa and Ukraine. Russian food exports to the EU or to Finland are not likely to grow due to fierce competition in Western markets.

### **3. FOREIGN DIRECT INVESTMENTS (FDI) INTO RUSSIA**

#### ***3.1. Development and significance of foreign direct investment in Russia***

Russia has great economic potential and enormous natural resources, but it has not succeeded in attracting much foreign direct investment (FDI).<sup>2</sup> Developed economies (such as the EU and the US) absorb the majority of world FDI, but emerging markets such as China and Latin America are becoming more and more interesting targets for foreign capital. The inward FDI stock of the EU accounted for nearly 37% of the world total FDI stock in 2002, whereas the US accounted for nearly one-fifth. China had an approximately 6% share and Latin America over 10% of the total FDI stock. Russia succeeded in obtaining only 0.3% the world's total inward FDI stock (Liuhto, Pelto & Lipponen 2004).

According to the local statistical office (Goskomstat), the annual foreign investments to Russia were \$ 40.5 billion in 2004, whereas FDIs were worth \$ 11.7 billion. Foreign investments have experienced a 36% rise since 2003 and FDIs were 39% higher than a year before. The positive trend in foreign investments continued in 2005. According to preliminary estimations, direct investments are estimated to reach \$ 20-25 billion (Liuhto 2006). The biggest single investment in 2005 was made by Coca-Cola Hellenic Bottling Company, which invested approximately \$ 500 million in the juice industry (Finpro 2005).

The main countries investing in Russia are the US, Cyprus, Germany, and the Netherlands. The US constituted 16% of the total FDI inflow in 2002, while the Netherlands had a 13% share of FDI and Germany 10%. Cyprus is also a significant investor in the Russian economy, having a 14% share of total FDI inflow in 2002. The reason behind this is that Cyprus is a well-known tax haven. It also worth noting that the money originating from Cyprus is actually Russian money returning home. Finland was among the ten biggest investor countries in the Russian economy in 2000 and 2002. Finnish direct investment was worth \$ 151 million to Russia, which was nearly 4% of the total FDI inflow to Russia in 2002 (Liuhto, Pelto & Lipponen 2004). In other words, Finland does not belong to the biggest investors, but relative to its GNP and population Finland is a significant investor (KTM 2005). The Finnish woodworking and paper and pulp industries are among the most significant foreign direct investors in Russia. Finnish FDI reached \$79 million in this sector in 2003, which constituted one-fourth of the sector's total foreign direct investment (Liuhto, Pelto & Lipponen 2004).

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<sup>2</sup> According to the International Monetary Fund, direct investment is defined as an investment by a resident entity in one economy in an enterprise resident in another country with the objective of obtaining a lasting interest in the enterprise and an effective voice in its management. For statistical purposes, an investment is classified as direct investment if the resident enterprise owns 10% or more of the shares of the foreign enterprise.

Russia has attracted little FDI compared to East European countries, the role of foreign direct investment in country's GDP has been significant in the CEE countries and in China. FDI constitutes approximately one-fifth of the GDP of CEECs, but annual FDI accounts for only 1.3% of GDP in Russia (Liuhto, Pelto & Lipponen 2004). FDI as a share of total capital investments is also low, constituting only 10% of all capital investments in 2003 (Finpro 2004). The low FDI inflow restricts Russia's economic growth potential. Even among the emerging economies, Russia has not been a very attractive target for foreign capital. In fact, Poland receives more than double the amount of FDI of Russia. If FDI stock is divided per capita, Russia's position among the Central and Eastern European Countries is even worse. The Czech Republic's FDI per capita is \$3751, Estonia, Slovenia and Hungary receive over \$2 000, but Russia has attracted only \$156 per capita (Liuhto, Pelto & Lipponen 2004).

Foreign direct investments are sorely needed in Russia in order to enhance the productivity of Russian industry. Industrial sectors with a high degree of foreign investment, such as tobacco and brewing, are among those with the highest productivity growth. Labour productivity in the brewing industry grew by 120% from 1997-2002, while in domestically-owned sectors such as grain processing productivity fell by 10%. According to the latest research, productivity in foreign firms is higher than in domestically-owned firms (OECD 2004). Investments are expected to grow in certain sectors, while others are not as attractive. It seems that the banking and finance sectors are sufficiently developed to offer efficient financing services for investments. Foreign direct investments constituted 28% of all investment in Russia in 1998-2003 (KTM 2005).

Investors have different motivations for investing in Russian markets. Investors may seek resources, such as firms concentrating on the natural resource business, or manufacturing sectors may have market seeking motivation behind the FDI. Economic sectors successful in exporting or with fast domestic growth have attracted most FDI in Russia. Especially the fuel and petrochemicals, food, beverages and tobacco industries, and the transport and telecommunications sectors have succeeded in attracting FDI. These sectors constituted nearly 60% of total inward FDI stock in 2002. The development annual inward FDI in Russia and its division between separate economic sectors is illustrated in Table 10. The table shows that the industrial sector's share of total FDI has declined, while the trade and catering sector has steadily attracted more investment. Within the industrial sector, the fuel industry has faced a significant rise in FDI inflow, while the food, beverages and tobacco sector has lost investment both in absolute and in relative terms (Liuhto, Pelto & Lipponen 2004). The manufacturing industry received 28% of total foreign investments (not FDI) in 2004, while the wholesale and retail industries accounted for 22% of total investments. The food industry's share of total industrial investments was 2.4% (Finpro 2005).

**Table 7.** *Development of Russian annual inward FDI according to sector.*

	1998	1999	2000	2001	2002	2003	Share of total FDI in 2003
<b>FDI inflow (million €)</b>	3 022	3 997	4 795	4 444	4 232	5 995	Per cent
Fuel industry	276	1 113	479	476	704	1 675	28
Ferrous metallurgy	35	52	42	130	21	74	1
Non-ferrous metallurgy	52	17	32	23	69	42	1
Chemical industry	45	18	53	98	112	85	1
Machine-building and metal-work	114	118	247	353	277	286	5
Forest industry	101	131	153	146	141	278	5
Construction materials industry	20	23	28	47	52	78	1
Food, beverages, tobacco	1 072	904	889	590	464	305	5
Construction	97	55	49	54	93	126	2
Transport	115	485	1 026	769	118	146	2
Trade and catering	440	560	904	845	1 014	1 338	22
Real estate and other services	227	78	160	253	316	390	7
Finance and insurance	59	29	28	44	59	164	3
Other sectors	293	437	631	521	588	1 008	17

Source: Goskomstat 2003.

The inflow of foreign direct investments is extremely unevenly distributed among the Russian regions. In fact, over half of the total accumulated FDI inflow from 1995-2002 was channelled into the Central Federal District. Moscow was naturally the most attractive destination in this district. Regions surrounding million cities have commonly attracted the highest accumulated FDI. For example, the Siberian Federal District attracted only 4% of total accumulated FDI, while the North-Western district, including St Petersburg and the Leningrad oblast, accounted for 10% of the total FDI stock (Liuhto, Pelto & Lipponen 2004).

Foreign investment in St Petersburg rose over by 40% in 2004 after two-year decline from 2002-2003 (see Table 11). The positive trend can be understood as a return to the level of 2001, or it may reflect a positive "anniversary effect" due to an intensive PR campaign. Direct investment increased by 60% in value terms, and FDI's share of all foreign investments grew as well. The main investors in St Petersburg were the US, Great Britain, Finland and Germany in this ranking order. The US had an almost one-fourth share of all FDI in St Petersburg, while Finland's investments constituted 10% of all investments. Machine building (46%), the food industry (22%) and trade and catering (6%) were the most attractive foreign investment targets in 2004. Inflow of foreign investment to the Leningrad Province decreased by nearly one-third in 2004 (see Annex 6). The slowing investment was due to the cyclical trend in foreign investment activity. The flow of FDI has, on the contrary, increased by 12%. The rise in FDI suggest that some new investments have started, which will probably later stimulate other foreign investments. Finland was the second largest investor in Leningrad Province in 2004, having a 16% share of foreign investments (ETLA 2005).



**Table 8.** Total Foreign Investments in St Petersburg in 2000-2004, USD million.

	2000	2001	2002	2003	2004	Change 03/04, per cent
Total Foreign investments in St Petersburg	1159.5	1171.3	881	695.8	985.1	42
FDI	146.3	113.6	84.1	70.3	111.9	59
Portfolio	5.1	15.2	12.6	36	24.7	-31
Other Investments	1008.1	1042.5	784.3	589.5	848.5	44

Source: Petrostat.

Multinational food firms are also interested in the Russian food markets, mainly due to the rapid growth of these markets. According to Ernst & Young, the average growth of the Russian food markets was 20% in 2004, while the growth in European food markets was 3-5% and is slowing. Moreover, the repayment period of investments is shortest in the food and tobacco sector. In other words, risks in the food and tobacco industries are smallest (KTM 2005). Table 7 revealed that the Russian food sector represented a significant part of the FDI several years ago. There are some reasons behind the decline. Russia is not self-sufficient in agricultural production, and imported food is simply needed to satisfy the domestic demand. However, political strategies have also accelerated the inflow of FDI into Russia. Roughly speaking, FDI is highly welcomed in Russia, but the Russian government still regulates FDI in some sectors more than in others. According to the interviewed Finnish experts, the food sector was not considered as a strategic sector in Russia, and thus foreign firms had a relatively free forum to operate in the food Russian markets. The boom in the investments of foreign companies related to the economic crisis in 1998 raised the investments in the food sector to an unusually high level. Since then the investments decreased both in absolute and in relative terms.

The majority of the investments have been directed into the brewery and tobacco industry. In fact, the magnitude of these investments can be compared to the investments directed to the oil sector. As a result of these business actions, the majority of Russia's brewery and tobacco industry is owned by foreign firms. However, the attraction of these sectors is declining because competition is keener than before. Furthermore, the Russian government has intentions to restrict the advertising of beer and tobacco products. The inflow of foreign investment has also been targeted to the dairy, confectionary, and pet food industries. It is unlikely that investment in the food sector will significantly increase in the near future. It seems that the fastest growth in the Russian domestic markets is over, but the Russian food markets will remain an interesting target of investments (KTM 2005).

Despite the great economic potential of Russia, Russia's aggregate volume of investments is rather low. The reason behind the relatively low level of FDI is Russia's business environment. There are several obstacles to foreign and domestic investment in Russia, such as political instability, low level of business transparency and limited investment protection. Moreover, bureaucratic barriers to business are numerous, the process for changing national

standards to international standards is slow, the coordination of power between regional and federal bodies is incomplete, and clear development priorities are missing (Dudarev et al 2004). Institutional and legislative issues are especially problematic in Russia, and thus the list of investment barriers is long: inefficient bureaucracy, corruption, cumbersome customs and custom legislation, poor functioning of courts, tax legislation, problems with competition, corporate governance, intellectual property rights, infrastructure, the banking system, and so on. However, according to the rating agency Expert RA and Expert magazine, the investment climate in Russia has improved. The investment potential and investment risk ranking of Russian regions assessed St Petersburg as having the lowest risk among Russian regions, and Moscow city has highest investment potential. Investment risk rating assesses legislative and political, economic and financial, as well as socioeconomic and crime-related risks (Liuhto, Pelto & Lipponen 2004).

The low level of FDI in Russia does not arise from direct formal restrictions but more from institutional factors. In fact, high entry barriers have also resulted in underdevelopment among domestic small and medium-sized businesses in Russia. Some sectors are highly concentrated and Soviet-era monopolies have survived in the Russian Federation. Russia has made several changes to legislation in order to protect the rights of foreign investors. The new constitution of the Russian Federation was passed in 1994, which included the protection of property and other economic rights of foreign investors. This was followed by the adoption of a Civil Code in 1995 and 1996, and a law governing fixed capital investment in 1998 and 2002. A law governing foreign investment in Russia was passed in 1994 and amended in 2002 and 2003. This law guarantees national treatment for foreign investors, and furthermore, investment activity in any form was authorised by law (OECD 2004).

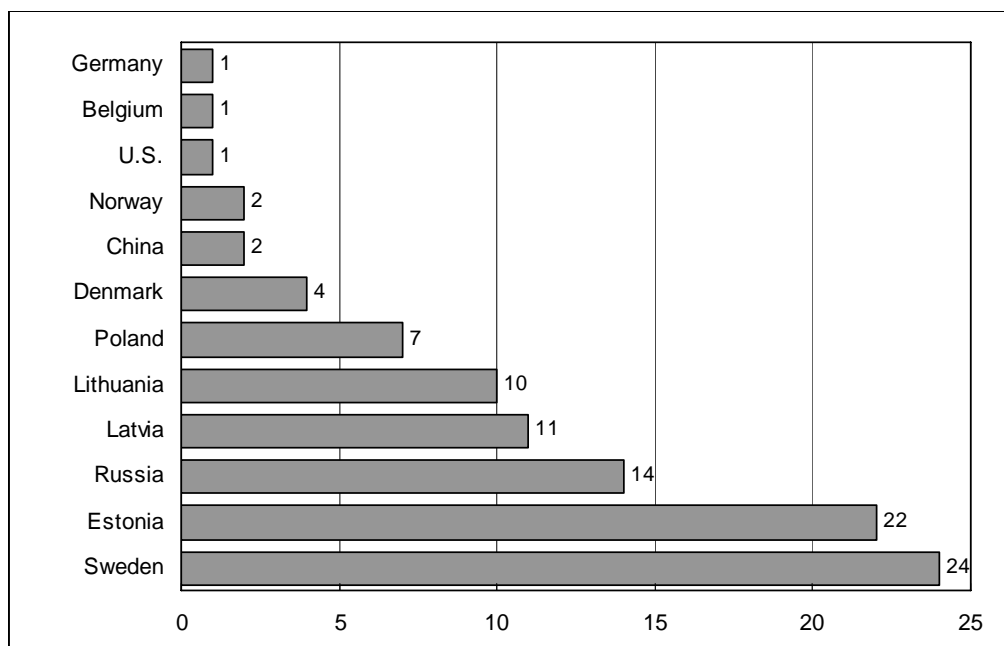
### ***3.2. Finnish FDI inflows into Russia and the Leningrad and Moscow regions***

Finland's trade with Russia considerably exceeds the level estimated by international trade models. These models take account such factors as the size of economies, the population and neighbourhood. However, if the actual investments from Finland to Russia (and vice versa from Russia to Finland) are compared to the model results, they are far too small when the same factors are applied. Finland's outward FDI stock in Russia was 1075 million euros in 2005. This was only 1,6% of Finland's total outward FDI stock in 2005 (KTM 2005, Bank of Finland 2006). The majority of the Finnish outward FDI stock channels into the EU countries. The new EU countries also receive more investment from Finland than Russia. For example, Finnish FDI stock in Russia was 342 million in 2002, while Estonia obtained almost twice that amount (681 euros) at that time. (Liuhto, Pelto & Lipponen 2004).

According to various expert sources, foreign investments in Russia by Finnish firms total approximately two billion euros. However, when including the foreign subsidiaries of Finnish companies the total sum is considerably higher (Finpro 2005, Liuhto 2006). Finnish foreign direct investments are geographically directed to St Petersburg, and to the Leningrad Oblast. Moscow is the second most popular region for Finnish FDI. (Liuhto, Pelto & Lipponen 2004). Finnish firms have two main motives to invest in Russian markets. First, Finnish firms have had resource-seeking motivation; labour costs are low (at least outside Moscow) and Russia has enormous natural resources. Second, growing domestic markets attract investments as consumer purchasing power grows and reconstruction continues (Liuhto 2006).

Foreign investments by Finnish food industry firms have considerably increased in past decade. In fact, EU membership in 1995 started an investment boom due to changes in the market environment. Foreign activities of the Finnish food industry were modest before EU membership. Figure 11 shows that majority of foreign activities have been channelled into Sweden and Estonia, followed by Russia. The Baltic countries have altogether been the most important investment target for Finnish food companies. The activities of food industries have been directed to neighbouring countries and/or the new EU countries, whose labour force costs are significantly lower than in Finland. Russia has also attracted investments by being the third most important target for foreign activities. However, it is worth noting that the number of activities does not indicate the *size* of these activities.

**Figure 13.** *Number of activities of Finnish food industries (joint ventures/production factories/sale companies) in foreign countries in 2005.*



Source: Finnish Food and Drink Industries' Federation.

According to a preliminary estimation the FDI stock of the Finnish food industries was 810 million euros in year 2004. It should, however, be borne in mind that this estimation probably underestimates the total FDI stock of Finnish industries, because it does not cover the whole sector. Figure 13 suggests that the Finnish food industry has also put some efforts in Russian markets. However, Finnish FDI stock into Russia is very modest. The Finnish FDI stock was only € 61 million in Russia in 2005 (Bank of Finland).

The Finnish food industry is planning to set up production plants in Russian and some firms have already made some investments. Baltic Beverages Holding (BBH) is still the most important investor<sup>3</sup> in Russia. BBH is the leading player in the brewing industry in Russia, Ukraine, the Baltic countries and Kazakhstan. Its FID stock in Russia was worth over one billion euros. Sinebrychoff has also invested in Russian markets by acquiring the Vena brewery.

Finland's biggest manufacturer of meat products, Atria, has also expanded its operations into Russia by acquiring the meat processing business of the PIT Produkt Group operating in the St Petersburg region. The PIT Produkt Group of companies consists of several subsidiaries. The turnover of the Group is expected to reach about \$50 million in 2006. With the acquisition of PIT Produkt, Atria will become a leading player in the St Petersburg area (Atria 2005).

The Finnish Fazer Group has expanded its operations in Russia and acquired a bakery in Moscow called OAO Experimentalny Konditersko-Bulochny Kombinat "Zvezdny". The turnover of Zvezdny was approximately 830 million roubles (approximately 23 million euros) and it employs altogether roughly one thousand people in 2004. Through its Hlebny Dom bakery operations, Fazer Bakeries is a market leader with its 27% market share in the Greater St Petersburg area. Fazer Bakeries has been operating in Russia since 1997, and Zvezdny is one of the biggest manufacturers of bake-off pizzas and frozen dough in Russia. Fazer has acquired 96.68% of the shares of the Zvezdny bakery (Fazer 2005).

The Finnish food firm Raisio Nutrition has established a margarine plant in Istra, about 60 km from Moscow. Altogether there are about 60 people working at the Istra plant and in the Russian sales organisation. Raisio Nutrition exported Voimix and Dolina Skandi margarines to Russia. These brands have an almost 10% market share in Moscow and St Petersburg. According to Raisio, starting the local production will strengthen the competitiveness of the firm. In 2004, Raisio's target was to improve its market position in Russia. Raisio assumes that the production volumes could be trebled by minor investment expenses in the next few years (Raisio 2005).

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<sup>3</sup> BBH is a 50:50 owned joint venture between Carlsberg A/S and Scottish & Newcastle plc. Finnish Hartwall and Pripps founded BBH in 1990.

The Finnish food companies interviewed for this study confirmed that almost all firms have plans to invest or expand investments in the Russian markets. However, the firms seemed to have a rather diverse picture of the Russian investment climate. Those firms that had already made investments and had a relatively long presence in the Russian markets had the most positive opinion about the Russian investment climate. These firms had typically already operated in the Russian markets for several years and they aimed to increase investments in Russia. Those firms with little experience, by contrast, had more negative attitudes towards the Russia food markets. These firms had certain key reasons behind their modest interest in local production:

1. "It is too late". Development in the Russian food markets has actually been very rapid during the past ten years. As a result of the boom in foreign capital inflow into the food markets, there is little room for new actors in some business lines. Some of the interviewed food firms assumed that penetration of mature Russian markets is simply too expensive and too risky. The prices of local production factories have dramatically risen and are not equivalent to the real value of the firms. In some cases, the price of a local company represents expectations of the future profit, not of the current profit. Taking into consideration the relatively small size of Finnish food firms and their limited resources, this is a big obstacle. The strengthening position of retail chains was also found to be an obstacle (and an advantage as well later), because the negotiating power of small food producers is weak against the big retail chains. Entry fees are also used in order for the product to be accepted onto the store shelves. Advertising's role in mature markets grows when international and local brands already have a strong market share.

2. Owners oppose – managers' support. Views on the importance of Russian food markets were not consistent inside the Finnish food firms. In some of the firms both owners and managers had a very similar idea about the great potential of the Russian food markets. However, some managers would have already taken bigger steps towards local production in Russia, while owners were more risk-averse.

3. Risks: firms are too small. The Finnish food companies' opinion seems to be somewhat divergent concerning the risks in Russian food markets. Those firms with a long experience and presence in the Russian food markets did not consider political or business risks to be insuperable. However, the other firms emphasized the small size of Finnish firms and their limited resources. Kaipio and Leppänen (2005) also found in their study that the small size of Finnish producers is a disadvantage to starting or expanding local production, since it is more difficult to obtain financing and to tolerate losses during crises.

4. Lack of raw materials. Availability of domestic raw materials was raised in almost all the interviews conducted for this study when the possibility of local production was discussed. Russia is self-sufficient in the grain sector, but in other sectors the availability of raw

materials is a problem. However, the Finnish food firms seem to have a very accurate picture of the benefits of cheaper production costs and the absence of custom problems if local raw materials are used. Those firms who have a local production factory in Russia mostly use local raw materials due to lower costs.

5. Russia is not a key market area. The Finnish food companies' views on the significance of the Russian market for their business were also somewhat divergent. Some interviewees considered Russia as a most important or one of the most important marketing areas for their company. Some firms, by contrast, found that Russia has only limited importance for their business and they had no special business strategy for the Russian markets, except a "let's wait and see" strategy.

The interviewed Finnish food firms altogether exported more food products than they produced locally. However, the long-term trend seems to be local production due to cheaper production costs. One of the main obstacles in move towards local production is the lack of domestic raw materials. As a result of the acute scarcity of raw materials, foreign firms are putting increasing emphasize on local raw material production, and vertical coordination is being developed in Russia. This might offer an opportunity for Finnish firms to export know-how and technological solutions when building up the chain. This could provide various opportunities for Finnish know-how in the Russian agro-food sector.

Kaipio and Leppänen (2005) also stated in their study that Finland's food exports to Russia are not likely to increase very much in the future. Competition in Russian markets from domestic and foreign producers has increased. Finnish food firms found investing in local production to be the most important strategy for increasing market share in the Russian food sector. Russia's consumers are increasingly favouring locally-produced food products over foreign products. Investments in local production would help Finnish food producers to cut production costs and shorten the distribution chain. Foreign firms commonly develop in the first phase an efficient delivery system for exported products in Russia and in the second phase local production is started by buying a local firm or by building a factory (KTM 2005). This was also the most common solution among the interviewed Finnish firms.

The Finnish food firms who had already operated in the Russian markets or those who had business transactions in progress had quite a clear view about the useful concepts in the Russian markets.

1. High-quality product. It is perhaps evident that the competitiveness of the Finnish food sector in bulk products is not the best possible due to the high cost structure. Thus, Finnish food producers have concentrated on high-quality products in the Russian food markets. Finnish producers estimate that the importance of high-quality products will become

increasingly crucial when the supply of private-label products increases in the Russian food markets.

2. Right attitude. Business is still highly dependent on personal relations in Russia. In big business transactions personal relations and the right attitude are crucial when pursuing a successful result. It was pointed out several times in the interviews that the Finnish business actors have an advantage in personal relations, because their manners and attitude are without arrogance. Moreover, Finnish firms have had longer experience in operating in the Russian markets and they know the Russian culture better than most of the competitors. Finnish firms also rely on their own knowledge, while foreign competitors use more consultants.

3. Local partners. In the interviews conducted for this study it was warmly suggested that Finnish food companies should pay special attention in choosing a good local partner. For example, Russia's market access system is complex and storage and delivery systems are highly underdeveloped compared to the corresponding systems in Finland. A local partner knows local practices and Finnish food firms can concentrate on other issues. The Finnish firms considered that the improvement of delivery systems will be one of the most important challenges in the near future.

4. Access to shelves in retail chains. The importance of the retail sector and retail chains in general has already been mentioned in this study. Those producers who have strong brands had a clear view that the strengthening position of retail chains is a positive development, and it has enabled growth in their sales. Retail chains operate in a similar way as in the Western countries and they have professional behaviour in all business transactions.

5. Remember the law and good customs. The Finnish food firms had only some experiences of the corruption in Russia. According to the interviewed experts, the probability of corruptions decreases if the law is obeyed and good practices are followed.

Interestingly, corruption and the shadow economy were not seen as big obstacles in the Russian food business. In fact, most of the interviewed firms had not faced such problems, but they had discovered presence of the shadow economy. Those firms with a long presence in the Russian markets mentioned that they had faced problems with bureaucracy, but they were not insuperable. However, the Finnish food firms had quite optimistic opinions about the Russian business culture and about the general functioning environment.

## ***Conclusions***

### **Finland's FDI stock in Russia is low**

Russia has great economic potential, but it has not succeeded in attracting much foreign direct investment (FDI). The low level of FDI in Russia does not arise from direct formal restrictions but more from institutional factors. Finland's outward FDI stock in Russia was 1075 million euros in 2005, which was only 1,6% of Finland's total outward FDI stock. According to various expert sources, the total sum of Finnish firms' foreign investments into Russia is considerably higher when including the Finnish companies' foreign subsidiaries.

### **The Finnish food industry has not yet invested much in Russia**

The FDI stock of the Finnish food industries in Russia was € 61 million in 2005, which was only of a fraction on total FDI. However, the Finnish food companies interviewed for this study confirmed that almost all firms had plans to invest or expand investments into the Russian markets.

### **Russia is an attractive market for the Finnish food firms**

Finnish food firms found investing in local production to be the most important strategy for increasing market share in the Russian food sector. Russia's consumers are increasingly favouring locally-produced food products over foreign products. Lower costs, growing market prospects and good profits were also seen as an advantage. The Finnish food firms with long experience in the Russian markets had quite a clear view of the keys to success in the Russian markets: High-quality products, well selected local partners, and good relations with the retail sector.

### **Challenges are also faced in the Russian food markets**

The firms seemed to have a rather diverse picture of the Russian investment climate. Those firms with little experience had more negative attitudes towards the Russia food markets. The main obstacles leading to the negative investing decisions were: mature markets with no room for new players, owners' opposition, a lack of raw materials, and the small size of Finnish food firms. For some of the food firms Russia had only limited importance for their business.



#### 4. MARKET ACCESS AND TRADE POLICY IN RUSSIA

Russia is the EU's fifth biggest trading partner, while the EU is Russia's main trading partner, accounting for 40% of its total trade. Several actions have been taken to improve economic relationships between the European Union and the Russian Federation. EU-Russian trade has been rapidly growing, and this trend continued after the EU enlargement, as they have become direct neighbours. EU enlargement had also had indirect effects on Finland. The double customs tariffs imposed on Estonia by Russia in 1995 hindered the development of Estonian-Russian economic relations, but after the EU enlargement double customs tariffs were abolished. Thus, terms of trade with Russia will be similar for agro-food exporters from Finland and the Baltic countries.

The EU and Russia signed a Partnership and Co-operation agreement (PCA) in 1994 which came into force in 1997. The PCA governs political, economic and cultural relations between the EU and Russia. Russia is entitled to Most-Favoured-Nation (MFN) status and does not meet quantitative limitations in exports except for steel product exports. The PCA agreement was extended to also cover the ten new EU member countries from May 2004. The EU enlargement has enhanced Russia's position in the new EU markets by simplifying market access regulations (European Commission 2004a). In 1999 the EU published a "Common strategy on Russia" that described the vision of a closer relationship between the EU and Russia. It also included the objective of forming a Common Economic Area (EEA). Russia seemed to support idea of the EEA as a long-term objective (Hamilton 2003).

At the St Petersburg Summit of May 2003, Russia and the European Union agreed to work together towards the creation of the Common Economic Space. The aim of this project is to make the EU and Russian economies more compatible to increase investment and trade. The ultimate objective is an integrated market between the EU and Russia. This can be achieved through regulatory convergence, which does not necessarily imply the harmonization of Russian norms and standards with the EU *acquis*. Regulatory convergence also includes cooperation on the environment. The bilateral agreement on Russia's terms of accession to the WTO, which was concluded in spring 2004, is also an important milestone in EU-Russian economic relations. Energy cooperation and cooperation on the environment fall within the common economic space. On this latter point, the EU warmly welcomed Russia's ratification of the Kyoto Protocol in November 2004 as a major step forward. Another mechanism is the development of pan-European networks of transport (e.g. motorways; rail links), energy (e.g. pipelines; links between electricity grids) and telecommunications. The EU-Russia Energy Dialogue feeds into the development of the Common Economic Space (The European Commission's Delegation 2005).

Despite the development in the Russian-EU relationship, the road to the Russian market is still tortuous. For example, Russia banned the import of animals originating from all the EU

member states in summer 2004. Russia requires exporters from the new EU member states to obtain individual inspection certificates from Russia's veterinary service. Moreover, Russia requires Russian inspection for sanitary and phytosanitary measures, and they do not recognise sanitary and phytosanitary expertise from the new EU member states (Purju 2004).

#### **4.1. *Current trade restrictions and custom procedures***

The Russian agrarian trade policy has been defined by three major factors during past few years. All the factors have led to more protectionist trade policy. First, after the Russian crisis in 1998, the Russian agro-food sector enjoyed a short-term advantage when the rouble was devaluated. However, import substitution is relatively short-term mechanism. The second factor driving protectionism in Russia was the WTO negotiations. Russia applied membership of the WTO, and import restrictions probably served that purpose. This is a kind of a paradox, because at the moment of entering the WTO a member country needs to reduce the agricultural support level. Therefore, Russia was aiming to increase the existing support level to have the opportunity to decrease it later when WTO membership takes place. Third, the budget ability for domestic support is limited. It is difficult to increase domestic support, but by raising import tariffs and introducing new quotas this can be done free of the budget (Serova 2004).

Restrictions on market access (e.g. tariffs, quotas, food safety inspections) have strong impacts on Russian agricultural production and trade. Before 2003, the only agricultural product on which Russia imposed an import quota was sugar. In spring 2003, however, Russia created tariff rate quotas for meat imports (Liefert et al. 2003). Quotas are also planned for dairy products. These actions may have direct effects on Finnish dairy and meat exports to Russia. Consolidation of food safety and inspection services in regulatory reform create obstacles in Russian trade. Changes in the governance of food safety and inspection services have complicated export procedures. Moreover, the Russian government is developing new regulations that would be in accordance with the General Law on Technical Regulations of 2003. The aim of the reform is to move away from strict and detailed standards to the concept of producer responsibility for food safety (USDA 2005).

Table 9 describes MFN<sup>4</sup> import tariff rates of agricultural and food products. The scale of tariffs varies from 5% to 25%, which is to say that the level of import duties is relatively low. However, sub-categories within the main tariff categories may include different rates. Not only tariff rates may change but custom procedures may be not automatically the same. Value-added tax is added to import tariffs. VAT is normally 18%, and it is levied on imports at the point of entry. For some food products the VAT rate is only 10%. Substantial excise

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<sup>4</sup> MFN = Most Favoured Nation

duties are also levied on imported alcoholic beverages. This tax can be even 200% (USDA 2004).

**Table 9.** *Import tariff rates for some agricultural and food products.*

	<b>Import tariff rate</b>	<b>VAT</b>
Poultry	25%, but not less than 0.2 €/kg	10-18%
Beef/veal	15%, but not less than 0.2 €/kg	10-18%
Pork	15%, but not less than 0.2 €/kg	10-18%
Offals	15%, but not less than 0.2 €/kg	10 %
Dairy products	15%, but not less than 0.18 - 0.30 €/kg	10 %
Fish and Seafood	10 %	10-18%
Fresh fruit, deciduous	Apples: 0.1-0.2 €/kg depending on season. Pears: 10%	18 %
Dried fruits and nuts	15 %	18 %
Coffee, te and spices	5-20 %, but not less than 0.03 €/kg	18 %
Canned fruits and vegetables	5-15%	10 %
Fruit juices/concentrates	5-15%	10 %
Grains	5%, rice: 10%, but not less than 0.06-0.15 €/kg	10 %
Wheat flour, starch, malt, grain, preps, gluten	10%, but not less than 0.03 €/kg	10 %
Oilseeds and oilseed products	5 %	10 %
Protein isolates and concentrates	10-20%	10 %
Hops	5 %	18 %
Convenience foods	10-20%	18 %
Sugar and confectionery products (not including cocoa)	5 %	18%, 10% (sugar and fructose)
Cocoa and cocoa products	5-10%	18%, 10% (cocoa butter and fat)
Pasta and baked products	15%, but not less than 0.06-0.15 €/kg	18%, 10% (pasta products)
Snack foods	5-15%	
Instant soup, ice cream, baby food, food ingredients	10-20%	18%, 10% (sauces, ketchups, coups, bullions, food mixes)
Alcoholic beverages	15-20%, but not less tahn 2 €/liter	18 %
Pet food	20 %	18 %
Animal feed	5-20%, but not less than 0.16 €/kg	10%, 18% (pet food packed for retail)

Source: USDA.

Russia created tariff rate quotas for meat imports in spring 2003. The aim of the import restrictions was to reduce the quantity of foreign meat coming into Russian market. Import quotas for poultry meat are considerably higher than for beef and pig meat. The Russian Economic Development and Trade Ministry has announced that 149 companies are allowed to import 951 tonnes of frozen beef, 185 companies to import 2 000 tonnes of pig meat, and 129 companies to import 1 200 tonnes of poultry meat. The rest of the remaining quotas have already been divided between three companies; 85% of total meat imports must be

divided among traders based on historical trading activity and 15% are set by auction. The overall quotas and estimated imports for 2005 are presented in Table 12. The table shows that quotas represent a significant part of total meat imports to Russia (USDA 2003). In-quota duties for meat are commonly approximately 15%, while out-of-quota tariffs rates range from 60-80% (Agri Food Trade Service 2005).

**Table 12.** *Russia's meat quotas and estimated meat imports for 2005 (1 000 kg).*

1 000 kg	Import quotas	Total imports	Quotas share of total import
Frozen beef	430 000		
Fresh and chilled beef	27 500		
Total beef	457 500	696 229	66 %
Pig meat	467 000	562 953	83 %
Poultry meat	1 090 000	1 318 157	83 %
Total	2 014 500	2 577 339	78 %

Source: Comtrade, East Europe.

Russia's market access system can be simply characterised by the following idea: Russia's tariffs are relatively low and applied tariffs are clearly below the official tariffs, but custom procedures may be long and unpredictable and do constitute a significant import barrier (Stern 2002). In fact, complicated custom methods and changing interpretation of customs rules are the most difficult problems in trade with Russia. According to the interviewed Finnish food companies, the unpredictability of the Russian custom procedures is nowadays the biggest problem in the market access system. The import duties were not considered very high, but there were some exceptions in certain sensitive products.

Food export to Russia can be a bureaucratic and time-consuming process. In fact, in most cases an experienced Russian importer or a freight-forwarder is a useful partner. The process includes two main steps: firstly safety, phytosanitary and veterinary clearance, and secondly, customs clearance. An exporter to Russia needs at least the following documents:

- Delivery contract
- Bill of lading
- Freight customs declaration
- Certificate of origin
- Hygiene or veterinary certificates
- Manufacturer's certificate of quality.

All food products imported, produced or sold in Russia are controlled by a set of sanitary epidemiological rules and regulations termed "Hygienic Requirements for the Safety and Nutrition of Foodstuffs". Russian labelling regulations have undergone several changes in recent years. Russia has detailed instructions for food imports for separate food products

(USDA 2004). Moreover, meat export to Russia requires special certificates. In fact, an importer must go through a number of steps before obtaining permission to import.

Customs clearance is undertaken at the customs office designated for the importer. Goods must be under seal to the clearance point. Customs fees are levied for customs clearance of the commodity. Import duties for foodstuffs depend on the contract value. Duties may also vary within a tariff category, and tariff levels and customs procedures do not necessarily remain unchanged. When exporting goods to Russia, it is worth becoming familiar with the Russian tax system, which consists of various parts:

- Import duties vary between products, but they commonly range from 5-30%.
- Value-added tax is 18%, and it is levied on imports at the point of entry. For some food products the VAT rate is only 10%.
- Customs clearance charges add up to about 1.25%. (The wholesale mark-up is typically 12-15%, while the retail mark-up can be 35% or more.)
- A profit tax is assessed at 39% of the gross margin.
- Excise duties are levied on imported alcoholic beverages.

Customs payments are also paid for imported food products. The payments can be divided into four groups: 1) 0.1% of the customs cost of the product in roubles, 2) 0.05% of the customs cost of the product in a foreign currency, 3) customs duty and 4) value added tax, which is calculated based on customs costs plus customs duty (USDA 2005).

All foods and beverages imported to Russia need a Certificate of Conformity from a laboratory, which is accredited by the Federal Agency for Technical Regulation and Metrology (FATR). The certificate is received after test samples have been tested in selected laboratories and the products meet Russian food safety standards. Certificates are valid for three years, but they must be presented to custom authorities upon every shipment (General Merchandise Trade 2005). The State Standards Committee (Gosstandart) is responsible for the certification of goods in Russia. It is worth noting that full certification according to standards set by Gosstandart is mandatory for all imported products. Hygiene certificate is also required for all food products, additives and preservatives (USDA 2004). Import licenses are required for certain products for health, safety and national security reasons. Such goods also include medicines, pharmaceuticals and liquors (Agri Food Trade Service 2005).

The process for importing meat or meat products includes two main steps. Safety, phytosanitary, and veterinary clearance are first required, followed by customs clearance (USDA 2005). The quota volume is first distributed through a licensing system based on the historical volume of imports. In other words, importers that were active during 2000-2002 received a share of the TRQ. However, the entire TRQ was not distributed between importers based on "historical" market shares. The remaining 10% was distributed by using a Dutch auctioning system. Firms that have officially registered in Russia may take part in the auction (USDA 2003).

After the quota volume is decided the importer obtains permission from veterinary authorities at local, regional, and central levels. After the shipment has arrived, the importer needs to present to customs documentation that duties and taxes have been deposited. Furthermore, normal documents mentioned above need to be shown (USDA 2005).

According to a study (Suomenlahden kasvukolmio 2002), Finnish food firms encounter several problems in food exporting. The most typical problems are:

- 1) Customs procedures;
- 2) Other market access problems such as certification, technical orders, distorting taxation, public purchases and human capital rights; and
- 3) Customs duties and tariffs.

According to the interviewed Finnish food firms, lack of transparency in the customs system is a problem for Finnish exporters, but the general slowness, changing legislation, changing interpretation of laws and sudden specific orders are among the most important problems in Russian trade. Furthermore, protection of human capital is not on a sufficient level in Russia. Pirated products are sold in market places, and the legal process in the Russian court of justice may take a long time. Certification is required for a wider sort of products. This process is slow and it causes extra costs. Cultural differences and instability of the Russian economy have also caused problems for Finnish companies in Russian trade.

In the interviewees conducted for this study, the Finnish food companies considered the Russian market access system complicated. However, they also pointed out that the complicity of import restrictions of other markets is commonly underestimated. If the customs documents are completed with care, the Russian border is crossed smoothly without problems. Some of the food companies also had some external (local) partners, which helped with the customs operations. The Finnish food companies also had quite an optimistic opinion about the future development in the Russian custom system and several positive issues were already recognised in the customs procedures.

The Finnish interviewees found that it is very difficult to predict the future development of Russian trade policy, because political connections with the elite that govern trade policy issues are common in Russia. Therefore, there is no single consistent trade policy strategy in Russia, but rather several different strategies. Despite this unpredictability, the interviewees considered it unlikely that food imports will be considerably restricted in the future for to several reasons. First, the food industry is not a strategic sector for the Russian government, and thus the relatively liberal import policy will continue. Second, the growing and more powerful retail sector is purchasing more foreign products. Third, both high-quality and less expensive imported products are increasingly demanded by consumers.

#### **4.2. *Russia's accession to the WTO***

Russia is the only economically significant country that is still outside the World Trade Organisation (WTO), but this is likely to change soon. Russia has finalised almost all bilateral negotiations with the WTO members (bilateral negotiations are still open with Costa Rica, Moldova and Georgia). Thus, Russia's membership in the WTO is close. Russia's WTO accession is expected to enhance openness, transparency and predictability in Russia. As a result of the accession, Russia could harmonise its domestic legislation and practices would be in accordance and comparable with its major trading partners. WTO accession would also remove the main obstacles to Russia's exports to WTO members. For example, WTO members constituted approximately 80% of Russia's total exports in 2002, while WTO members export 95% of their total exports to other WTO member countries (Lissovolik & Lissovolik 2006).

Russia liberalised its international trade as a result of an IMF stabilisation program in the early 1990s. Thus, no major changes were needed in all sectors to meet the WTO obligations. For example, the effective tariff rate in the late 1990s was around 10%, excluding some exceptions and pervasive non-collection. However, the structure of foreign trade regulations is very complex, including ad valorem and specific tariffs, licensing requirements and qualitative restrictions. The tariff system was reformed in early 2001 and commodities were classified into four major subgroups: raw materials, semi-finished goods, food stuffs and finished products. As a result of the reform, the average tariff rate was lowered from 11.4% to 10.7%, excluding some exemptions (e.g. spirits 100%, cigarettes 30% and sugar 30%) (Chowdhury 2003).

The WTO accession negotiation process is long. The accession agenda covers various issues such as agriculture, intellectual property, services, standards and certifications, investment, government procurement, and state trading. A working party (WP) consisting of representatives of interested GATT countries, formed in 1993, had a mandate to negotiate the requirements for Russia's participation in the WTO and to study the trade regime in Russia. Russia has negotiated with all the interested members of the WP about the terms of WTO membership (Chowdhury 2003). Russia first applied for WTO membership in 1993, although active negotiations and discussions started only a few years ago after President Putin declared that WTO accession was one of the goals of his presidency. Russia submitted its first market access offer in February 1998, and in spring 2002 the working party completed its report (World Bank 2002).

Russia's accession to the WTO had some unusual features. When Russia applied for WTO membership, its economic structure was different from the market economies. In fact, it did not have such sectors as a service sector, and many important regulations had not been legislated. Ten years later, Russia's legislation system is still incomplete. This had

implications for the accession process, because Russia was unable to submit all the necessary information about regulations. Russia's WTO membership will take place after the Uruguay Round, and therefore Russia will have to accept more obligations than older member countries (Yudaeva 2003c).

Russia's negotiations about bilateral agreements with all interested WTO members are still under way. This is a part of the WTO accession process. Russia concluded bilateral market access negotiations with the EU for the accession of the Russian Federation to the WTO in May 2004. The aim of the bilateral deal is to set commitments that the Russian Federation will apply in goods and services once Russia accedes to the WTO. According to the agreement, Russia's average tariff level will not exceed 7.6% for industrial products, 11% for fishery products and 13% for agricultural products. For fresh and frozen meat and poultry imports, 600 million tariff rate quotas are set per year. This represents approximately 15% of total EU agricultural exports to Russia (European Commission 2004a).

#### ***4.2.1. Likely changes after Russia's WTO membership***

According to preliminary estimations, WTO membership will provide Russia with several trade advantages, including access to foreign markets and the provision of non-discriminatory treatment for Russian exporters, access to the international dispute settlement mechanism, and a favourable climate for foreign investments. The WTO might be an excellent base for growth in the quality and competitiveness of domestic production due to the growing import of foreign goods, services and investments. Russia would also obtain a better opportunity to invest in other WTO member countries (Chowdhury 2003).

The importance of foreign trade has increased in the Russian economy; exports form a growing and significant part of the gross domestic product. WTO membership would benefit Russia by opening new markets for exporters and it would also help anti-dumping actions which are set against Russian products. The Russian Ministry of Foreign Trade assumed that around 120 antidumping actions were in place in year 2003, which would cost approximately US \$ 4 billion for Russia a year. WTO membership will also imply changes in Russia's domestic market, because domestic competition is severely restricted in certain areas and across regions (Chowdhury 2003).

Since WTO accession presumes some significant changes, it raised some concerns regarding the general benefits of accession in Russia. First, benefits and prospects of free trade are perhaps ambiguous after the failures in Cancun and Seattle. Second, domestic opponents have argued that only limited gains from membership will be obtained, because the country already enjoys an MFN status and some countries have accorded preferential treatment to Russia under the Generalised System of Preferences (GSP). Third, benefits in exports would



not compensate concessions on imports and a possible short-term output contraction. Fourth, changes transmitted to the domestic economic and social sector are unpopular, for example liberalisation of domestic energy prices. Finally, some sector lobbies oppose WTO membership for their own interest, but ideological opposition also exists. Advocates of WTO accession have pointed to gains from the WTO membership. It is worth noting that such gains are not only related to issues like lower tariff levels, but WTO membership enables access to the dispute settlement body of the WTO and to other relevant decision mechanisms. For example, Russia's outsider status does not automatically provide MFN status (Lissovolik & Lissovolik 2006).

WTO membership has been seen as a threat to some parts of the Russian economy. However, a more thorough analysis of these threats shows that the myths are not necessarily true. The current Russian tariff system does not protect Russia from foreign competition. In fact, Russia already applies relatively low tariff rates, which provides very little protection for domestic production. Therefore, WTO accession will not reduce tariffs dramatically; in fact, they may even increase in some products categories. Moreover, the government still has some means to protect domestic producers, because WTO members have a right to use temporary tariff raises and some other actions if they are economically justified. According to several studies, the openness of the economy has a positive influence on economic growth, although it may have some short-term negative effects. In fact, rejecting WTO membership may produce economic and social losses, due to inefficient enterprises not being pushed into necessary reconstructions (Cefir 2001). An examination shows that WTO accession has resulted on average in a \$ 4 billion increase in FDI from developed to developing countries. Thus, Russia could improve its FDI to GDP ratio by accepting WTO membership (Yudaeva 2003a).

Several studies have tried to empirically estimate the economic implications for the Russian economy. The results suggest that WTO membership would have several implications for the domestic economy. The results can be summarised as follows. First, the current tariff rate in Russia is already low, indicating no major changes for the economy. However, a decrease in non-tariff barriers would have a positive impact. Second, reconstruction of the service sector would generate positive externalities. Third, gains and losses in economic life would be divided in the following way: natural resource extracting sectors and producers of metals and chemicals are likely to benefit from WTO membership, while the labour-intensive sectors, such as food, light and machine building industries would be losers in the accession (Chowdhury 2003). Fourth, WTO accession will have a significant effect on Russian imports from non-CIS countries, both in the volume and composition of imports. Fifth, reforms in Russian institutions would increase Russia's trade volume (Yudaeva 2003b).

The Finnish interviewees estimated that Russia is not well prepared for the WTO membership. In fact, there was no consistent discussion about the possible gains and losses

of WTO accession. The opinion of the Finnish interviewed actors in general seemed to be that Russia's WTO accession will have no major implications for Russia's trade policy. The main advantages of WTO accession are that the predictability of the trade policy may improve and import duties will decrease by some percentage units. However, implementation of the laws may be incomplete and general benefits may only be seen in the longer term. Interestingly, most of the interviewees estimated that WTO accession will probably have some positive effects, but the Finnish firms relied more on their own knowledge, for example concerning market access operations, than on the WTO agreement. The Finnish interviewees expect that no major changes will occur, even if WTO accession does take place. Russia will still remain Russia.

### ***Agricultural sector***

Unlike in the EU, the US and in Japan, Russia's agricultural sector does not offer a strong protection for its farmers. Agricultural subsidies are relatively modest in Russia, and agricultural tariff rates are lower than average tariffs in the WTO. Thus, WTO membership would not indicate any dramatic change in protection in the agricultural sector. Moreover, the long distances in Russia do protect the agricultural sector rather effectively: transportation costs from Europe increase even by several dozen percentage points the prices of imports when products are transported to most Russian areas (Cefir 2001).

Interregional barriers in agricultural trade across Russia complicated Russia's WTO accession. The decentralized policy decision structure in Russia's regions was a one of the key concern in Russia's WTO accession. As a result of decentralisation of the federal government in the early 1990s, regions have restricted agricultural inflows and outflows. In fact, Russian regional authorities have applied a wide range of trade barriers to the Russian agricultural market. Controversy over federal and regional macroeconomic policies is impeding the formation of the Russian market, and it may result in regional authorities not following agreements made by the federal government. Russian regions apply a number of regulatory measures and directly intervene in interregional trade economic relations, which is inconsistent with the provisions of the GATT and WTO Agreement of Agriculture. Moreover, barriers result in negative economic consequences such as high prices, reduced output and diminished product and service quality (Zadorozhniy 2002).

In the GATT Uruguay Round in 1994 agriculture was for the very first time taken into the GATT tariff reduction process. The Agreement on Agriculture is based on three main pillars: markets access, domestic support and export competition. All these elements include important issues for Russia. It seems that Russia insisted on higher levels of binding import tariffs, and it was also pursuing the right to introduce export subsidies. Russia also pursued to bind the domestic support at a significant level.

*Domestic Support.* When the Agreement on Agriculture was signed, the common base period for the participants was 1986-1989. That is to say, this was the base period for the percentage reduction in subsidisation that was adopted in the six following marketing years from 1995. For Russia the applied base period has a great deal of importance, because 1986-1989 was the period with the highest support provided to Russian agriculture. At the beginning of the 1990, by contrast, Russia's agricultural subsidisation was at the lowest level. The base period for subsidisation was one of the critical subjects in the negotiations. Russia was pursuing to keep the domestic support at \$ 9 billion, but the consolidated budget of the Russian Federation at the beginning of the 21st century was around \$ 2 billion. In other words, Russia pursued a support level significantly higher than the current budget, but the agreed level of domestic support is on a lower level compared to other members of WTO. A credit system, insurance system, export infrastructure and consulting services are also needed in the Russian agro-food sector. All these measures belong to the so-called green box and are not under the domestic support reduction scheme. In other words, green box policy actions are favourable for Russia, and they are not subject to reduction because of the Agreement (Serova et. al 2002).

*Market Access.* Russia's bound tariffs are not exactly high compared to many other countries. In fact, Russia has one of the lowest tariff levels in the world. According to Russian trade experts, agricultural tariffs will not be reduced much, because industrial commodities tariffs will be cut relatively more. In fact, current agricultural tariffs can be lower than those which will be applied after the implementation period (Serova et al. 2002).

*Export Competition.* Russia has not applied export subsidies until now; on the contrary, it has sometimes applied export taxes. However, Russia aimed to have an opportunity to introduce export subsidies in the future. Domestic policy actions such as overrated railway tariffs, non-harmonised standards, the absence of certification agencies abroad, and export duties have actually partly impeded agri-food exports from Russia. WTO accession will require Russia to put these issues into conformity with WTO legislation. This would be an advantage to Russian food exporters (Serova et al. 2002).

Implications of WTO accession for Russia's agricultural sector are not well-known, because the estimated gains and losses vary considerably between studies. For example, Ivan Ushachev, director of the Russian Research Institute of Agricultural Economics, estimated that Russia could lose at least \$ 4 billion as a result of WTO membership. This sum exceeds Russia's consolidated budgetary expenditure on agriculture by 200%. Ushachev pointed out that the terms for WTO membership are much stricter than trade liberalisation commitments for current WTO members. Ushachev estimated that Russia's foreign trade deficit in agricultural products would grow by \$ 3.3 billion per year. Russia would also see a decline in its share of world exports from 1.3% to 1% and Russia's share of world imports would grow from 1.9% to 2.3% (East Europe 2/2005).

Lyahovich (2006) finds that agricultural sector is not sufficiently well prepared for tough international competition. The WTO-membership will hardly provide any benefit for the Russian agro-food sector. In fact, only few Russian food products have a quality certification, and thus products cannot be exported to the EU or the US markets. Only some Russian dairy and meat firms are certificated and thus having export opportunities. Ice cream, juices, certain grains, flours, sunflower oils are also potential export products. As most countries, Russia also pursues to protect domestic production and Russia is seeking more influence over trade as a member of the WTO.

The fact is that Russian agricultural markets are not yet ready for keen competition, problems lie in several places. First, Russian agricultural markets are divided to many parts and areas as a legacy from central planning, where self-sufficiency was highly appreciated. It is worth noting that agricultural trade restrictions hinder trade more at the regional as a federal level. Thus, increasing public awareness of market economy and advantages of trade in general particular inside the Russia could decrease strong regional emphasis. (Serova et al. 2002) stress that individual regions have quite an independent role in applying agrarian policy measures in their territory. This not only creates a problem for Russia's agriculture and markets, but it is also difficult to collect information from the 87 subjects of the Federation for notifications purposes for the WTO. It is also evident that some regions of Russia will lose as a result of WTO membership, and some region-donors with a strong lobbying position may oppose WTO membership by using the national concerns on food security as an argument against the WTO.

Second, infrastructures are mostly in poor conditions that seriously hinder all kind of transactions. It is worth reminding that Russia is geographically world's biggest country, transportation issues really do matter in Russia. Third, storage has traditionally been a pain an Achilles heel in Russian agricultural markets, but international (and increasing also domestic) firms have placed special emphasis to improve these systems. However, obviously upgrading and monitoring of storage standards is the responsibility of the Russian authorities. As long as transportation and storage are not sufficiently organised, agricultural sector cannot meet international standards leading problems in food exports.

The WTO membership probably drives the Russian agricultural sector to a new situation, which requires more efficiency of the existing systems. The restructuring may mean production concentration to more limited area, it may lead to resource re-allocation, and/or it may restrain significant improvements to infrastructure. These actions would increase farmers' incomes and improve competitiveness of Russian agricultural sector. Investments on agricultural research and increasing public awareness of new cultivation inputs are probably needed too. However, one should not forget the key role of money. Russian government is willing to support agriculture and rural areas with budget transfers, but these actions should not violate the WTO rules.

## ***Conclusions***

### **Russia's market access system is complicated, but the Finnish firms have adapted to a situation**

Russia's import tariff rates for agricultural and food products are relatively low, in average 15%, but customs procedures may be long and unpredictable, which constitute a significant import barrier. According to the interviewed Finnish food firms, the lack of transparency in the customs system is a problem for Finnish exporters, but the general slowness, changing legislation, changing interpretation of laws and sudden specific orders are among the most important problems in Russian trade. However, it was also pointed out that complicity of import restrictions of other markets is commonly underestimated. If the customs documents are filled in with care, the Russian border can be crossed smoothly without problems. The Finnish food companies also had quite an optimistic opinion about the future development of the Russian customs system.

### **Russia's WTO membership is a challenge for the Russian agro-food sector**

Russia's membership in the World Trade Organisation (WTO) will be take place soon. The main advantages of WTO accession are that predictability of the trade policy may improve and import duties will decrease by some percentage units. However, implementation of the laws may be incomplete and general benefits may only be seen in the longer term. The opinion of the Finnish interviewed actors is that Russia is not well prepared for the WTO membership and Russia's WTO accession will have no major implications for Russia's trade policy. Agricultural sector is not sufficiently well prepared for tough international competition. The WTO-membership will hardly provide positive prospects for the Russian agro-food sector, and policy actions are needed that farmers' incomes and competitiveness of Russian agricultural sector could be enhanced.

### **The WTO accession will not provide major changes**

Most of the interviewees estimated that Russia's WTO accession will probably have some positive effects, but the Finnish food firms relied more on their own knowledge, for example concerning market access operations, than on the WTO agreement.

## **5. CONCLUSIONS OF THE STUDY**

### **Nearly 20% of Finland's food exports go to Russia – exports will be replaced by domestic production in future**

Russia has been a significant food exports target for the Finnish food industry during the past decades. For Finnish agricultural and food exports, Russia is by far the most important destination. Approximately 20% of Finnish food exports go to Russia, and Finland's food trade balance with Russia is highly positive. The proximity of the growing and significant Russian food markets is one of the main advantages for the Finnish food industry. The structure of Finnish food trade with Russia experienced some significant changes during past ten years. Ten years ago Finland was a significant exporter of chocolate, margarine coffee, tea, cocoa and spices. As a result of the economic crisis, consumers again preferred domestic goods, because the price of imported goods was too high. After the crisis the food imports for certain products significantly reduced, and moreover, transit trade also practically ended in 1998. For example, margarine and chocolate constituted approximately 20% of the total food exports value to Russia ten years ago, but they had only a 3% share of total exports to Russia in 2004. Cheese and curd, butter and other milk derived fats, cereals and flour preparations nowadays constitute nearly two-thirds of total exports.

Russia attracts interest nowadays not only as a destination for food exports, but also as a possible target for FDI. In the interviewees conducted for this study, the Finnish food companies considered that the share of local production will increase in Russia in the future. Russian consumers seem to appreciate domestic production and this partly creates a pressure for Finnish producers towards local production. Lower costs, growing market prospects and good profits were seen as an advantage too. It is very likely that the growth of food exports to Russia will decelerate and will be replaced by local production, but according to the interviewees' local production in Russia is not a threat to Finnish farmers. First, the lack of raw material continues in the Russian agro-food sector. Second, it seems that Finnish food firms are seeking a better profit for their business in general, which is an advantage for their business in Finland as well.

### **Finnish food firms find Russian food markets challenging ...**

The Finnish food companies interviewed for this study confirmed that almost all firms had plans to invest or expand investments into Russian markets. However, the firms seemed to have rather diverse picture of the Russian investment climate. Those firms with little experience had more negative attitudes towards the Russia food markets. There were some main obstacles behind the negative investment decisions. As a result of a boom in foreign capital inflow into the food markets, there is little room for new actors in certain business lines. Some of the interviewed food firms assumed that penetration of the Russian mature

markets is simply too expensive and too risky for small Finnish food firms. Views on the importance of Russian food markets were not consistent inside the Finnish food firms. In some of the firms, both owners and managers had a very similar idea about the great potential of the Russian food markets, but this was not the case in all firms. Managers seemed to be more eager for local production, while owners were risk-averse. Some of the Finnish firms estimated that Russia had only limited importance for their business. The lack of domestic raw materials was also raised in almost all the interviews conducted for this study when the possibility of local production was discussed.

### **...but success can be attained with right strategy**

The opinion of the Finnish food industry in general seems to be that Russia is the most important or one of the most important export markets for their companies. Finnish food firms found investing in local production to be the most important strategy for increasing market share in the Russian food sector. Russia's consumers are increasingly favouring locally-produced food products over foreign products. Investments in local production would help Finnish food producers to cut production costs and shorten the distribution chain.

The Finnish food firms who had already operated in the Russian markets or those who had business transactions in progress had quite a clear view about the useful concepts in the Russian markets. Finnish food producers have concentrated on high-quality products in the Russian food markets. Finnish producers estimate that the importance of high-quality products will become increasingly crucial when the supply of private-label products increases in the Russian food markets. It was also pointed out Business is still highly dependent on personal relations in Russia. In big business transactions personal relations and the right attitude are crucial when pursuing a successful result. It was warmly suggested that Finnish food companies should pay special attention in choosing a good local partner. A local partner knows local practices and Finnish food firms can concentrate on other issues. A special emphasis was also placed to retail chain. The interviewed food actors mentioned that their Russian sales had grown by dozens of per cent once their products had been accepted on the store shelves of big retail chains. The Finnish food firms had only some experiences of the corruption in Russia. According to the interviewed experts, the probability of corruptions decreases if the law is obeyed and good practices are followed.

### **Russia's custom duties are relatively low, but custom bureaucracy is time-consuming**

Russian agrarian trade policy has been characterised by growing protectionism during past couple of years. The aim of certain import restrictions was to reduce the amount of foreign food coming into the Russian market, in an attempt to improve domestic production and move towards a greater self-sufficiency rating. However, there is no one consistent trade

policy strategy in Russia, but rather several different strategies. In fact, it seems unlikely that food imports will be considerably restricted in the future. First, the food industry is not considered as a strategic sector for the Russian government, and thus foreign actors have a relatively free forum to operate in the Russian food markets. Second, the growing and powerful retail sector partly owned by foreign firms simply purchases foreign food products. Third, Russia is not self-sufficient in certain food products, and certain high-quality foreign food products are demanded by more wealthy consumers.

Russia's market access system is commonly described a complicated process. The system can be simply characterised by the following idea: Russia's tariffs are relatively low and applied tariffs are clearly below the official tariffs; import tariff rates are in average 15%. However, customs procedures may be long and unpredictable, constituting a significant import barrier. According to the interviewed Finnish food companies, the unpredictability of Russian customs procedures and time-consuming bureaucracy are nowadays the biggest problems in the market access system. However, they also pointed out that the complicity of import restrictions of other markets is commonly underestimated. If the custom documents are filled with care, the Russian border is crossed smoothly without problems. The import duties were not considered very high, but there were some exceptions with certain sensitive products.

### **Russia's WTO accession will not provide big changes in the short run**

Russia is the only economically significant country that is still outside the World Trade Organisation (WTO), but this is likely to change soon. Russia's WTO accession is expected to enhance openness, transparency and predictability in Russian trade policy. However, it is assumed that Russia is not very well prepared for the WTO membership and future implications of membership are partly unknown. It seems that agricultural sector is not sufficiently well prepared for tough international competition. The WTO-membership will hardly provide positive prospects for the Russian agro-food sector, and policy actions are needed that farmers' incomes and competitiveness of Russian agricultural sector could be improved.

Most of the interviewees estimated that WTO accession will probably have some positive effects, but the Finnish firms relied more on their own knowledge, for example concerning market access operations, than on the WTO agreement. The main advantages of WTO accession are that the predictability of the trade policy may improve and import duties will decrease by some percentage units. However, implementation of the laws may be incomplete and general benefits will probably only be seen in the longer term.



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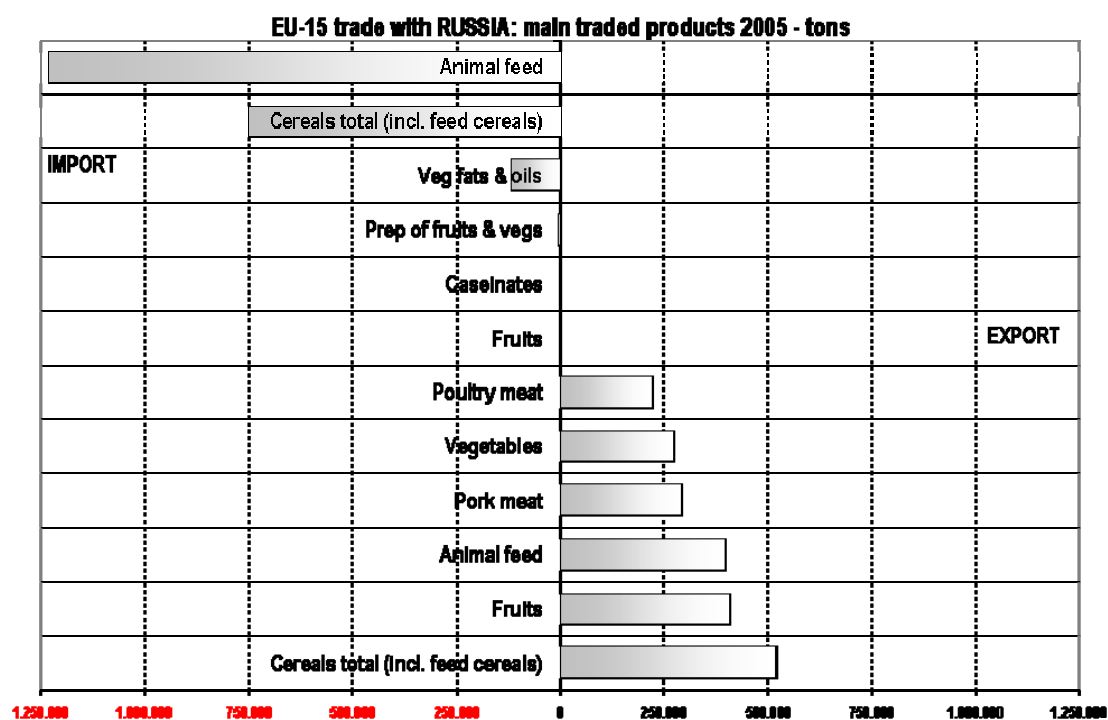
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### ***Annex 1. List of the interviewed experts for the study:***

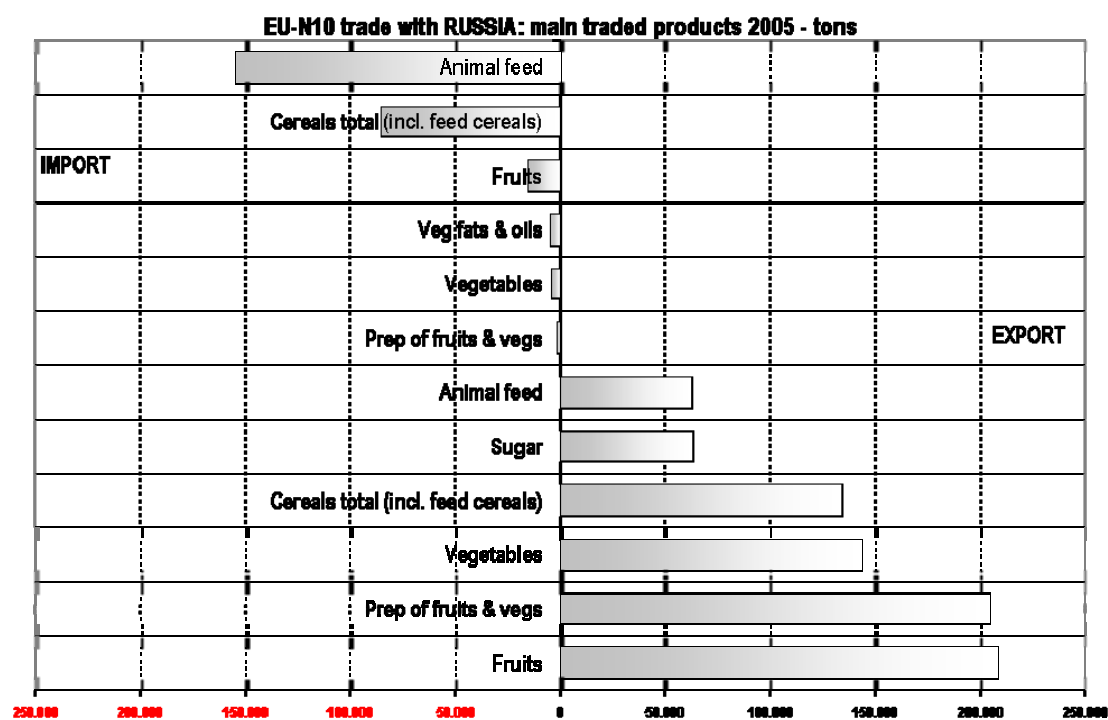
Commercial Counsellor Johanna Ala-Nikkola	Ministry for Foreign Affairs
Director General Kirsti Eskelinen	Ministry for Foreign Affairs
Export Manager Pasi Heikkilä	Maltax
Second Secretary Antti Helanterä	Embassy of Finland, Moscow
Managing Director Erkki Isokangas	Saarioinen
Director Juha Karimaa	Fazer
Chief Executive Officer Matti Lappalainen	Vaasan & Vaasan
Director Antti Latva-Rasku	Suomen Rehu
Director Erkki Lepistö	Lännen Tehtaat
First Secretary Marja Liivala	Ministry for Foreign Affairs
Executive Vice President Olavi Kuusela	Raisio
Consultant Dmitry Makolkin	Finpro
Senior Vice President Veijo Meriläinen	Valio
Chief Executive Officer Seppo Paatelainen	Atria
Chief Executive Officer Simo Palokangas	HK Ruokatalo
Chairman of the Board Bertel Paulig	Paulig
Director Petri Salo	Ministry for Foreign Affairs
President and CEO Director Harry Salonaho	Valio
Managing Director Kai Seikku	HK Ruokatalo
Market Analyst Seija Spiridovitsch	Finnpro
Managing Director Kari Tillanen	JärviSuomenPortti
Managing Director Kaija Viljanen	Avena Nordic Grain

**Annex 2. The EU-15's agro-food trade with Russia (tons).**



Source: European Commission.

**Annex 3. The EU-10's agro-food trade with Russia (tons).**



Source: European Commission.

**Annex 4. Structure of the Finland's food exports to Russia in 2004 and in 2005.**

	<b>2004</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>
	1 000 €	1 000 €	Share %	Share %
Live Animals	133	231	0.1	0.1
Meat and meat preparations	12 004	18 932	7.3	10.8
Dairy products and birds' eggs	78 972	92 521	48.3	52.8
Fish and fish preparations	4 697	6 407	2.9	3.7
Cereals and cereal preparations	37 046	27 721	22.7	15.8
Vegetables and fruit	1 418	1 323	0.9	0.8
Sugar, sugar preparations	3 987	1 751	2.4	1.0
Coffee, tea, cocoa, spices	4 622	4 325	2.8	2.5
Feedstuff	9 536	13 969	5.8	8.0
Miscellaneous products	11 005	8 045	6.7	4.6
<b>Total</b>	<b>163 420</b>	<b>175 225</b>	<b>100</b>	<b>100</b>

Source: Finnish Customs.

**Annex 5. Structure of the Finland's food imports from Russia in 2003.**

	<b>2004</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>
	1 000 €	1 000 €	Share %	Share %
Live Animals	40	50	0.4	0.6
Meat and meat preparations	0	0	0.0	0.0
Dairy products and birds' eggs	0	6	0.0	0.1
Fish and fish preparations	463	231	4.2	2.6
Cereals and cereal preparations	144	181	1.3	2.1
Vegetables and fruit	9 799	7 483	87.9	85.8
Sugar, sugar preparations	0	1	0.0	0.0
Coffee, tea, cocoa, spices	1	4	0.0	0.0
Feedstuff	232	688	2.1	7.9
Miscellaneous products	469	78	4.2	0.9
<b>Yhteensä</b>	<b>11 148</b>	<b>8 722</b>	<b>100</b>	<b>100</b>

Source: Finnish Customs.

**Annex 6. Leningrad District and the most important cities in that area**



Regions	Population	Area
1. St. Petersburg City	4 669 400	2 000
2. Leningrad Region	1 671 100	83 900
3. Arkhangelsk *	* 1 335 700	* 587 400
4. Vologda	1 270 000	145 700
5. Komi	1 019 000	415 900
6. Kaliningrad	955 200	15 100
7. Murmansk	893 300	144 900
8. Pskov	760 900	55 300
9. Karelia	716 700	172 400
10. Novgorod	694 700	55 300
11. Nenets District	41 500	176 700

**Annex 7. Central district and the most important cities in that area**



Regions	Population	Area (sq.km)
1. Moscow City	10 357 800	1 000
2. Moscow Region	6 627 000	47 000
3. Voronezh	2 379 000	52 400
4. Tula	1 675 700	25 700
5. Vladimir	1 524 900	29 000
6. Belgorod	1 512 400	27 100
7. Tver	1 472 600	84 100
8. Bryansk	1 378 900	34 900
9. Yaroslavl	1 367 700	36 400
10. Kursk	1 235 600	29 800
11. Ryazan	1 228 000	39 600
12. Lipetsk	1 213 400	24 100
13. Tambov	1 179 600	34 300
14. Ivanovo	1 148 900	21 800
15. Smolensk	1 050 500	49 800
16. Kaluga	1 040 900	29 900
17. Oryol	860 600	24 700
18. Kostroma	737 500	60 100

**Annex 8. St Petersburg's foreign trade in 2000-2004, USD million.**

	2001	2002	2003	2004
Foreign trade turnover	5 872	6 617	8 542	10 908
Exports from St Petersburg	1 911	1 739	2 747	3 993
Imports to St Petersburg	2 487	4 877	5 795	6 916
Trade balance	-2 050	-3 138	-3 048	-2 923

Source: Petrostat.

**Annex 9. Foreign investment to Leningrad Province in 2000-2004, USD million.**

	2000	2001	2002	2003	2004
Total volume	306	327	148	240	161
Foreign direct investments	206	238	115	118	133
Other investments	100	89	33	122	28

Source: Petrostat.





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