



Hannu Kaipio – Simo Leppänen

DISTRIBUTION SYSTEMS OF
THE FOOD SECTOR IN RUSSIA:
THE PERSPECTIVE OF FINNISH FOOD INDUSTRY

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FOREWORD

This study describes the distribution systems of foodstuffs from the perspective of Finnish food producers. It discusses the strategies to enhance the access of Finnish products to the shelves of Russian stores. The study has been compiled by the Center for Markets in Transition (CEMAT) of Helsinki School of Economics. The research was conducted by Simo Leppänen and Hannu Kaipio, and supervised by project manager Piia Heliste and director Riitta Kosonen. This research is a part of a larger project, *Competition and Co-operation between Finnish and Russian Enterprises*, financed by the National Technology Agency, TEKES, and run by Lappeenranta University of Technology. The project is also part of the Finnish Academy's research programme *Russia in Flux*. The study is published in both NORDI's (The Northern Dimension Research Centre of Lappeenranta University of Technology) and CEMAT's publication series.

The study concerns food retail in Russia, which has been in a turmoil during the period of the economic transition caused by the collapse of the Soviet Union. The dismantlement of the centrally planned economic system was followed by a period of reconstruction. The trade structures, such as wholesale trade and distribution systems, had to be built from scratch. In the beginning of the 1990s, the key actors in the food retail were privatised state shops, together with open markets and kiosks. In the second half of the decade, a growing number of self-service shops started emerging. The newest stage of the development is the vigorous expansion of both Russian and foreign store chains. For the Finnish producers, the essential question is how their products can be extensively distributed through these chains. The report evaluates the access of Finnish foodstuff onto the shelves of Russian store chains by looking at the main factors affecting the development: the most important local and foreign players, the logistics chain of the food sector, procurement policy in the retail trade, segmentation of the foodstuff trade and the development of domestic content.

Lappeenranta, August 2005

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ABSTRACT

Finnish food producers' trade with Russia has went through profound changes since the collapse of the Soviet Union. Simultaneously, the distribution systems of foodstuffs have changed remarkably. Food trade in Russia after the collapse of the Soviet Union – as well as many other things – can be divided into two parts separated by the financial crisis of 1998. Previous research on this topic focuses on the period before the 1998 crisis. However, the development after the crisis has been fast and dramatic and thus a comprehensive overview of the topic is needed. This study sheds some light into these changes and analyses the current situation in distribution systems of foodstuffs in Russia. In addition, the study discusses the possibilities of Finnish food producers to get more of their products to the shelves of Russian food retail stores.

Before the 1998 financial crisis, level of imports of foreign foodstuffs was high in Russia due to strong rouble and lack of local products of good quality. However, the crisis collapsed the Russian food imports as the dramatically devaluated rouble resulted in soaring import prices. The exports of Finnish foodstuffs to Russia have been recovering in recent years, but no product category has reached its pre-crisis export level. In some product categories (e.g. margarines and other edible fats and meat products) the growth has been only marginal. It is very possible that the pre-crisis level will never be reached due to tough competition, high customs tariffs and high costs of Finnish food production. However, it has to be taken into account that increasing local production of Finnish producers in Russia shows as slower growth in export statistics. Indeed, it seems that starting local production will become increasingly important in the future for Finnish food producers operating in Russia. This is further encouraged by the fact that Russian consumers favour domestic food products. Russian consumers are very price conscious and demand quality in food products.

The majority of foodstuff retail is still conducted via unorganised forms of trade (e.g. kiosks and marketplaces) but the modern retail chains, both Russian and foreign, are developing at a fast pace in Russia. They are also expected to dominate the retail trade in foodstuffs over the unorganised forms of trade in the future. This changes also the distribution systems. The retail chains are trying to shorten the distribution chain, similarly to what has been seen in the Western countries. This, along with the strengthening of retail chains, is likely to shrink the role of the wholesalers as the chains increasingly want to work directly with the producers. Many large retail chains are acquiring or have already acquired a distribution centre or centres in order to boost efficiency and control the product flow. The strengthening of the retail chains also gives them power in negotiations, to which the producers and distributors have to adjust. For example, store entry fees and retail chains' own private label products pose challenges to the food producers.

In the food production sector the competition is fierce, as large Russian and foreign producers want to ensure their piece of the huge market. The largest international producers (e.g. Mars) are utilizing their size: they invest in big marketing campaigns and are willing to pay high entry fees to retail chains in order to secure a place on the store shelves and to build a strong brand in Russia. This complicates the situation from the viewpoint of small producers.

Smallness was one reason why many Finnish producers (e.g. meat producers) had to cut down their operations in Russia due to the 1998 crisis. Smaller producers had fewer resources to tolerate losses during the period of the crisis. Smallness is reflected also on trade negotiations with retail chains and distributors. It makes it harder to cope with the store entry fees and to differentiate from the mass of products propped up by expensive advertising. Finally, it makes it harder for Finnish producers to start or expand local production since it is more difficult for a small producer to get financing and to tolerate the increased risks. Compensating for the smallness might become the crucial factor determining the future success of Finnish food producers in the Russian market. However, those products and

producers that have a strong and well-known brand (e.g. Valio) and/or novelty product (e.g. FinnCrisp of Vaasan) or a new kind of distribution solution have a good chance of thriving in the market.

Currently, the most popular type of distribution system among the interviewed Finnish food producers is based on a network of local distributors. The producer can try to strengthen or weaken the mutual competition between its distributors depending on whether it wants to e.g. secure a uniform price level of its products or enhance the efficiency of its distributors. In addition, there is a strong consensus on the importance of starting local production in order to be a serious actor in Russia in the future. Given the relative smallness of Finnish food producers, realistic strategies for increasing their market share in Russia would be to focus geographically or segment-wise, introduce new products and cooperate with other Finnish producers. Factors that hinder the starting of local production include the lack of local infrastructure, lack of qualified staff and low risk tolerance of the Finnish firms. Major barriers for gaining market share in Russia include the actions of the authorities, fierce competition, fragmented market and Finnish producers' heavy production costs.

TIIVISTELMÄ

Suomalaisten elintarviketuottajien käymä idänkauppa on muuttunut huomattavasti Neuvostoliiton hajoamisen jälkeen. Samalla myös elintarvikkeiden vähittäiskauppa ja kaupan jakelujärjestelmät ovat muuttuneet merkittävästi. Neuvostoliiton jälkeinen aika voidaan elintarvikekaupan osalta, kuten monen muunkin asian kohdalla, jakaa kahteen ajanjaksoon, joiden vedenjakajana toimi Venäjän vuoden 1998 taluskriisi. Aikaisempi tutkimus tämän raportin teemasta keskittyy aikaan ennen 1998-kriisiä. Kriisin jälkeen kehitys on kuitenkin ollut nopea ja dramaattinen, mistä johtuen kattava katsaus viime vuosien kehitykseen on tarpeellinen. Tämän tutkimuksen tavoitteena on havainnollistaa näitä muutoksia, analysoida Venäjän elintarvikesektorin jakelujärjestelmien nykyistä tilaa ja tutkia, millä keinoin suomalaisten elintarvikkeiden pääsy venäläisten vähittäiskauppojen hyllyille voitaisiin edistää.

Ennen vuoden 1998 taluskriisiä Venäjälle tuotiin paljon elintarvikkeita ulkomailta, sillä tuonti oli edullista vahvan ruplan ja huonolaatuisen paikallistuotannon vuoksi. Taluskriisi kuitenkin romahdutti elintarvikkeiden tuonnin, kun rajusti devalvoituneen ruplan myötä tuontihyödykkeiden hinnat nousivat pilviin. Suomalaisten elintarviketuottajien vienti Venäjälle on jälleen viime vuosina kääntynyt kasvuun, mutta missään tuotekategoriassa ei edelleenkaan ole saavutettu kriisiä edeltänyttä viennin tasoa. Tiettyjen tuotekategorioiden viennissä (kuten margariineissa ja muissa elintarvikerasvoissa sekä lihatuotteissa) ei palautumista kriisistä ole juurikaan ollut havaittavissa. On hyvin mahdollista ettei kriisiä edeltänyttä tasoa tulla saavuttamaan johtuen kovasta kilpailusta, tulleista ja suomalaisen elintarviketuotannon kalleudesta. On kuitenkin otettava huomioon, että vientitilastoista jää pois lisääntynyt paikallinen tuotanto. Näyttääkin siltä, että pidemmällä tähtäimellä paikallisen tuotannon aloittaminen Venäjällä muodostuu yhä tärkeämmäksi vaihtoehdoksi suomalaisille elintarviketuottajille. Tätä kehitystä edistää venäläisten kuluttajien kotimaisia ruokatavaroita suosiva

kulutuskäyttäytyminen. Elintarvikkeiden osalta venäläiset kuluttajat ovat yleensä hintatietoisia ja vaativat laadukkaita tuotteita.

Elintarvikkeiden vähittäiskaupasta suurin osa tapahtuu Venäjällä edelleen mm. torien ja kioskien kautta, mutta nykyaikaiset vähittäiskauppakettit, sekä venäläiset että ulkomaiset, kehittyvät nopeasti ja niiden odotetaan tulevaisuudessa hallitsevan markkinoita. Tämä muuttaa myös elintarvikkeiden jakelujärjestelmiä. Vähittäiskauppakettit pyrkivät lyhentämään jakeluketjua samaan tapaan kuin länsimaissa ja työskentelemään suoraan valmistajien kanssa. Tämä kehitys yhdessä vähittäiskauppojen aseman voimistumisen kanssa tulee todennäköisesti johtamaan tukkukauppioiden roolin pienenemiseen. Useat suuret vähittäiskauppakettit hakevat tehokkuutta ja parempaa tavaravirtojen kontrollia perustamalla jakelukeskuksia. Vähittäiskauppojen voimistuminen verrattuna muihin toimijoihin antaa niille myös neuvotteluvoimaa, johon valmistajat ja jakelijat joutuvat sopeutumaan. Muun muassa kauppojen perimät hyllymaksut ja omat private label –tuotteet aiheuttavat haasteita tuottajille.

Elintarviketuotannossa kilpailu on kovaa venäläisten ja ulkomaisten valmistajien kamppaillessa markkinaosuuksista, sillä kaikki haluavat varmistaa paikkansa Venäjän valtavilla markkinoilla. Suurimmat kansainväliset valmistajat (kuten Mars) käyttävät hyväkseen kokoaan investoimalla suuriin markkinointikampanjoihin ja maksamalla korkeita maksuja vähittäiskauppakettijuille saadakseen tuotteensa myyntiin sekä rakentaakseen voimakkaan brändin Venäjällä. Tämä hankaloittaa tilannetta pienten elintarviketuottajien kannalta.

Useiden suomalaisten elintarviketuottajien pieni koko (esimerkiksi lihanjalostusalalla) olikin keskeinen syy sille, että ne joutuivat vähentämään toimintojaan Venäjällä vuoden 1998 kriisin jälkeen. Pienillä valmistajilla oli vähemmän resursseja kriisin vaikutuksista selviämiseen. Valmistajien pienuus näkyy myös neuvotteluissa vähittäiskauppakettijujen ja jakelijoiden kanssa. Kauppakettijujen vaatimat hyllymaksut ovat kovat ja erottuminen muista tuotteista,

joita suuret valmistajat tukevat laajalla mainonnalla, on vaikeaa. Pieni koko vaikeuttaa luonnollisesti myös paikallisen tuotannon aloittamista tai laajentamista, sillä pienen valmistajan on vaikeampi saada rahoitusta ja sietää lisääntyneitä riskejä. Pienuuden kompensoimisesta saattaakin tulla kriittinen tekijä suomalaisten toimijoiden menestymisen kannalta Venäjän elintarvikemarkkinoilla tulevaisuudessa. Kuitenkin tuotteet ja valmistajat, joilla on hyvä ja tunnettu brändi (kuten Valio) ja/tai uudentyypinen tuote (kuten Vaasan FinnCrisp) tai uudenlainen jakeluratkaisu pystyvät kilpailemaan isompienkin toimijoiden kanssa.

Tällä hetkellä suomalaiset elintarviketuottajat ovat yleisimmin järjestäneet jakelunsa Venäjällä usean paikallisen jakelijan muodostaman verkoston kautta. Tuottaja voi pyrkiä vahvistamaan tai heikentämään näiden jakelijoiden keskinäistä kilpailua riippuen siitä halutaanko esimerkiksi taata tuotteen hinnan yhtäläisyys vai lisätä jakelijoiden tehokkuutta. Lisäksi, elintarvikevalmistajien piirissä vallitsee yhteisymmärrys siitä, että paikallisen tuotannon aloittaminen on tärkeää, jos haluaa olla vahva toimija tulevaisuudessa Venäjän markkinoilla. Suhteellisen pienen kokonsa vuoksi useiden suomalaistuottajien kannalta realistisimpia vaihtoehtoja markkinaosuuden kasvattamiseksi olisivat keskittyminen yhteen maantieteelliseen alueeseen tai kuluttajasegmenttiin, uusien tuotteiden esittely markkinoille ja yhteistyö muiden suomalaisten valmistajien kanssa. Infrastruktuurin heikkoudet, pätevän henkilöstön puute ja suomalaisten yritysten haluttomuus ottaa riskejä ovat tekijöitä, jotka kuitenkin hidastavat suomalaisten investointeja Venäjän elintarvikesektorilla. Esteenä vahvemman jalansijan saamiseksi koetaan myös viranomaisten toiminta, kova kilpailu, hajanaiset markkinat ja suomalaisten tuottajien korkeat tuotantokustannukset.

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1 INTRODUCTION

The Russian food sector experienced serious turmoil after the collapse of the Soviet Union. The old system, in which food supply was based on the production of specialised Soviet republics, was replaced by more or less normal foreign trade. Simultaneously, the distribution system in the food sector based on state organisations was replaced by private entrepreneurs. This structural change, combined with rapidly liberalised trade, created a situation where opportunist operators reached for the high profits available in the distribution business. The system started to improve gradually as more professional operators entered the market in the 1990s. However, just before the financial crisis in 1998, the distribution system of food was still very disorganised.

The 1998 crisis became a watershed for the development of the distribution systems in food industry. In the toughened market environment only the strongest and most efficient operators survived. As the demand for foreign products collapsed, local production got a huge demand boost. Along with the increased demand, also an investment boost was experienced in food industry, retail trade, and to a lesser extent in agriculture.

The Finnish food industry also experienced a structural change during the 1990s and simultaneously began to internationalise, which was related to the accession of Finland to the European Union in 1995. The role of East European economies has been significant in the internationalisation process of the industry and the region is an important export target for Finnish firms. During the bilateral clearing trade arrangement, the Soviet Union had been mainly the export target for the excess supply of Finnish foodstuffs. However, as the market was liberalised in the beginning of the 1990s and the demand for processed foreign food products skyrocketed, Finnish food producers became attracted by the Russian market.

Challenges in distribution have played an important role in hindering the market penetration of Finnish food producers to Russia. The most recent comprehensive study examining this topic is by Ruohonen (1999). Her examination period ends with the Russian financial crisis in 1998, and the change in distribution systems of foodstuffs since then has been substantial. Therefore, this study discusses the current situation in Russia's distribution system of foodstuffs and food retail, as well as the major changes after the 1998 crisis. The intention is not to consider the technical aspects of distribution but rather to assess the Russian distribution systems from the perspective of Finnish food producers and their possibilities to penetrate the Russian food markets.

The objective of the study is to find out how Finnish food producers could better get their products to the shelves of Russian food retail stores. The issue is examined from five angles:

1. Foodstuffs trade in Russia
2. Domestic content of the food sector in Russia
3. Distribution system of foodstuffs in Russia and the purchasing policies of retail chains
4. Russians as consumers of foodstuffs
5. Current availability of Finnish food products in Russia and the barriers to entry for new products

The structure of the report is as follows. First, the current situation in Russian food retail is examined (Chapter 2). Second, the development of the country of origin and domestic content of foodstuffs in Russia are portrayed (Chapter 3). Third, the main topic of the study, distribution systems in the Russian food sector are examined (Chapter 4). The purchasing policies of retail chains are also examined in this part. Fourth, the segmentation of consumers and its implications to Finnish food producers is analysed (Chapter 5). Finally, the current availability of Finnish food products in Russia and means for increasing their market share are highlighted (Chapter 6). Also the barriers to entry for new products are discussed here. Together

these five angles allow us to form a picture of the distribution systems of foodstuffs in Russia and the factors affecting their development.

This study is based on semi-structured interviews, seventeen of which were made with Finnish and eight with Russian companies or experts. The interviewees were guaranteed anonymity. The Finnish interviewees included representatives of food producers, retailers, and experts of the food sector. The Russian interviewees included representatives of retail chains, a logistics company, a wholesaler and a food organisation. The citations appearing in the text are those of the interviewees. The Finnish producers were selected by investigating the archives of Kauppalehti and selecting the relevant firms that were most often mentioned in the context of operations in Russia. The firms that were selected had a strong Finnish background even though they were not necessarily under Finnish ownership any longer. This approach was based on the following factors: first, there is quite a limited number of Finnish food producers who have operations in Russia. Second, ownership relations tend to change also in the food business. Third, even if the selected firms are no longer under Finnish ownership, they have a similar starting point as the firms operating under Finnish ownership, and thus it is useful to learn from their experience. Focusing on interviews as the main source of data serves two purposes. First, since there is very little information available on the topic of the study, interviews bring new knowledge about the experiences and strategic choices of Finnish producers operating in Russia. Second, the approach provides a forum for Finnish producers to compare their experiences and choices. Anonymous quotes are presented in the report to illustrate the views of the interviewees. In addition to interviews, information was gathered from previous studies, statistics, by carrying out two small surveys and reviewing the archives of relevant Finnish and Russian magazines. The authors are aware of the shortcomings of some of the statistics provided by Goskomstat (Federal State Statistics Service of Russia). However, Goskomstat statistics are by far the most comprehensive source available and therefore they were used in order to get at least an overview of some of the studied phenomena.

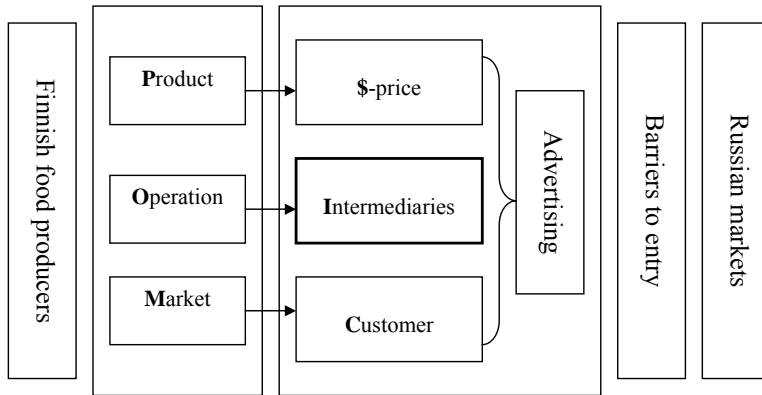
The definition of a distribution chain used in this study is as follows: “A channel of distribution shall be considered to comprise a set of institutions which performs all of the activities (functions) utilised to move a product and its title from production to consumption” (Bucklin 1966, ref. Kotler 1980, 413). The term value chain is sometimes used in this study instead of distribution chain to pay more attention to the value-formation in the chain.

The distribution system in Russia is still quite disordered, which is reflected also in the terminology of this study. In case of foreign operations, the distribution network between the producer and retailer basically consists of an importer, a wholesaler and a distributor. However, in Russia the activities of these operators are often more or less overlapping. Furthermore, many interviewees used the terms analogously, e.g. the term distributor was used when referring to wholesalers. Thus, also in this study the term distributor can include importers who bring the merchandise into the country, wholesalers who store the merchandise, and distributors who take care of the physical distribution of merchandise but never own it. The operator in the distribution network is specified more accurately when relevant.

1.1 Framework of the Study

The theoretical frame of reference applied in this study is based on the so-called POM\$ICA-framework created by Luostarinen (1994). The framework of the study is illustrated in Figure 1.

Figure 1. Framework of the study (applied from Luostarinen 1994)



Luostarinen's framework can be used for studying the internationalisation strategies of firms. The framework includes the product, operation and market strategies of the internationalising firm. For this study, the Finnish food producers, the barriers to entry, and the Russian market have been added to the framework. In the framework, the product strategy consists of decisions concerning on product itself. From the product strategy follows the decision on the price of the product. Operation refers to the operation mode that is used by the producer. After the decision on which operation mode to use, the producer needs to choose the intermediaries that are needed. This concerns the distribution systems, which are the main focus in this study. Market refers to the choice of market (in this case St. Petersburg, Moscow and/or regions), and customer refers to the chosen customer segment for the products. Based on the product, price, intermediary and customer strategies, the companies make the decisions concerning the advertising of the product. There are also specific barriers that have to be overcome before the entry to the Russian market. The framework is useful in distinguishing the factors that affect the Finnish food producers' success in the Russian foodstuff market.

2 FOOD RETAIL IN RUSSIA

This chapter analyses the development of retail trade in Russia focusing on foodstuffs. The geographical focus is on Moscow and St. Petersburg, where the majority of the Finnish companies operating in Russia are the most active.

2.1 Retail trade in Russia

In the Soviet times, retail trade was controlled by the state. According to Ruohonen (1999), the state stores accounted for approximately 75 % of retail trade. Part of the state retail system were the so-called *berjozhkas*, i.e. stores that had a wider assortment of products than regular stores. However, they were not open for the general public but targeted for tourists and certain privileged circles in the Soviet Union. The purchases could be made only with foreign currency. Other forms of foodstuff trade were the co-operatives in the countryside and the *kolkhoz* (or collective farm) marketplaces. The stores were typically very small. A central feature of retail trade in the Soviet Union was that demand exceeded supply manifold. As a result, long queues in front of shops were commonplace. Also black market existed and it was actually the most effective distribution channel. (Ruohonen 1999, pp. 179-181)

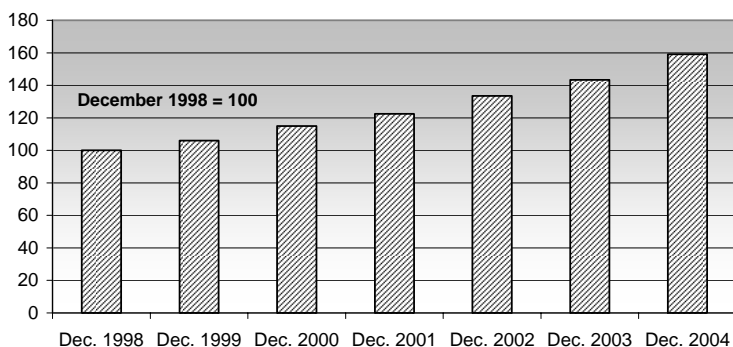
After the collapse of the Soviet Union, the retail trade structure was disrupted and fragmented. The first supermarket was opened in 1995 by Sedmoj Kontinent. By 2000, retail trade had undergone tremendous changes especially in large cities. One important feature was the growth of store size. Competition tightened as foreign chains started to enter the market actively in 2000. (GAIN 2005)

2.1.1 Current situation in retail trade

At the moment, retail trade is growing fast. According to an estimate by Rosstat, the turnover of the retail sector (including non-food) was 5565.5 billion roubles (approximately 154.9 billion euros) in 2004. This shows a 12.1 % growth compared

to the year 2003 (product.ru 26.1.2005, Prime-TASS), and similar kind of growth rates were experienced also in the first quarter of 2005 (product.ru 21.4.2005, Gazeta.ru). In 2004, foodstuffs contributed 45.6 % of the retail trade (product.ru 26.1.2005, Prime-TASS). Figure 2 shows the real growth of food retail turnover in Russia since 1998. The growth rates have been measured by comparing the figures from December of each year (the most active month) to each other. The graph shows a steady growth of turnover in real terms.

Figure 2. Real growth of food retail turnover, December 1998 = 100



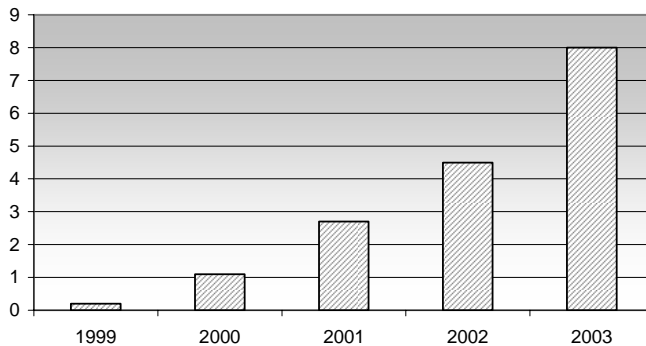
Source: Goskomstat

Simultaneously, also the share of retail chains in the retail trade turnover has been growing (see Figure 3). However, unorganised forms of trade¹ still constitute a clear majority of food retail sale. According to a poll conducted on Russian eating habits by the Public opinion foundation in 2002 (FOM 2002), 36 % percent of respondents bought most of their foodstuffs from stores (including both retail chains and unorganised stores), and 35 % from marketplaces. The rest were more or less self-sufficient, acquiring most of the food from their own small household plots or from the nature (by hunting, fishing, gathering berries and mushrooms etc.). The poll was nationwide with 1500 respondents from 100 different places in 44 Russian regions,

¹ Unorganised forms of trade refer to kiosks, marketplaces, etc. traditional, non-chained forms of trade. In Russian articles they are also sometimes referred to as “uncivilised” forms of trade.

and it clearly illustrates the role of unorganised forms of trade in Russia. For example, in Moscow there were altogether 154 marketplaces in February 2003, the total turnover of which was approximately \$8.3 billion (product.ru 12.2.2003, Vedomosti).

Figure 3: Share of retail chains in the retail trade of Russia, percent



Source: GAIN (2005)

According to an estimate by the United Financial Group (Объединенная финансовая группа, ОФГ), the turnover of the Russian foodstuff market was \$67.5 billion in 2003, of which 15 % came from so-called modern forms of trade, i.e. organised retail chains comprising supermarkets, hypermarkets, discount stores, etc. (product.ru 26.4.2004, Vedomosti). Additionally, according to ACNielsen, the share of modern forms of trade was 21 % in foodstuff retail trade in the largest Russian cities in September 2004 (product.ru 24.3.2005, Vedomosti). Thus, the economic significance of the unorganised forms of trade is still significant in Russia. Different experts expect the retail trade to strengthen during the next 6-8 years so that the share of modern forms of trade will be some 50 % on average in Russia (product.ru 26.4.2004, Vedomosti; product.ru 26.11.2004, RosBiznesKonsalting). Similar views were expressed also by the retailers interviewed for this study. However, a distinction was made between two types of unorganised trade forms: the kolkhoz (collective farms that are a legacy of the Soviet times) marketplaces and others. It

was proposed by one interviewee that the kolkhoz marketplaces will survive because they are frequented by people with real purchasing power and they sell specialty items, like fresh meat, fruits and vegetables. Nevertheless, they need to modernise their operations in order to survive. The other types of unorganised trade have low prices but the products are of inferior quality. They will lose shares to the discounters and hypermarkets that also compete with price. It was also pointed out that the producers are more interested in working with the retail chains, which further increases the weakening of the unorganised trade.

The authorities of some cities are clearly against the unorganised forms of trade. According to one interviewee: *“If the market forces don’t kill them, they will be killed by administrative order”*. This is at least partly because collecting taxes from the unorganised forms of trade is a big challenge. In Moscow and some other cities (e.g. Nizhnyj Novgorod and Novosibirsk, see the map in Appendix 1) the authorities have closed down a great number of unorganised stores or taken other actions to restrict their operation (see for example product.ru 25.12.2001, Gazeta.ru; product.ru 14.2.2002, RIA Novosti; product.ru 4.11.2002, Vedomosti; product.ru 2.2.2004; gzt.ru, product.ru 12.4.2004, ng.ru; product.ru 1.6.2004, Vedomosti). According to an interviewee, the retail chains have also appealed to the authorities that they should control the unorganised trade forms so that there would remain room for the forms of trade that pay taxes. The authorities have taken the cue and acted accordingly. However, it was still presumed by one interviewee that some of the marketplaces are protected by the authorities, because they unofficially pay money for it. Nevertheless, the issue is not clear-cut, as the authorities have to weigh the benefit of increased tax income against the loss of cheap foodstuffs for poorer people, who are frequent users of unorganised trade forms.

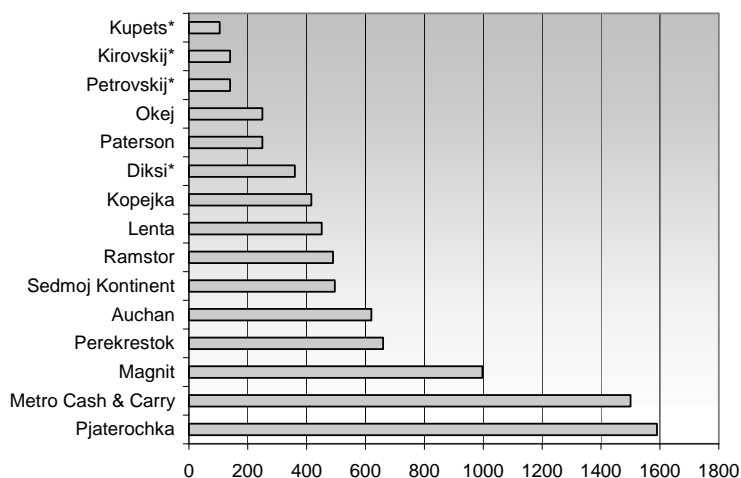
2.1.2 Recent developments in Russian food retail

The strongest trends in the Russian food retail sector in 2004 were consolidation and regional expansion (Emerging Europe Retail Update 8.2.2005). At the same time, the unorganised forms of trade were losing their position. Consolidation was

based mostly on mergers and acquisitions, and it is expected to continue as some of the regional chains will most likely be absorbed into the Moscow-based retail chains (Bezrukova 2005).

As a result of the growth of trade and consolidation, the number of retail chains is decreasing and the turnover of the biggest food retail chains (see Figure 4) is growing rapidly. The chains are expected to grow at an annual pace of 15-20 % during the next few years (product.ru 17.2.2005, Vedomosti). The sales of five biggest retail chains constituted some 30 % of the sales of all food retail chains in 2003, while it was 20-22 % in 2002 (product.ru 26.4.2004, Vedomosti).

Figure 4: Annual turnover of the largest retail chains in Russia in 2004, mln USD



Source: Various magazines and web sites, Vedomosti-magazine, retail.ru and gazeta.ru among others.

** data from 2003.*

In 2003, Moscow-based chains started to expand their operations to the regions (Bezrukova 2005). They were soon followed by their St. Petersburg-based counterparts. Some chains have also started to expand to other CIS countries. One of the main reasons for expansion is the intensive competition and saturation of

markets especially in Moscow, which has resulted in weakening profitability (Ekspert 35, 2004). The interviewed Russian retailers expected the competition also in St. Petersburg to tighten during the next three years so that the market will be difficult to penetrate by new entrants. Regional expansion also offers a chance to fast growth of sales with relatively small investments. Competition in the regions is far from the situation in Moscow and the local players are often less competitive than the chains originating in Moscow. The chain formats are also continuously diversifying (Emerging Europe Retail Update 8.2.2005).

The three most active retail chains that are expanding their operations to the regions at the moment are Pjaterochka, Perekrestok and Paterson. Pjaterochka is currently the largest retail chain in Russia with an annual turnover of \$1.59 billion (product.ru 24.3.2005, Vedomosti). It has expanded to the regions largely via franchising operations (Bezrukova 2005), and opened its first regional outlet in Voronezh in November 2002 (product.ru 29.10.2002, Vedomosti). Perekrestok belongs to the five largest retail chains with a turnover of \$660 million (product.ru 5.4.2005, Gazeta.ru). In 2004, it opened several new outlets in Samara, Togliatti, Volgograd, Lipetsk and Voronezh (Bezrukova 2005). Paterson is considerably smaller with an annual turnover of \$250 million (product.ru 9.3.2005, RosBiznesKonsalting). It has opened 12 stores in different cities in Russia and was among the pioneers in regional expansion together with Diksi. These three players continue their expansion to the regions, but also all the other large retailers have announced plans to open several new outlets in the regions (Bezrukova 2005; product.ru 30.7.2003, Vedomosti).

One of the most alluring regions is considered the Samara oblast. In the end of 2004, Pjaterochka, Metro Cash & Carry and Ramstor opened stores there, in addition to the already present Perekrestok and Paterson. Examples of cities with developed retail trade are Nizhnyj Novgorod and Yekaterinburg. In Yekaterinburg, 25 % of the volume of trade goes through retail chains (Bezrukova 2005), which is more than in Moscow. In addition, the price of the average shopping basket is

estimated to grow 10 % a year in Yekaterinburg (product.ru 30.7.2003, Vedomosti). The local chains are very strong in these cities, which makes it difficult for the Moscow-based chains to enter the market (Ekspert 35, 2004). Also the local administration poses problems in some cities, e.g. in Yekaterinburg, as they try to keep the cities closed to non-local competitors (ibid.). The regional retailers expect the competition to tighten during the next couple of years, as the lack of commercial real estate disables faster progress. The marketplaces will be first affected by the increasing competition (Bezrukova 2005).

Consolidation and regional expansion are expected to continue in 2005. However, the expansion to new regions will probably be less aggressive, as the retail chains now concentrate on developing their existing businesses in the regions. Their expansion to the regions is also slowed down by the lack of available commercial real estate (Bezrukova 2005). Another factor hindering the expansion is logistics: most of the retail chains do not have enough distribution centres in the regions. However, the interviewed Russian retailers pointed out that the chains have already made plans for developing logistics and founding stores, which they are starting to realise in the regions. The moves of the competitors are also keenly followed and the retail chains learn from each other.

There are also some regional retailers entering the Moscow and/or St. Petersburg markets. The strongest regional retailer is Magnit, with a turnover of almost one billion dollars and over 1000 stores. Magnit entered Moscow in 2002 when its parent company Tander acquired the Moscow-based chain Nesterovskij and converted the stores to Magnits (Bezrukova 2005). Another example of a successful entry to the capitals was the Viktorija company from Kaliningrad, which opened a Kvartal-store in St. Petersburg in August 2002, and had already 17 stores in Moscow at that time (product.ru 10.7.2003, Vedomosti).

So far, the number of foreign retail chains is relatively small in Russia. The most important ones are the German Metro, the French Auchan and the Turkish Ramstor.

Investments from some of the biggest retail chains in the world have been expected in the Russian markets for some years now, but so far they have not been realised. Nevertheless, foreign chains are expected to dominate the market in the future with some 70 % share (product.ru 26.11.2004, RosBiznesKonsalting). A retailers' association has even asked for government protection against the threat of entry of foreign players (Lorentz 2004, 40). For example, Wal-Mart has been rumored to enter the Russian market. According to the latest news, they are interested in the Russian retail market, but are not ready for investment yet (product.ru 22.4.2005, Interfaks). According to the general director of Pjaterochka, Sergej Lepkovich, there is still plenty of room also for foreign entrants (Torgovets December 2004). However, he does not expect their entry to be easy due to the peculiarities of Russia: *"It is easier for a Russian to start a business in Russia, as they know whom to talk to, with whom to make deals, who will help them to solve problems."* The Russian retailers interviewed for this study expect the foreign retailers to acquire some of the less competitive Russian retail chains. Foreign players will have an effect on the development of the retail trade, when they are ready to make big investments. The foreign chains also have the required technology, whereas the Russians still need to make considerable improvements in that respect.

2.1.3 Retail formats in Russia

There are basically six different types of retail store formats that are commonly used in developed markets (Arnold 1983). Five of them can be identified also in Russia, and they are briefly described below.

Discount stores emphasize low prices and utilise large quantity procurement with low mark-ups. They have relatively small assortment and the quality of the products is reflected in the price level. They are usually located in centres of population. A typical store size is below 400 m². Examples of these in Russia are Diksi, Pjaterochka, Kopeika and Magnit (Lorentz 2004).

Convenience stores emphasize location near the customer and flexible opening hours. The prices are higher than in most other formats. The store size is usually small. Examples of these in Russia are Petrovskij and Spar, at least partly (Lorentz 2004). It is not clear whether they should be classified as convenience stores or supermarkets. Sedmoj Kontinent also has a store format that can be classified as a convenience store.

Supermarkets have a wide assortment and often also good service and quality of products. They emphasize the ease of finding all the products in one place, i.e. one-stop shopping. Some supermarkets are located in centres of population while some are located outside of them in a place that is easily reached by car. Small supermarkets have a size of 400-999 m², large ones over 1000 m². Examples of these in Russia include Paterson, Sedmoj Kontinent and Perekrestok (Lorentz 2004).

Hypermarkets combine the features of discounters, supermarkets and warehouse operations in one place. They offer low prices and wide assortment and are usually located outside of the city centre in a place that is easily reached by car. Hypermarkets have a size of over 2500 m². Examples of these in Russia include Auchan, Marktkauf, Ramstor, Mosmart/Rosmart and OKei (Lorentz 2004).

Retail warehouses utilise large scale, low rent and isolated buildings with minimal services and low price. They are typically large. These are not easily identifiable in Russia at the moment.

Department stores emphasize location in the city centre. Typical features are good service and high quality. The customers are usually well-off. The stores are organised into different departments according to the merchandise sold. The store size is over 1000 m². They may also be specialised in certain products or cover a wide range of products. An example of a general type of department store selling also food in Russia is Stockmann.

An additional definition that is needed is *Cash & Carry* –type of stores. These are stores that sell (usually) exclusively to other legal persons instead of selling directly to consumers. Examples of these in Russia are Lenta (which sells also to consumers) and Metro (which sells only to legal persons). A new retail format that has appeared in St. Petersburg in 2004 is *multiplex* (Economic Monitoring). They are large entertainment and shopping centres.

It seems that the retail formats used in Russia do not differ much from the corresponding retail formats in Western markets. The customers of the stores, however, might differ from those in Europe, as in Russia the consumer segments are more polarised in terms of income than in Europe or other Western markets. This makes some retail stores in Russia inaccessible to some consumers with lower incomes. A marketing-related problem that came up in the interviews is that the producers do not always understand the differences between different retail formats and offer their products to wrong types of retail chains. For example, discounters emphasize low prices, which might make them difficult to access for Finnish producers, as Finnish products usually cannot compete with price. A strong brand makes the access easier and it also makes the customers want the product more, compared to alternatives.

2.1.4 Finnish food producers' views on retail trade in Russia

Finnish food producers seem to have a very accurate picture of the market situation in Russia. They acknowledge the ever-tightening competition in the market and the strengthening of retail chains, which result in the decrease of non-chained stores and traditional forms of trade like kiosks and marketplaces. They also expect a shake-out period that will decrease the number of retail chains. As the competition increases, the role of brands becomes vital (this is discussed in more detail in Chapter 6 on the availability of Finnish products in Russia). Along with the growth of retail chains the whole business is expected to become more professional.

The share of unorganised trade in food retail is anticipated to decline, but regional differences in this respect will prevail. In Moscow and St. Petersburg the decline will most likely be relatively rapid and the same applies also to other big cities. In the rest of the country, unorganised trade is likely to continue in some form also in the future due to tax evasion and cheaper prices. Many interviewees shared the view that the authorities try to get rid of these forms of trade, but it is not always simple: *“If the city [authorities] prohibit them, they will just move outside the city area and the consumers will find them unbelievably quickly.”* However, the actions of the authorities combined with the increase in income levels, quality needs of consumers, and need for comfort in shopping are prone to result in the growth of retail chains at the expense of unorganised trade.

Finnish firms expect the large Western retailers to enter Russia in the near future. According to some interviewees, a large number of Russian retail chains are searching for Western partners or preparing themselves for sale. Thus, foreign firms have the possibility to use acquisition as the form of entry. Greenfield investments may be more challenging due to lack of suitable locations for building stores in large cities. On the other hand, there are examples of successful entry via greenfield investments. For example, Metro Cash & Carry has grown very rapidly via greenfield investment, being currently the second largest retail chain in Russia measured by annual turnover.

The impact of foreign chains is a matter of some dispute. It seems that so far the impact of foreign chains is already quite high in Moscow and their influence is continuously rising. Foreign firms are considered to have an important role as determiners of the quality of products. In addition, profit margins are expected to decrease with their entry, thus tightening competition. Currently, the profit margins are still quite high in Russian retail. On the other hand, when looking at the whole Russia, the influence of foreign companies is very modest and is not necessarily expected to rise very much. In addition to Moscow, Western players are mainly interested in expanding to the ten largest Russian cities. However, also in their case

the underdeveloped logistics infrastructure complicates the delivery of products to other regions. Therefore, the Russian countryside is not considered very attractive.

“Probably the cities with more than a million inhabitants will develop quite quickly, but the countryside is a big question mark”.

In conclusion, the opinions of interviewees seem to suggest that the retail chains themselves consider the level of competition already quite high and that it will become higher with the emergence of more foreign chains to the market. The presence of foreign chains was not considered a bad thing, but rather as a learning opportunity. In general, competition was regarded as a positive factor.

3 DOMESTIC CONTENT OF THE RUSSIAN FOOD SECTOR

This chapter analyzes the development of domestic content in Russia's food sector by discussing food production, food imports and agricultural production. There are some problems in analyzing the domestic content that are related to statistics and defining the term. It is debatable whether a product that is produced in Russia in a factory that is owned by a big multinational company can be regarded as Russian production. Or, whether production taking place in Russia in a joint venture of a Russian and a foreign firm is Russian production. Since a thorough discussion of this would require a study of its own, here the topic is examined through interviews and statistics on production and imports. First, the topic is analyzed through interviewees' perceptions and poll results. After that the development and prospects of Russia's food and agricultural production are discussed. Finally, the role of foreign investments in Russia's food sector is shortly examined. The 1998 crisis influenced the domestic content in Russia's food sector heavily and thus it is discussed in more detail next.

The first years of Russian transition were extremely difficult. The dismantling of Soviet central planning with fixed prices caused a very strong inflationary wave, while economic activity (Gross Domestic Product) decreased rapidly. Amid this stagflation (a combination of economic decline and strong inflation), average monthly gross wages measured in "hard" currency (ECU, European currency unit) showed an amazing boom. Between 1992 and 1997, the real effective exchange rate of the Russian rouble appreciated strongly.

Under these circumstances, it was very advantageous to import consumer goods, including foodstuffs in Russia. This new demand in Russia created export opportunities in neighbouring countries, Finland included.

In the mid-1990s, the inflationary wave in Russia showed signs of abating. Therefore, a semi-fixed exchange rate policy was launched in the beginning of 1998 in Russia. In this system the central rate of the rouble was fixed at RUB 6.2 = USD 1. Fluctuations of 15% were permitted in that system ($\pm 15\%$ around the fixed central rate) to allow market flexibility. This system of semi-fixed rouble exchange rate collapsed in August 1998. In this context, the external value of the rouble depreciated strongly (for details, see Tiusanen 2003). Price-sensitive imports – foodstuffs among them – suffered a strong decline as a result of this depreciation.

The rouble crisis of 1998 has eventually turned out to be a clear blessing to the Russian economic development. A very deep slump in investment activity came to an end in 1999, because the depreciated rouble exchange rate gave a clear incentive to develop import-substituting activities. Investments have recovered strongly in the post-crisis period.

At the turn of the century, the world market price of oil rose essentially. Mainly as a result of this event, the value of Russian exports grew by no less than 60 % in 2000. Ever since the prices of oil and natural gas have shown favourable development from an exporter's point of view. Thus, there has been a rapid recovery in the post-crisis economy of Russia. The purchasing power has increased rapidly in the early years of the present decade.

Investing in local production was regarded as the most important strategy for increasing the market share in the Russian food sector by the interviewed Finnish producers. Pressures on Finnish food producers are exerted through increasing competition from Russian producers and other foreign producers, which already have production in Russia. Now the opinion of the Finnish food industry in general seems to be that the exports to Russia cannot be increased very much. Furthermore, local production might become a necessity in the future as Russian consumers increasingly favour locally produced food products instead of foreign ones. However, this offers also possibilities, because investing in local production helps

the Finnish food producers to reduce their production costs and shorten the distribution chain. The problem of finding enough raw material of sufficient quality is hindering the start or expansion of local production for some Finnish producers at the moment.

3.1 Finnish and Russian views on domestic content

An intuitive measure for the domestic content in the Russian food sector is the share of Russian products in the assortments of retail stores. Unfortunately, this kind of data is very difficult to obtain. The highly developed retail chains in Russia have good monitoring systems of their product assortment, but understandably they do not want to reveal this kind of information. Even if they did, the share of chains in the retail trade today is less than ten percent (GAIN 2005). Thus, this information would not be very comprehensive.

Another approach is to consult consumer questionnaires. The Russian Public Opinion Foundation (FOM) has carried out polls on Russian consumers' perceptions on the share of domestic and imported products in the stores. The polls indicate a clear change in favour of domestic products caused by the financial crisis in August 1998 (FOM 1998, FOM 1999). In a poll that was done a little before the crisis in 1998 (FOM 1998), 1500 people nationwide were asked about the share of domestic and imported food products in the stores of their place of residence. In a similar poll carried out by FOM in July 1999 (FOM 1999) the results were clearly different. Within just over a year consumers' perceptions on the shares of imported and domestic food products in nearby stores shifted markedly towards domestic products. However, these polls must be regarded as a very rough indicator of the reality due to subjectivity issues and the fact that the methodology of the polls was not explained explicitly in the information source.

The Finnish and Russian companies interviewed for this study confirmed the above result: according to them the share of Russian products clearly increased after the

1998 financial crisis. The demand for domestic products increased as consumers shifted consumption to domestic products because of financial necessity after the crisis. Wholesalers that used to take only foreign products to their assortment were compelled to include also Russian products. The share of foreign producers on the market depends very much on the specific food category in question. Often, the basic food products, e.g. flour, are produced by Russian producers, or foreign companies that have invested in Russia. On the other hand, in case of newer product categories, it takes some time before Russian producers can obtain or develop the required production technology. According to the CEO of the most successful Russian retail chain, Pjaterochka, a large part of their assortment is Russian goods, but they want to ensure the availability of the largest international brands as well (Torgovets 2004). Thus, the big multinational firms with the strongest brands are in good position also in Russia.

The increased demand for domestic products started already before the crisis as an endogenous phenomenon. The crisis and financial distress acted as an exogenous force that accelerated the development of increasing domestic product demand. The development has continued ever since. Although demand is a necessary condition for sustainable domestic production, it is not sufficient. Supply has to be ensured as well, which has not always been evident in Russia.

3.2 Food production, food imports and agricultural production

Supply consists of local production and imports. In order to get as comprehensive a picture as possible on the domestic content in Russia's food sector, also agricultural production has to be analyzed, since it is closely related to food production through its role as a raw material supplier. These considerations offer additional empirical support for the interviewees' perceptions and poll results that were discussed above.

3.2.1 Food industry production

”Food and eating have traditionally been important in the Soviet Union and Russia. Lately, the trend has been that the sales of high quality products are growing. For example, all Russian producers say that they produce premium products. It’s a relative concept, what is premium and what is not.”

Food industry has experienced remarkable growth in Russia since the mid-1990s. For example in 1996, the most dynamic growth sectors were the car, chemistry, oil chemistry and food industries (Ekspert 6.10.1997). Food industry had also received more foreign investments than any other sector by 2000 (Voprosy ekonomiki 17.6.2002). After the 1998 crisis, Russian food production began to develop even faster. This was triggered by the general growth in the economy experienced in 1999-2001 (Voprosy ekonomiki 20.5.2002). The share of imported foodstuffs was high until the rouble crisis and devaluation in 1998, after which the local production started to develop strongly and replaced imports, as people shifted their consumption to domestic products due to financial necessity. As a result of investments in local production, the competitiveness of Russian foodstuffs has increased.

One reason for the fast development of food production could be the larger than average share of production by foreign firms. In 2000, the share of foreign firms in production in Russia was less than 15 % in most industrial sectors, but in food production it was 27 % (Ekspert 3.11.2003). The presence of foreign competition has forced the domestic firms to develop faster. Competition is especially intensive in St. Petersburg and Moscow. The number of companies in food production and processing industries quadrupled in the seven years before 2004 (Pichcevaia promyshlennost 30.1.2004). The impact of authorities on competition was considered to be high by some interviewees, i.e. authorities may sometimes favour some firms over the others. It was pointed out that as the laws change they may treat different players in a different way, so that the competition is not as straight and fair as in some Western countries. Another example is the various certificates that are

needed for importing products. Some of these are so expensive that smaller firms cannot afford them.

In the 1990s, Russia experienced a drastic decline in its food production. Russia's food industry suffered from a shortage of inputs, inefficiency and weak competitiveness. However, there were some exceptions to the general trend in the most competitive food industry branches. This can be seen in Table 1, which shows the development of production in selected product categories. (Helanterä 1998)

Table 1. Production of selected food products in Russia, thousands of tons

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Meat	6484	2370	1900	1510	1315	1113	1193	1284	1456	1678	1698
Granulated sugar	3758	3155	3294	3778	4745	6808	6077	6590	6165	5839	4852
Bread and bakery products	18242	11336	9851	8832	8459	9160	9005	8575	8388	8394	8092
Vegetable oil	1159	802	879	687	782	881	1375	1281	1197	1597	1867
Butter (tons)	833	421	323	292	276	262	267	270	279	285	271
Whole milk dairy products	20.8	5.6	5.3	5.2	5.6	5.6	6.2	6.7	7.7	8.5	8.7

Sources: Regiony Rossii and Goskomstat

The decline in output varied between product categories. Meat production, for example, declined as much as 70 % in 1990-1997, whereas the production of granulated sugar revived from the crisis quite rapidly and passed the level of 1990 already in 1997. Alcoholic beverages (not included in the table) followed a similar trend. Nevertheless, in the majority of product categories only the 1998 crisis reversed the trend of declining production. There are some statistical issues that have to be taken into account here. Firstly, according to Helanterä (1998) the actual food production is probably somewhat higher than reported due to tax evasion efforts. Secondly, Tekoniemi (2003) argues that in 1990 – still Soviet time – the production levels in statistics were exaggerated. If this is true, then also in food production the severity of the decline might be somewhat exaggerated. Nevertheless, regardless of potential manipulation of the statistics the general trend is evident.

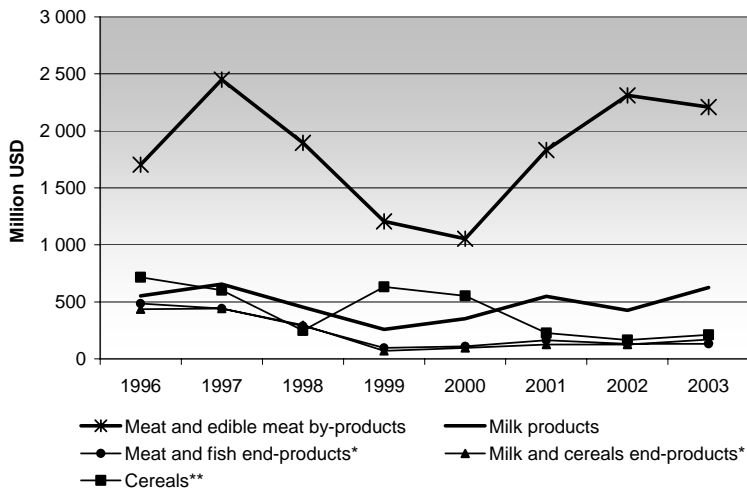
The Finnish interviewees had a clear view that growing local production is the trend of the future. However, according to IET (2005), year 2004 ended the period of recuperative growth launched by the 1998 crisis and both agriculture and food industry stopped growing. Support for this argument can be found in the table above. The growth of production decelerated or production even declined in all product groups except vegetable oil in 2003-2004. In some product groups the deceleration started already a couple of years earlier.

Does this mean that the trend of growing local production is halting? It could be a slowdown resulting from problems of getting raw material for food production (discussed later in this chapter). However, it could even be an indication of the opposite. According to IET (2005), this slowing down is at least partly a result of the rapid polarisation of the food industry. One part of the industry is quite competitive and has succeeded in modernising its operations. The other part consists of firms that suffer from the Soviet heritage and have been able to merely prolong their life with the aid of the devalued rouble. The decelerating food production visible in statistics might be a result of restructuring of the industry, as old inefficient firms incapable of adjusting to the new environment are withering away. However, the development of local production is only one part of the supply. The second part is considered next.

3.2.2 Food imports to Russia

In addition to end-products, imports can provide raw material for local food production. This has been a significant feature of Russia's food sector. Russia's food industry has been suffering from input shortage and therefore imported raw material has played a major role in the industry's revival. Figure 5 shows the development of imports of selected raw materials and processed food products to Russia.

Figure 5. Russia's imports of selected un-processed and processed food products



Source: Russian customs

* End-products mean processed food products, e.g. fish end-products are processed food products made from fish

** "Cereals" is a foreign trade statistics term referring to different types of grain crop products.

Figure 5 gives support to the argument that the 1998 crisis was a turning point for Russia's domestic production. The imports of all the selected product categories dropped clearly due to the crisis. However, the most intriguing feature in the graph is the discrepancy between the development of processed foods and raw materials. The imports of unprocessed meat have grown strongly from 2001 onwards. The same trend, although not as strong, can be witnessed in the case of unprocessed milk. However, the milk and meat end-products have revived very slowly and are still far from the pre-crisis levels. This supports the argument that the Russian food industry revived with the aid of imported raw material and took over the markets from Western producers, who have been unable to reach the previous export levels in processed food products.

An interesting detail is the development of cereals imports. The imports of these products declined the same way as those of other products, but there was a steep rise in their imports already in 1999. This is most likely a result of the food aid delivered to Russia from EU and US. In 1999, the cereals exports from the EU to Russia grew 20-fold compared to the 1998 levels, but in the next year decreased by more than 70 %. Also the EU's meat exports had a similar tendency but not as drastic²: a rise of almost 40 % in 1999 and then a decline of 35 %. The food-aid was a very controversial issue at that time. On the other hand, Russia's officials requested the aid but at the same time critics – the Russian meat processing industry among them - claimed that the EU and US used this food-aid to get rid of their excess production and that it benefited mostly Western agricultural and shipment companies, not to mention criminal activity (Kauppalehti 2.8.1999, Kramer 1999). After the food-aid stopped, the imports of cereals have been declining and Russia was even a net exporter of grain in the harvest year 2001-2002.

Table 2 presents the three biggest importers of selected food products to Russia in a particular year. Some caution has to be taken regarding these statistics, especially concerning the earlier years in the table and the case of Belarus. The import statistics show basically non-existent imports for Belarus in 1997 but in 1998 its shares grew considerably and have continued to do so after that. This might be a result of structural changes in imports due to the 1998 crisis. However, it might also be due to changes in the reporting practices of imports.

² Most of the EU's food aid was cereals products (Kauppalehti 2.8.1999)

Table 2. Biggest food importers³ to Russia and their share of imports, percent

	1997	1998	1999	2000	2001	2002	2003
Meat and edible meat by-products	1.US 30 2.Ukr 10.5 3.Ger 6.1	1.US 30.3 2.Chi 9.6 3.Ukr 8.3	1.Ger 18.6 2.US 17.3 3.Ukr 13.8	1.US 30.8 2.Ukr 18 3.Ger 8.3	1.US 32.6 2.Ger 14.6 3.Bra 9.9	1.Bra 27.3 2.US 20.5 3.Ger 9.4	1.Bra 28.3 2.US 19.9 3.Ukr 10.1
Milk products	1.Ger 19.6 2.Fin 6.9 3.Neth 6.3	1.Bela 21.8 2.Ger 14.3 3.Ukr 8.1	1.Bela 26.5 2.Ukr 12.4 3.Ger 9.5	1.Bela 23.5 2.Ukr 15.8 3.Ger 11.7	1.Bela 21.8 2.Ukr 21.7 3.Ger 11.7	1.Bela 25.9 2.Ger 17 3.Ukr 14.2	1.Bela 28.7 2.Ukr 18.4 3.Ger 15.4
Fruits and peanuts	1.Uzb 9.7 2.Mold 8.8 3.Chi 6.2	1.Uzb 7.5 2.Chi 5.1 3.Mold 4.9	1.Col 8.2 2.Turk 6.7 3.Chi 5.3	1.Ecua 23.3 2.Uzb 12.6 3.Kaz 6.7	1.Ecua 23.3 2.Uzb 9.6 3.Turk 8.3	1.Ecua 22 2.Turk 9.8 3.Arg 6.5	1.Ecua 21.5 2.Turk 7.8 3.Arg 6.8
Animal and vegetable fats	1.Neth 15.1 2.Arg 15 3.Ger 11	1.Neth 14.5 2.Arg 13.1 3.Ger 12.3	1.Neth 16 2.Arg 13.8 3.Belg 11.4	1.Neth 16.6 2.Ukr 16.2 3.Belg 10.7	1.Neth 17.6 2.Ukr 13.6 3.Mal 10.7	1.Arg 16.8 2.Neth 13.8 3.Mal 13.4	1.Mal 18.9 2.Ukr 18.8 3.Indo 11.1
Meat and fish end-products	1.US 20.3 2.Ukr 16.5 3.Pol 13.5	1.Ukr 19.7 2.US 18 3.Pol 14.9	1.Ukr 36.5 2.Pol 11.8 3.US 11.5	1.Bela 14.7 2.Ukr 13.5 3.Pol 11.9	1.Lat 18.6 2.Bela 14 3.Pol 10	1.Lat 23.1 2.Bela 21.1 3.Pol 10.5	1.Bela 33.2 2.Lat 18.7 3.Chi 9.4
Sugar and sugar confectionaries	1.Cuba 26.6 2.Bra 23.4 3.Ukr 16.3	1.Cuba 30 2.Bra 29.9 3.Bela 6.6	1.Bra 44.2 2.Cuba 27.5 2.Ukr 5.9	1.Cuba 28 2.Bra 25.9 3.Bela 8.6	1.Bra 39 2.Cuba 28.5 3.Bela 4.7	1.Bra 33.8 2.Cuba 24.5 3.Bela 12.7	1.Bra 38.9 2.Bela 14.3 3.Cuba 13.3
Milk and cereals end-products	1.Ger 13.3 2.Italy 11 3.Pol 8.4	1.Ger 12.7 2.US 11.8 3.Italy 10.7	1.Neth 17.6 2.Ukr 11.1 3.Pol 10.6	1.Ukr 18.2 2.Ger 11.1 3.Bela 9.4	1.Ukr 14.8 2.Pol 13.3 3.Ger 10.1	1.Pol 17.2 2.Ger 12.1 3.Ukr 10	1.Ukr 11.6 2.Pol 11.5 3.Ger 11
Beverages	1.Mold 37.4 2.Italy 6.9 3.Ger 6.8	1.Mold 29.9 2.Fra 7.5 3.Italy 6.8	1.Mold 32.6 2.Fra 13.5 3.Geor 6.4	1.Mold 31.1 2.Fra 11.1 3.Geor 8.8	1.Mold 31.1 2.Fra 14 3.Italy 6.9	1.Mold 25.4 2.Fra 17.8 3.Geor 7.5	1.Mold 22.3 2.Fra 17.4 3.Ukr 11.2

Source: Russian Customs

The domination of the US in (unprocessed) meat imports seems to have ended and Brazil has been taking over its place. Brazil also clearly dominates the sugar imports. Also Netherlands has lost its long-lasting leader position in animal and vegetable fats. It seems that traditional industrial countries are losing their position to importers from South America as well as to other cheap countries such as Belarus and Ukraine who have a long common history with Russia. The fact that big industrialised countries have lost their shares of imports to countries of cheaper production creates pressures for starting local production. Or, alternatively, it can act as a boost for starting production in other countries of cheap production such as

³ The abbreviations in the table are: US = United States, Ger = Germany, Bra = Brazil, Chi = China, Ukr = Ukraine, Bela = Belarus, Fin = Finland, Neth = Netherlands, Uzb = Uzbekistan, Col = Columbia, Ecua = Ecuador, Mold = Moldova, Turk = Turkey, Kaz = Kazakhstan, Arg = Argentina, Mal = Malaysia, Belg = Belgium, Indo = Indonesia, Lat = Latvia, Pol = Poland, Geor = Georgia, Fra = France

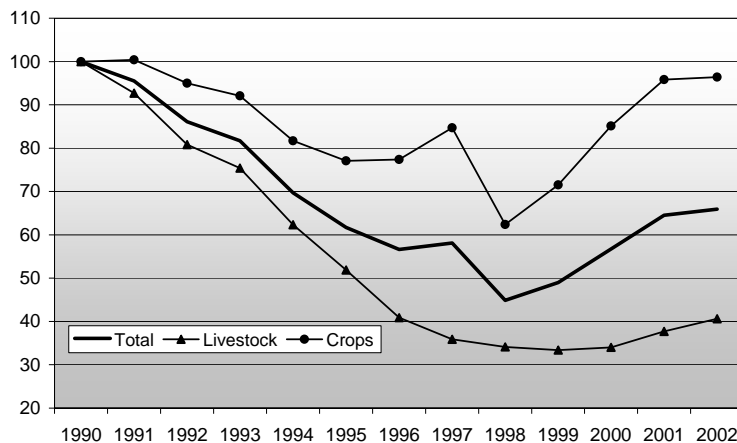
Ukraine, if production in Russia is not possible due to e.g. shortage in the raw material.

3.2.3 Agricultural production

In the 1990s, Russia's agricultural production contracted to almost half of its 1990 level. This was a consequence of several factors: the cultivated area declined by one fourth, productivity worsened considerably and investments in agriculture declined to a level of three percent of all capital investments from the previous level of almost twenty percent. Behind these factors were the reduction of state subsidies and decreased demand as the population's real incomes were declining (Tekoniemi, 2003). According to agriculture expert Eugenia Serova⁴, Russia's agriculture was exposed to "shock treatment" in 1992 as prices were liberalised, subsidies cut down and the state decreased its purchases. The agricultural sector was not able to adjust to the new circumstances, and consequently the food markets were filled with imported products. Serova estimated the share of imported food to be around 25% just before the 1998 crisis. A Finnish expert estimated in 1997 that 70-80% of Moscow's and St. Petersburg's food supply was imported (Kauppalehti 29.08.1997). Probably the most important factor in the decline was the heritage of the Soviet Union. The food supply in the Soviet Union was based on specialisation of regions to certain products. The collapse of this system, combined with the general inefficiency of the sector, had inevitable consequences. The development of Russia's agricultural production is depicted in Figure 6.

⁴ Head of the agriculture department of Moscow based Institute for Economy in Transition. Interviewed in Kauppalehti 1.11.1999.

Figure 6. Development of agricultural production, 1990 = 100



Source: Goskomstat

The decline of agricultural production was even deeper than that of food production. The decline seemed to level out in 1996, but the 1998 crisis made the production levels fall once more. The food industry was able to revive from the 1998 crisis faster than the agricultural sector. According to Tekoniemi (2003), the average growth of agricultural production was 5.5% per year while the growth of food industry production was 8% per year in 2000-2003. One important factor that contributed to this was that the food industry was able to get foreign raw material for processing (as was pointed out above), because there was a shortage of domestic raw material. Another factor is that the food industry seems to have adjusted to the new market environment faster than the agricultural sector.

However, also the agricultural production started to revive soon after the 1998 crisis. Crops recovered clearly faster than cattle (Tekoniemi, 2003). The capital investments to agriculture grew by more than six percent per year in 2000-2002. When Vladimir Putin came to power, a new program for agriculture development extending to the year 2010 was launched. It emphasized creating a market environment to the agricultural sector and developing big farms through vertical

integration. In recent years many large firms, often from a completely different industry, have invested in agriculture in order to create a complete supply chain from fields to stores and thus avoid shortcomings in production and distribution. Companies started vertical integration projects right after the 1998 crisis when everything was cheap, there was little competition and profit expectations were high. However, in recent years the benefits from the rouble devaluation have worn out and the investors' enthusiasm has subsided, apparently due to overrated profit expectations (Tekoniemi 2003). In the last couple of years, Russian agricultural production has been basically stagnant (IET 2005).

According to Tekoniemi (2003), Russia's agricultural sector is becoming increasingly polarised. There are firms that are created with heavy investments and operating according to vertical integration, but on the other hand, there are also heavily indebted firms in desperate need for investments. The latter group will probably wither away or merge into the large agricultural companies. According to an interviewed expert, the growth of Russia's agricultural production actually comes from just a small number of efficient farms. These farms will probably expand in the future by acquiring more land or cattle. IET (2005) confirms that polarisation is taking place and shows that the agricultural production is increasingly concentrated to the hands of the best companies. The process of polarisation is more apparent in agriculture than in food production (*ibid.*).

There is potentially a significant structural problem ahead, because this efficient and growing part of Russia's agriculture is situated away from the consumers, especially from those of Northwest Russia and St. Petersburg. According to IET (2005), there is increasing evidence of a shift of agricultural production towards the top performing regions. Furthermore, a large part of machinery is in desperate need of modernisation, which also raises questions concerning the future. However, investments in farm machinery have recently started to grow again. Thus, the future of the Russian food sector is still somewhat vague. The determinants that are crucial to this development are considered next.

3.3 Determinants of domestic content development

One of the most important factors affecting the development of domestic content in Russia's food sector is the state's trade policy. The state wants to protect domestic industries the same way as other countries do. Protectionist policies are carried out in Russia by customs regulations, custom duties and various other requirements for importers, e.g. health certificates. All these measures increase the price of imported goods and create uncertainty among the importers. Thus, many producers have decided to shift production inside the customs barrier. According to IET (2005), the Russian government is compensating its reduced financial aid to agriculture with increased trade protectionism.

Another factor affecting the development of food industry is the demand for domestic products, which has to be sufficiently large in order to create a competitive industry. The early years of the 1990s that were characterised by craving for foreign goods are in the past. Towards the end of the 1990s the popularity of domestic food products started to increase, and the trend strengthened considerably after the 1998 crisis and has stayed so.

The future of agriculture is also important to the development of domestic content in the Russian food sector, since favourable demand and producers willing to start production are not enough without sufficient inputs. There is already a shortage of raw materials for food processing, which curbs the production investments of some firms, since the availability of raw material of sufficient quality cannot be ensured. This is currently the case e.g. for some Finnish companies. If the development of the Russian agricultural sector continues to linger behind the development of food industry and if the foreign producers continue to expand production in Russia, then the competition for the already scarce raw material will accelerate. Eventually this should be reflected in the production costs, and food producers might start to think of other options. One potential scenario is the shifting of production to Ukraine, from where the goods could be exported to Russia. Ukraine has good potential for

food producers due to its favourable climate, rich soil and long traditions in farming. In fact, the number of joint ventures or foreign-owned food processing companies in Ukraine is currently growing (Tiusanen et al. 2004)⁵. Furthermore, recently also Ukraine's political development seems to have taken a better direction.

What is the potential of Russia's agriculture? According to Tekoniemi (2003), Russia's new agricultural development program aims at self-sufficiency e.g. in poultry by 2010. This would need huge investments, which the state cannot afford by itself. The interviewed Finnish expert questioned the rationality of these kinds of targets. He said that there is some Soviet time attitude in this thinking and that food production is based more on the ideology of securing food supply than on economic reasoning.

However, since the state seems to be striving towards self-sufficiency in agricultural production, it is useful to assess the plausibility of this target. Its strengths are the large areas of cultivable soil, the "black soil" area, as well as low production costs. On the other hand, the weaknesses include slow structural changes, the low-productivity of labour, outdated machinery, underdevelopment of markets, as well as shortcomings of the infrastructure (Tekoniemi 2003). The state clearly has a role to play here. The pace of reforms could be accelerated and the state should also make some painful decisions regarding the (artificially) prolonged lifespan of many bankrupt agricultural companies in order to create a viable agricultural sector.

Restructuring the food production and agricultural sector is crucial. If there really is restructuring going on in these sectors (as suggested above), then the current deceleration of production might be replaced by growing production of more competitive and productive companies. However, restructuring needs investments and a lot more is needed, especially in agriculture. In the period 1998-2003, the share of agriculture as a recipient of all investments in fixed capital was around 3-4%. In 2000-2002, investments in the agricultural sector were increasing in absolute

⁵ See also Helanterä (2003) for information on Ukraine's agro-food sector.

terms but they seem to have stagnated in 2003-2004. This might indicate investors' fading interest towards the sector.

3.4 Foreign investments in Russia's food sector

As foreign companies fled and the demand for imported food collapsed due to the crisis in 1998, local producers and retail chains got their chance to develop. However, an interesting question is where did all the money come from that was needed in creating and modernising a part of the food industry in a country struggling with severe financial crisis. Foreign investors have had a notable role in this. Table 3 below shows the shares of the food sector as a recipient of all fixed investments and all foreign investments.

Table 3. Share of recipient industries of all fixed capital investments and all foreign investments, percent

	1998	1999	2000	2001	2002	2003
Share of all fixed investments in:						
Food production	4.1	5.9	3.6	3.2	3.8	3.6
Trade and catering	2.5	2.4	2.8	3	3.7	2.8
Agriculture	3	2.9	2.7	3.9	4.4	2.9
Share of all foreign investments in:						
Food production	12.5	14.8	16.3	10.9	6.1	3.5
Trade and catering	10.2	17	17.8	37.1	44.5	35.4

Source: Goskomstat

Foreign investors have been active in Russia's food sector. Especially trade and catering have received a remarkably large share of foreign investments. The share of foreign investments in agriculture has been negligible and its future is uncertain, as it experienced a threefold growth in foreign investments in 2003 but then a decline of 30% in 2004. Although the trade and catering industry consists of a lot more than just food retailing, the investments in retail chains are included in the figures. The figures show an increase in investments to the trade and catering industry right after the 1998 crisis, and the absolute amount of foreign investments to trade and catering is still growing at quite a fast speed. The share of food

production as a recipient of both all fixed capital investments and all foreign investments had a more moderate jump and it started to decline quite rapidly after the crisis. However, the absolute amounts of foreign investments in food production have been steadily declining since 2000, being less than one billion dollars in 2004 according to Goskomstat. This suggests that the first wave of investing in local production has already taken place and that the second wave has not really started yet. If this scenario is true, then the Finnish producers have a chance to contribute to the development of the industry.

In the interviews conducted for this study it was suggested that the operations in food production were at least partly funded by offshore money that fled from Russia earlier in the 1990s. Before the 1998 crisis, the rouble was overrated and everything was expensive, as foreign actors were rapidly penetrating the market. After the financial crisis, large Russian investors saw their chance for big profits and started to repatriate their money, investing in food industry and other sectors.

It is quite often argued that the investments from Cyprus to Russia are actually of Russian origin (see e.g. Pelto et al. (2003), Grigoryev and Kosarev (2000)). The significant role of Cyprus as an investor to Russia has been persistent and at the end of the year 2004, Cyprus was cumulatively the largest foreign investor in Russia (Goskomstat). It is believed that this is linked to “round tripping”⁶. Although this is very difficult to verify, some support for the claim of major Russian investors’ “round tripping” after the 1998 crisis can be obtained from the foreign investment statistics. At the same time as foreign investments in food production and trade and catering started to grow right after the 1998 crisis, the share of Cyprus as a source of investments started to increase as well. This can be considered as an indication of the participation of offshore money in funding the development of Russia’s food production and retail chains. More information on this will probably be obtained in

⁶ “Round tripping” means transferring funds abroad in order to bring them back, partly or wholly, as FDI, in order to obtain the tax and other benefits offered to foreign investors (Kalotay, 2003).

the near future as retail chains are entering the stock exchange and they have to reveal their owner structure more accurately in the process.

3.5 Conclusions

Generally speaking, all sources of information gave a similar kind of picture. Before the 1998 crisis, imported goods were thriving, but the crisis ended this development as the rouble devaluation suddenly raised the prices of imported goods dramatically. Because of financial necessity, Russian consumers shifted their consumption towards domestic products. With the aid of increased demand and imported raw material, Russia's food production got back on its feet. However, this revival concerned mainly the efficient part of the industry and the industry started to polarise more strongly. A similar pattern can be seen in the agricultural sector.

The abovementioned development is reflected in the statistics on imports. All imports declined due to the crisis, but imports of unprocessed food products revived quite rapidly, whereas imports of processed foods have revived very slowly. Also, it seems that food is imported to Russia increasingly from countries of cheap production, such as South American countries and Ukraine. This creates pressures for the Western producers to shift production either to Russia or some other country of cheap production if they want to increase or even maintain their presence in Russia.

The development of the agricultural sector might prove to be crucial for the further development of domestic content in Russia's food sector. The food industry is already suffering from a shortage of raw material, and if foreign producers increasingly enter the market, the situation might get even worse. The growth in food production and agriculture seems to have halted at the moment. However, this might be temporary, if the halt is just a result of a restructuring of these sectors.

The future of domestic content in Russia's food sector depends on several things. If the Russian government keeps up its import barriers, foreign producers are likely to increasingly shift production to Russia in order to circumvent the trade barriers and shorten the distribution chain. But modernisation of food production and agriculture has to continue for local production to be viable. This calls for both domestic and foreign investments. However, at the moment it seems that these investments have stopped growing or have even begun to decline. Especially foreign investments in food production were steadily declining in 2000-2004. This might indicate that the biggest rush of foreign producers is yet to come and that there is still room for them in Russia.

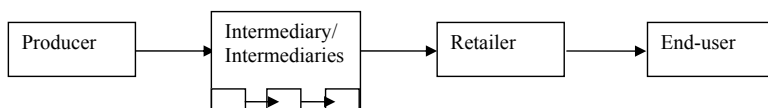
4 DISTRIBUTION SYSTEM OF FOODSTUFFS IN RUSSIA

This chapter examines the main topic of the study, i.e. what kind of a distribution system of foodstuffs is applied in Russia. To obtain a comprehensive picture of the distribution sphere the topic is analysed from the perspectives of retailers and producers, as well as intermediaries. Additionally, the historical development is discussed in order to understand the current situation better. Especially the role of the 1998 crisis is emphasized in the analysis. Some important factors shaping the current distribution sphere, such as the strengthening of the retail chains are examined as well.

4.1 History of distribution of food in Russia

This section examines the main trends of distribution systems from the collapse of the Soviet Union to the present day. By contrasting the distribution systems that existed before the crisis of 1998 and the ones that exist now, the changes that the crisis brought to the distribution systems can be analysed. Below is a simplified model of a distribution chain or system.

Figure 7. Simplified model of a distribution chain



There may be several intermediaries, which may include wholesalers, forwarding agents, importers and/or distributors

4.1.1 The collapse of the Soviet Union and the early 1990s

The Soviet era distribution system had three characteristics: massive volumes, centralised control and lack of competition. Most of the food supply in big cities was produced in a few massive production plants and delivered through the whole

supply chain by a couple of state enterprises that had specialised in food transportation. Moscow's authorities carried out the planning and controlling of the food supply chain. The whole supply chain was constructed so that no competition took place. Thus, there was practically no commercial activity between the firms, which acted as a significant impediment to productivity enhancement. (Taylor, 1994)

As the centralised system was abandoned, after the collapse of the Soviet Union, Russia had to adjust also its distribution system of food to the new economic, political and geographical environment. The deficiencies of food production forced the country to liberalise its foreign trade radically in 1992 in order to ensure food availability (Helanterä 1998). The other Soviet republics were important to Russia's food supply in the Soviet era. The crisis following the collapse of the Soviet system decreased food imports from former republics considerably until the year 1993, for example because of problems in payments.

Food imports to Russia from the West decreased also considerably from 1990 to 1994. The common perception of dramatic growth in western food exports to Russia is due to the fact that at that time the structure of food imports to Russia clearly changed. Food imports changed from mostly fodder imports to processed food products that appeared also in normal grocery stores. The demand for Western products was strong despite their higher prices because the local production was not able to compete in quality. People were also enthusiastic about Western products. (Helanterä, 1998)

"The situation was that everything that came across the border was very much in demand. It was incomprehensible, the so-called wholesalers came here [Finland] with plastic bags full of cash and wanted everything they could buy. The packaging was not Russian and they didn't even want it. It was an advantage, that we had Western packaging."

Liberalisation of foreign trade combined with the general liberalisation of economy and society, as well as the general chaos together produced a messy distribution system. On one hand, the distribution was largely in the hands of former state enterprises in the early years of 1990s. The wholesale trade was dominated by wholesalers belonging to former state trade organisations (Torgs), and former state transportation firms still mostly handled transportation. In the retail trade, the dominance of previous state monopolies was broken at least partially. A large proportion of food also still went to different kinds of organisations or canteens via privatised supermarkets or wholesale markets (Spiridovitsh, 1994).

On the other hand, in the new environment distribution was a very lucrative business due to the size of the country, easiness of starting a business (no major starting investments were required) and relatively certain extra incomes. In addition, the capital invested in business was easily detachable to other uses, which was visible e.g. in the volatility of the assortment of firms practicing distribution (Ruohonen, 1999). The situation produced several “one man and a truck” -type of actors who usually acted locally and sold practically anything. However, their importance in the whole distribution system was rather small (Spiridovitsh, 1994).

Taylor (1994) has identified some problems and characteristics of Russia’s distribution system of food in the early 1990s. The main ones were: old distribution network and infrastructure (e.g. problems with road and railway capacity), wastage due to spoiling and looting and poor managerial skills. Managers were interested only in their own business and did not see themselves as a part of the whole supply chain. Usually the managers of newly privatised firms were the ones who had managed the firms in the Soviet era. Information technology was very little utilised and customer needs were not considered when building the supply chain.

Evidently, dismantling the centralised distribution system that had prevailed for decades, and replacing it with a system built on private business actors was

challenging. Although the centralised system had major efficiency-degrading flaws, the necessary structural change caused even more problems in the short term.

4.1.2 From mid-1990s to the crisis of 1998

The development of distribution systems was nevertheless rapid and the role of old state organisations became insignificant in just a few years, as private businesses took over the distribution chain. Despite the rapid development of Russia's distribution system, at least distribution of food was still relatively unstructured at the time of the crisis in 1998. However, the basic structure was already visible and it was capable of delivering some modern services, such as 24 hour guaranteed delivery. Tightening competition and the growing local activities by foreign actors had an impact also on the development of the distribution system. (Ruohonen 1999)

The vagueness of the system was largely a result of the yet underdeveloped competition because it enabled opportunists to operate side-by-side with professional actors. The low centralisation of capital resulted in an abundance of small uncompetitive firms that could not guarantee sufficient service level. On the other hand, the lack of competition enabled the firms operating in the field of distribution to do business with a wide array. For example, it was profitable to operate in both wholesale and forwarding. Even today mark-ups for wholesalers and retailers in Russia are high compared to Western equivalents. Another thing making it more difficult to grasp the big picture at that time was the large differences in the development of the distribution in different regions (Ruohonen, 1999). Geographical differences are substantial even today.

The penetration of Western firms had a major impact on Russian distribution systems. One of the first Western firms to begin building a distributor network in Russia was Mars Inc. in 1991 (Mars Inc. homepage). The reasons for doing this were the same for Mars and other companies, which followed them: aggressive growth of sales volumes and fast growth of partners who wanted to work directly with the companies. (marketing.spb.ru)

Often a Western company chose the most reliable, stable and financially strong company as its main distributor among all of its Russian partners. Its management was trained intensively in organising logistics, working out the supply schedule, thinking about the assortment policy etc. The rest of the distributors were made sub-distributors of the selected main distributor. The reason for this strategy may be the fact that the market risk of Russia as perceived by Western companies was still high and they did not want to use resources for training more than one representative company at first. (marketing.spb.ru)

Around 1995 Moscow and St. Petersburg began to show first signs of market saturation for Western companies, while the growth of market potential was high in the regions. Also the competition was intensifying. Because of this, the biggest companies started to change their distribution structure. The head of the office and the personnel in representative offices in the regions became Russian (earlier at least the director was usually Western). Most of the companies also abandoned the "one official representative Russian company" principle they had earlier. They started to use different prices for different regions, depending on the demand and purchasing power of each region. This was only possible through strict control of the whole supply chain. Thus, the common way for a large Western company was to pick 5-10 distributors and give them fixed territorial limits. In their designated territories, these distributors had to organise a sales network, guarantee after-sales service and conduct regional advertising. This led to conflicts with the previous official representatives in regions. This was the usual distribution system until the crisis of 1998, when a lot of companies had to make difficult decisions concerning their distribution system and presence in Russia. As can be seen today, almost all of the large Western players stayed in the market. (marketing.spb.ru)

PriceWaterhouseCoopers (PWC 1999) examined Russia's food distribution system immediately after the crisis of August 1998 by interviewing Finnish and Russian actors. According to PWC, there was no clear and easily understandable distribution

scene at that time in Russia. It was often difficult to tell whether the so-called distributor was a wholesaler, retailer or something in between. The fact that the producers often did not have a clear knowledge of where their products would end up, on a supermarket shelf or in a kiosk window, was characteristic of the situation.

According to the interviewees in the PWC study, the 1998 crisis quickly cut the number of operators in distribution of food, although this would have probably happened sooner or later even without the crisis. The distribution system was unstable and fast-evolving. The biggest problems for Finnish producers were caused by wholesalers who did not meet the expectations. The importance of personal relationships was accentuated during the crisis. On the other hand, big and financially strong distributors were considered to be in a strong position towards both producers and customers. Storage facilities of high quality were scarce and the existence of these was one of the main criteria when selecting a distributor. During the crisis, Finnish food producers had two main ways of exporting products to Russia: either a Russian wholesaler came to pick up the merchandise from the factory in Finland, or the Finnish producer's subsidiary or a trusted Russian wholesaler took the products across the border. The first way was used to minimise risks and the second to maintain control in the distribution of premium and perishable goods.

Ruohonen (1999) presents the characteristics of Russia's distribution system at the time of the crisis in 1998. These were the central role of Moscow as the distribution centre of Russia and the smallness and low level of development of regional wholesalers and distributors. Because of this, goods were first brought to Moscow and from there sold to regional wholesalers. On the other hand, even though wholesalers still had a strong position in the regions, firms that concentrated solely on distribution services had already become the most important link in the distribution chain of fast moving consumer goods in the biggest centres. The distribution system in Russia could be more accurately described as a pick-up system at the time, since in every stage of the distribution chain the customers

(wholesalers, retailers) typically used their own equipment and picked up the merchandise by themselves from the seller. (Ruohonen 1999)

According to Ruohonen (1999), Western producers used five types of distribution solutions in Russia in 1998: outsourcing of distribution to a single Russian partner, creation of a network of local distributors, using a subsidiary, creating a completely own distribution network, and local production. These are briefly discussed below.

Outsourcing the whole distribution responsibility to a single Russian partner was practical in the case where the firm wanted its products to the Russian market with minimal commitment from their side. Foreign companies came to Russia and found a Russian partner who was in charge of the distribution. This option was suitable for products not requiring special sales staff education. The option was especially attractive due to its easiness and small risk and was thus used in most cases of market entry to Russia by foreigners. The biggest problem of this model is the lack of control. Single distributors rarely had a network with national coverage through which they could actively market the products in whole Russia. In addition, the distributors often had competing products in their assortment. Furthermore, big and professionally operating distributors were aware of their importance and insisted on getting good credit conditions as well as strong advertising and sales promotion efforts from the producers.

Firms could use also a *network of local distributors* in order to ensure larger sales volumes. In this case, the operation was based on cooperation with Russian importers, wholesalers and other firms operating in the field of distribution. A problem with this distribution model was that the prices differed depending on the specific distributor. Representatives were used to coordinate the cooperation between the producer and importer as well as for sales promotion in the retail tier.

Some foreign producers established a local *subsidiary* and in some cases their own warehouses in places of commercial relevance, typically in Moscow and St.

Petersburg. The subsidiary took care of the customs duties partly or wholly and sold the merchandise forward to large and middle-sized distributors. In this model, the control was more in the hands of the producer, especially regarding the price formation of the product. The downsides of this option were heavier costs and increased risks concerning e.g. exchange rate fluctuations.

Creating a *completely own distribution network* was highly expensive and increased the risks involved considerably. On the other hand, it maximised the producer's control over the distribution chain. This model required financial resources from the firm to make the needed investments and large sales volumes for the investment to be profitable.

Firms having their *own local production* were typically firms who had already operated in the Russian markets for several years and who had a clear strategy for increasing the investments. Clear benefits of the model were cheaper production expenses and the absence of customs problems and duties due to local raw material procurement. However, also in this case the firm had to choose the optimal distribution system locally.

Although all the five options presented above were used by foreign firms in Russia, they often reflected the life span of the distribution system, the firm's commitment to the Russian markets and its strategic plans for the future. In the beginning of the 1990s, when the risks were still considerable, a typical solution was to operate through one importer or a network of importers. In the mid-1990s many foreign firms established subsidiaries, and towards the end of the decade starting local production became more and more common.

4.1.3 From the crisis of 1998 to the present

As in many other respects, the financial crisis of August 1998 presented a watershed for the distribution system development. The events of 1998 have been recorded in numerous publications (e.g. Komulainen and Korhonen 2000), and thus we will

focus here only on the dynamics of the distribution system of food set in motion by the crisis. The consequences of the crisis on Finnish food exports to Russia are discussed in Chapter 6.

In the aftermath of the financial crisis, the actors in the food sector were sceptical about the retail chain development in the near future. If such development would take place, wholesalers' and distributors' roles were expected to be insignificant. The Finnish actors assumed that retail chains would emerge only in the long run, largely due to the existence of organised crime in business (PWC 1999). However, the actual development of retail chains has been fast (see Chapter 2). On the other hand, the prediction on the diminishing role of distributors might be realising at the moment. This topic is discussed more thoroughly in section 4.2. Another major trend speeded up by the crisis – besides retail chain development – was the revival of Russia's own food production (as discussed in Chapter 3). We will concentrate here on the effects of these two trends on the distribution system.

Firstly, the strengthening of retail chains has made the food sector business more professional as the tightening competition slowly but surely removes fragmented, inefficient and opportunistic actors from the market. However, it has also strengthened the retail chains' negotiation position towards distributors and producers (see section 4.3 for more discussion). Furthermore, it is gradually making the position of wholesalers more difficult, since chains increasingly want to operate directly with the producers.

Secondly, the strengthening local production creates increasing pressure for foreign producers to start production in Russia or at least to establish their presence more strongly in the Russian markets (discussed in Chapter 6). Furthermore, Russian consumers are increasingly favouring Russian food products instead of foreign ones (discussed in Chapter 5). Thus, shortening of the distribution chain by starting local production might well be essential in the future in order to stay in the markets.

Before the 1998 crisis, many Finnish producers actually had more activities in Russia than nowadays, such as logistics and trade promotion agencies of their own, as well as concrete plans for further investment. Because of the crisis, the activities were drastically scaled down due to decrease in demand, credit losses etc. Russia as an investment target was forgotten for several years.

The crisis tried the firms in various ways and there were also different kinds of means to cope with the crisis. Products targeted for the wealthy segment did not suffer from the crisis so badly or at least revived from it quite rapidly. Another strategy for making it through the crisis was having good relations with the distributor and sharing the losses. This way it was possible to maintain the operations intact. If a producer had local production, procurement was shifted to Russian raw materials and production concentrated on a few most lucrative products. Finally, a strong brand helped to maintain demand in spite of the crisis. These strategies could be applicable again in case of another backlash in the Russian economy.

“One could say that our salvation was that we had working distributor relationships and so we licked our wounds together with them. Everyone took their share of the losses. That way the distribution system survived in spite of the difficulties.”

“In my opinion, if we had retreated, it would have been a mistake. The Russians would remember it, if we had left. We never retreated from the market. Of course, we had to scale down our operations back then.”

In the PWC (1999) report the Russian interviewees said that it is essential to stay active in the market despite the crisis; those that survived the crisis would prevail in the future. Many foreign companies, among them also many Finnish ones, however, fled from Russia as a consequence of the crisis. The Russian interviewees' comment seems to have been correct, since – at least in the case of Finnish firms – those firms that stayed in Russia through the crisis are currently quite successful. Many of the

Finnish firms interviewed for this research said that it would have been a mistake to leave Russia in 1998 and, on the contrary, it would have been a perfect time to invest more since everything was cheap. Nevertheless, they recognised that many firms made huge losses and very few believed in such a fast recovery that actually took place.

“Exactly then was the time to invest in local production. You could have gotten anything with a cheap price. With one year’s rent you could have gotten any real estate you wanted. ... But everyone did just the opposite. We already had the financing, but the financier withdrew, because of the crisis.”

“Trade stopped back then because of external forces. But, I would add that the risk-taking ability of Finns is not the highest possible, because many have suffered losses there before.”

4.2 Food wholesale trade in Russia

This section discusses the history, current state and some future trends of food wholesale trade in Russia, as they are an essential part of the distribution system. Some forces affecting the development of wholesalers will also be described.

After the collapse of the Soviet Union, wholesale trade in Russia degenerated severely. In Soviet times, the wholesale sector had concentrated on capital goods, the demand for which decreased to a great extent after the collapse (Eronen 1996). In 1992, the foreign trade was liberalised and new, powerful wholesalers started to emerge. The development of the wholesale sector started in food products. New firms developed their storage and distribution systems to replace the collapsed distribution system of the state, and Moscow became the centre of wholesale business in Russia. The distribution system and its wholesale tier were very fragmented at the time, at least in St. Petersburg. Wholesalers were starting to

specialise in some specific food product categories (see Heikkilä 1997, Eriksson 1997 and Martin 1997 in Ruuhonen 1999).

Some trends in Central and Eastern Europe (including Russia) that affect wholesalers are the rapid development of a modern retail sector, growing concentration in the retail sector and changes in procurement systems that affect farmers and also the wholesale markets. However, Russia is lagging behind many other countries in Central and Eastern Europe in this development. The greatest threats facing the wholesale markets come from the changes in procurement methods. First, chains are shifting from traditional wholesalers to “specialised/dedicated wholesalers” that are specialised in a product category and dedicated to supplying supermarkets. Thus, the new wholesalers become more responsible for the quality, safety and consistency of the products. Second, the new wholesalers move from buying at wholesale markets or customary suppliers to contract-based production with producers that meet the specific standards of the retail chain. Third, in some cases it has been noted that the retail chain eventually acquires the wholesaler, or that they form a joint venture. In general, it can be said that the wholesalers and retailers are forming closer partnerships instead of arms-length relationships. (Shepherd 2004)

The food wholesalers in Russia are usually specialised and have a small assortment. They are increasingly under pressure from the retailers and, in some cases, also from the producers. As the retailers increase their share of food retail trade in Russia, the number of wholesalers will probably diminish. Some retail chains will use them mostly for making additional purchases, but not for buying high-volume products. One possibility is also that wholesalers will stay as importers or suppliers of small businesses (product.ru 10.7.2003, Vedomosti – Sankt-Peterburg). Sergej Lomakin, the general director of Kopejka retail chain, has said that the wholesalers with exclusive brands have priority (product.ru 11.12.2002, Kompanija). Otherwise they would rather work straight with the producer. The director of Pjaterochka has suggested that the wholesaler is an extra element in the value chain and that 60 % of

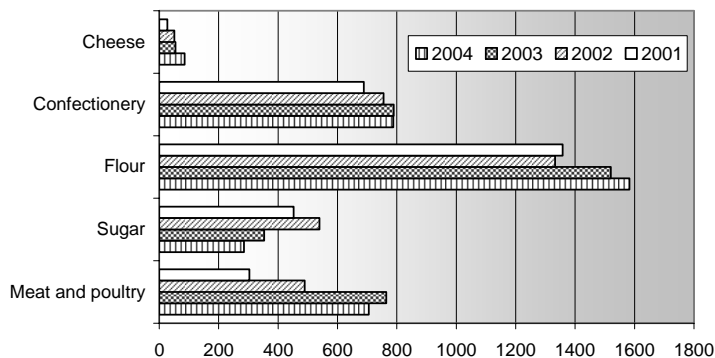
the goods in their stores already come straight from the producers and the rest from the wholesalers, but the share of the wholesalers is diminishing (product.ru 10.7.2003, Vedomosti – Sankt-Peterburg). From the smaller retail chains' point of view, the problem with the wholesalers is that as each wholesaler supplies only some specific foodstuffs, and thus the number of suppliers needed to build up an assortment becomes very large. Larger retailers, on the other hand, have in many cases the possibility of working straight with the producers and bring the goods to stores via a distribution centre. It is possible that the wholesalers are not large enough to be efficient in their field of business. In a business where efficiency is the key as the profit margins are shrinking, the wholesalers might need to merge and seek economies of scale.

Some wholesalers cope with the changing business environment by integrating their functions up- or downstream in the distribution chain and becoming producers or retailers, either wholly or partly. Some producers shorten their distribution chain like the retail chains have done. This has happened at least in the beer industry (product.ru 2.3.2005, Kommersant). There were earlier many layers of intermediaries between the retailer and beer producers, but they have been cut down by the producers. The role of the distributor is nowadays just to bring the goods to the right address, thus operating as a pure distributor. Baltika remains a notable exception, but it is likely to change its distribution system soon as well (ibid.).

In spite of this development, there will be some scope for efficient wholesalers or distributors also in the future. As the Western retail chains come to the market, more distributors will be forced to develop into real logistics operators.

Figure 8 below presents the sales volumes of selected food categories by wholesale companies in years 2001-2004. The food categories that are presented in the figure were chosen according to their importance and share of sales of all the foodstuffs.

Figure 8. Sales of selected food categories by wholesale companies, in 1000 tons, except for sugar in 10 000 tons



Source: Goskomstat

Judging from the figures, it would seem that the decline in the wholesalers' role has not started yet, as the trend is upward for most product categories. An interesting exception is sugar. Its wholesale volumes have dropped steadily since 2002. One explanation for this could be retailers' increasing purchases directly from the producers as private labels. The sales of other items have continued to rise more or less steadily, but, for example in confectionaries the growth has been very slow and is potentially stagnating.

4.3 Distribution of foodstuffs in Russia today

The distribution system seems to be still relatively disorganised in Russia. The roles of the actors in the distribution chain are often unclear, which complicates the situation especially from the viewpoint of foreign producers aiming at the Russian market. For example, the wholesaler is often also the importer and the distributor. In addition, the importer may also have such products in its assortment that it has not imported itself. The distribution system has undergone radical changes during the past 15 years and e.g. Nestlé, which is one of the biggest actors in the field, has changed its distribution system several times. Nevertheless, definite improvements

have taken place in particular since the 1998 crisis. As a result of the crisis and tightened competition, many opportunistic actors have disappeared from the market, making the business more professional. Furthermore, at least the Finnish producers nowadays have a relatively accurate knowledge on where their products end up, which was not the case in 1998. However, there still exists a lack of information concerning more remote regions and unorganised forms of trade.

Another major change concerns the so-called “pick-up systems” emphasised by Ruohonen (1999). Particularly in the 1990s it was very common that the retailer picked up the merchandise from the distributor. Currently, this older system and a more modern system in which the merchandise is delivered all the way to the retailer co-exist. The latter system is becoming more common due to the development of retail chains. The older system is still applied among unorganised forms of trade, as single shops or kiosk keepers come to pick up the merchandise from the distributor.

In foodstuffs, the distribution system is an important factor influencing competitiveness. Some Finnish interviewees even considered it more important in Russia than in the Western markets, and its role is expected to increase in the future. However, it was also pointed out that during the last few years, brand building and maintaining have been more important. Many producers expect major changes in distribution, especially concerning the development of retail chains.

There are some political and administrative factors affecting the development of distribution in Russia. One major issue is the trade policy and especially Russia’s potential WTO membership. Russia’s seemingly arbitrary trade policy seems to present problems to importers. Finnish producers find the unpredictable customs regulations problematic for making long-term plans. Also the fact that the Russian authorities utilise every case of animal disease to protect domestic producers concerns Finnish producers. This is, of course, rather common also in many other countries. The problems caused by the trade policy to Finnish producers seem to

differ depending on the product category. Problems caused by the trade policy often increase the motivation for starting local production, which is often one aim of the government in defining the policy.

Concerning technical issues of exporting, most interviewees did not see major problems in crossing the border, and according to them this depends largely on the exporter itself. If the documents are filled in with care and by the book, things will run smoothly most of the time. Also one reason for this view is that many Finnish producers do not take care of the customs operations themselves.

Finnish views on Russia's potential WTO accession were generally quite pessimistic. The producers did not believe that this would remove the trade disputes. However, it was pointed out that Russia's accession to WTO could somewhat stabilise the situation as the trade regulations would be harder to change for fear of sanctions. This kind of development has been seen in China after its accession to WTO. There are also joint Finnish-Russian projects aimed at making customs declarations easier. Currently the so-called Vihreä Linja (Green Corridor)⁷-project is showing promising results and might become a significant benefit for Finnish exports to Russia.

Although looking at the issue from somewhat different perspectives, the Finnish producers and Russian retailers seem to share a number of issues they consider challenging in the distribution system in Russia. Firstly, both point out the inefficiency caused by fragmentation and decentralisation of the distribution system. Working with a large number of small distributors generates complexity within the distribution system. One reason behind this is that the wholesalers are highly specialised: one sells fish, the other sells vegetables, and the third sells vodka. There are also problems arising especially with small suppliers due to lack of technology and developed product flow systems. As a result, they have problems

⁷ The aim of the Green Corridor system is that firms accepted to the procedure could send the necessary customs information electronically to the Russian customs officials before the physical border crossing.

in ensuring the agreed delivery time and high enough quality of products. Especially the retailers emphasized the lack of logistics operators, i.e. firms that would build logistics centres with high quality warehouses and sell logistics services.

Secondly, the question of distribution costs and their impact on the end price of the product was raised. In the food sector, basically all products are volume products with relatively low added value. Thus, transport costs make up a large share of the end price. In addition to distributors cutting a relatively large share of the profit, the costs are further increased by the deficiencies of the transport infrastructure in Russia. As a result, the producers find it more difficult to expand the geographic coverage of their products. This also creates a situation in which the people in the capital regions (which are also the richest, i.e. Moscow and St. Petersburg) get their food cheaper than people in more remote and poorer regions. Vast delivery distances also exacerbate the existing problem of securing the quality of the merchandise through the whole distribution chain. This is naturally a bigger problem for perishable products. Defects in cold transportation and cold storage still persist. Problems in storage capacity and delivery reliability also exist for non-perishable products, which creates a problem for the retailers as well. Both parties seem to be of the opinion that the producers should have more control over the distribution chain in order to reduce the distributors' contribution to the end price of the product. This issue is evidently more problematic for smaller producers: large firms are stronger and can control the whole distribution chain and thus also the price.

Thirdly, as is often mentioned in the context of Russia, bureaucracy complicates business operations. This concerns also distribution and trade. For example, returning the goods to the producer is troublesome and bureaucratic. Also reporting the volume-discounts is difficult in the Russian accounting system. Some of the Finnish interviewees also mentioned corruption as a general problem.

”[Common problems are] general ineffectiveness and lack of planning that lead to the fact that too large a share of the end-price of the product goes to the distributors. Their share might be even 45 %, when it should be about 10 % according to common sense.”

”A Russian knows how to make things bureaucratic. And - how should I put it – Russia is a totally corrupted society and it won’t change very fast. But you can work sensibly even in those circumstances.”

Both Finnish and Russian interviewees expect the development of retail chains and increasing competition to mitigate some of the above mentioned problems. The number of distributors and especially wholesalers is expected to decline and the toughening competition will force them to make investments in facilities. In addition, retail chains are setting up their own distribution systems in order to ensure smooth supply of products, which is discussed in more detail below.

4.3.1 Distribution systems of the retailers

Currently, the retail chains are developing their logistics systems fast and this is regarded as very important for ensuring the competitiveness. This process was going on at all the interviewed Russian retailers. The strengthening of the role of retail chains has impacted also the balance of power in the negotiations between the retail chains and producers and distributors. Nowadays, the retailer often has the dominating position, but this evidently depends on the situation; how much the retail chain needs the specific producers’ or distributors’ products and vice versa: how much the producer or distributor needs to get the products into that retail chain. Some producers are strong enough to organise the whole value chain as they wish. This way they can control the margins that each link in the distribution chain gains and thus make it profitable for everyone to push the products forward.

The negotiation power of wholesalers and other distributors is expected to diminish (see section 4.2 on wholesalers). Furthermore, it was claimed that the negotiation

power of wholesalers is already very weak since the wholesale business is so fragmented in the regions and there are no actual nationwide wholesalers. Nowadays, considerable weight is given to brands. Their importance is expected to grow further in the future. Strong brands shift power to the producers, since consumers' preferences force the retail chains to include the brands into their assortment.

Despite being still relatively fragmented, the distribution systems in Russia are beginning to resemble those applied in Western systems at least on the retail chain's end of the distribution chain. In other words, evolution has taken place in this respect since Ruohonen's (1999) study and the speed of change has been quite rapid. The variation in distribution systems is at least somewhat caused by the different formats used by the retail chains and the number and regional distribution of their stores. Chains with fewer shops tend to use wholesalers that bring the goods directly to the stores. As the wholesalers are usually quite small and/or have a relatively limited catalogue of products, this system causes a lot of traffic. One interviewee mentioned that there was "a traffic jam at their backdoor".

The larger chains with more stores tend to prefer to work directly with the producers, thus cutting off the intermediaries and being able to sell the goods cheaper to the consumers, or securing themselves a larger margin. A common tendency among the Russian retailers seems to be the aim to shorten the distance from the producer to the end-user or, in other words, to shorten the value chain. If this wish is realised, producers have to acquire transport equipment or outsource the delivery to some firms offering delivery services. However, this is also in the interests of the Finnish producers as they find the logistics system in Russia inefficient partly because there are too many links in the value chain. As a result, the price for the end-user becomes too high. Especially the wholesalers were blamed for taking too large a share of the profit, at least compared to their Western counterparts.

One alternative for decreasing the number of links in the distribution chain is the establishment of a distribution centre. Practically all large retail chains seem to either already have a distribution centre or centres, or are in the process of acquiring one, either by building it themselves or renting the facilities. In 2002, the first seven retail chains announced their plans to build distribution centres (product.ru 28.5.2002, Vedomosti). They included Pjaterochka, Kopejka, Perekrestok, Diksi, Ramstor, Sedmoj Kontinent and BIN. At that time, storage facilities could occupy almost 50 % of the total area of a store in Moscow. The reasons cited for building the distribution centres included increasing the productivity of labour in the store, simplification of supplying goods to the store and increasing control of the product flow.

Building a distribution centre obviously requires financial resources, which is why it is not always a viable solution. For example, the Pjaterochka chain first rented three warehouses, in order to avoid building one. However, the system turned out to be a nightmare from the viewpoint of logistics and they decided to build their own distribution centre, which has helped them to boost efficiency and lower expenses (Torgovets December 2004). The problem with the existing storage facilities is that they are old and do not cater to modern demands (product.ru 18.2.2003, Finansovye izvestija). There is clearly a need for high-quality logistics enterprises and warehouses in Russia. Currently, these services are available mainly in Moscow and St. Petersburg.

Also the way of using the distribution centre differs among the retail chains. Some chains have the objective to move all the goods through a central warehouse. This improves delivery planning and the control of the product flows to the stores. This is not conceivable when the producers or distributors bring some of the goods straight to the store. Another reason is that by keeping a small stock they can protect themselves somewhat against adversary price changes or temporary insufficiency of supply. However, it is common to have certain goods delivered straight to the store despite having a distribution centre. This is usually the case with perishable goods.

A matter related to the tendency of minimising logistics costs and shortening the value chain is the new emphasis on co-operation between the members of the value chain. Close cooperation is needed e.g. when applying just-in-time distribution systems, which have gained popularity also in Russia. In addition to cost reduction, the ultimate aim of these systems is to increase the delivery reliability, which is still a big problem with many distributors in Russia. The functioning of the producers' distribution system is an important factor influencing the retailers' selection of business partners.

Ultimately, the selection of the distribution system depends on the objectives of the retail chain, i.e. what it wants to achieve with the system. The number of stores and their geographical proximity are also factors that affect the choice of the system. And as the chain develops, it may feel the need to change its system and its suppliers need to change with it, if they want to keep supplying products.

4.3.2 Current issues in retail affecting distribution

In addition to the balance of power between the producer, distributor and retailer discussed in the previous section, two other significant factors are shaping the trade in foodstuffs in Russia: the strengthening of retail chains and the development of retail chains' private label products. These are discussed next, and some additions will be made to the discussion on the balance of power.

4.3.2.1 Strengthening of retail chains

It seems inevitable that retail chains will dominate the retail trade in Russia in the future. The Finnish producers' opinions seem to be somewhat divergent on this issue. Roughly speaking, producers who have strong brands and who operate in the premium segment, see the development as a positive thing. They believe that once a producer has a good product and well-functioning distribution system, it has a place on the shelves of retail chains.

The strengthening of retail chains is expected to have many positive effects for producers. Consolidation reduces the vast amount of actors in the business, which will clarify the retail scene. The remaining actors are also the most professional ones, which makes it easier to act in cooperation in issues such as trade promotion. Other mentioned benefits are simpler negotiations (as there are fewer players to negotiate with), increased price level compared to unorganised forms of trade, and increased sales volumes. Increasing competition forces market operators towards more market orientated practices, although interpersonal relations are still considered to affect purchasing decisions.

"I would say that we have better chances this way [as the retail chains get stronger], because then the business will usually become more professional and automation will also increase."

"In Russia the business is conducted not with the head, but with the heart".

"Let's say that interpersonal relations are always, of course, important. But the strengthening of the retail chains and their emergence have brought more kind of professionalism in it. The rouble counts more than purely personal relationships."

However, there are also downsides. The most important issue is the shift of negotiation power on the retailers' side. As a result, it is likely to be more difficult to get products into the retailers' assortment. Furthermore, it is not sufficient to get the products in the stores, they also have to sell well in order to stay there. This usually requires more marketing efforts. Many Finnish producers also regarded the retail chains' terms of contracts as outrageous. Entry fees for products are increasingly demanded by the retail chains, and the retailers affect also the positioning of products on the store shelves. Finnish producers consider these fees to distort the market. Furthermore, the Federal Antimonopoly Service is currently investigating misconducts in the retailer-supplier relationships and threatening some large retail chains with cartel charges (product.ru 4.2.2005, Kommersant-Daily).

“Entry fees, shelving fees and others... Russians are kind of learning the toughest ways of trading from the Western markets and then toughening them a bit further.”

“It will, of course, affect us the same way as the local actors, when the price of getting to the shelves rises, like the entry fees and such, it will all in all make getting to the assortment more difficult. We have already experienced it in other markets.”

4.3.2.2 Private labels

Retail chains' private labels have the potential for shifting the balance of power even more to the retailers. They give more control over the distribution chain to the retail chains and thus give them also more control over the price formation of the product. This creates a threat to the producers since private label products compete with their brands. Finnish producers are not very worried about the development yet. One reason for this is that Finnish producers' products are mostly in the higher price category, whereas private label products are typically meant for less wealthy customer segments.

“Everywhere the private labels will take a certain share of the market. One must just adjust to it and every firm [producer] will make their own decision, whether to produce them or not. But, let's say that it is a threat in the sense that if we don't do anything, the end-result is probably bad.”

The share of private labels of the sales of all food products is still very small in Russia compared to most Western markets, even though private labels have been in Russian food markets since 1999 (product.ru 26.10.2004, Vedomosti and Torgovets December 2004). However, this depends on the product category. Some retail chains have intentions to raise the share of private labels a lot during the next few years (ibid.). However, the rationale for retail chains having private labels in the assortment was questioned. It was suggested that the retail trade is still so fragmented in Russia that private labels do not bring any benefits. Furthermore, it

was claimed that Russian consumers favour strong brands and therefore private labels are in a weak position in the Russian market. Although private labels are targeted at consumers belonging to the lower-income segment, the products need to be of sufficient quality. For example, it was alleged that the private labels have failed to increase sales for a known discounter chain as the customers have found out that the quality is not as good as it was claimed in the advertisements.

4.3.3 Finnish producers' distribution solutions

In order to obtain a comprehensive picture on the distribution system of food, it is necessary to examine also the producers' viewpoint. In the following the currently used distribution systems of the thirteen interviewed Finnish food producers operating in Russian markets are presented. Unorganised forms of retail trade are still significant distribution channels for some Finnish producers, but the producers' distribution systems are largely the same regardless of whether their products end up in unorganised retail sale or on the shelves of retail chains. The five typical distribution models used at the time of the 1998 crisis are still used by Finnish producers. However, alongside those five models, it is useful to specify one more: operating with a big producer who has a good distribution system. Furthermore, another notable feature is the generality of mixed model distribution systems.

Table 4 presents a simplified classification of the distribution solutions that the Finnish producers interviewed for this research currently use in Russia. The classification of the distribution systems in the table proceeds according to the level of commitment to the market: from a minimal commitment model of outsourcing the system completely to own production and an own distribution network.

Table 4: Finnish food producers' current distribution systems in Russia

Distribution solution	No.*	Benefits of the model	Shortcomings of the model
1. Outsourcing to a single Russian distributor	2	Minimal commitment and risk	Lack of control, lack of market monitoring, vulnerability, within-portfolio competition, tough trade conditions
2. Operating alongside a big producer with a good distribution network	2	Less within-portfolio competition and stronger portfolio position, large coverage, synergy benefits, better negotiation power towards retailers	Increased vulnerability, tough trade conditions, balancing between own and partner's products
3. Network of local distributors	8	Competing distributors	Price policy (competing distributors)
4. Subsidiaries	1	Division of risk	Conflicting interests
5. Own distribution network	2	Maximal control and market monitoring, response to the retail chain development	Expensive to build and maintain
6. Own (and/or licensed) local production	4	Production costs, minimising custom duties	Expensive to build and maintain, risky, funding
7. Mixed models	5	Depends on the mix	Depends on the mix

* Number of interviewed firms using the particular distribution model. Many firms have mixed models so they are included more than once.

Also some characteristic benefits and shortcomings of each distribution solution are identified. There are certain factors that create a continuum in relation to commitment and thus they are not named in every distribution system. These factors are cost, control of distribution and market monitoring (meaning information on customer purchases and preferences). The deeper the commitment is, the more the producer has control over distribution, and the more information is obtained from the distribution chain and consumers. However, also the needed investments are bigger and the maintenance of the system becomes more expensive. In the following each distribution solution is discussed more thoroughly.

Outsourcing to a single Russian distributor. Regardless of the fast development of Russia's distribution system and economy, outsourcing seems to be still used as a distribution solution among some Finnish food producers operating in Russia. This might indicate that the development of the producers' distribution systems has remained partly at an infant level. However, it has to be taken into consideration

that in many cases the producer previously had a more elaborate system which had to be cut down due to the 1998 crisis. Through this strategy the producer can avoid price venturing and other unwanted results of mutual competition between the distributors. This can also be a good strategy for a producer aiming at building a strong brand, since the resources can be better focused. It helps, if the distributor already has other strong brands in its assortment. Furthermore, the distribution system is quite simple and carries a low financial risk.

The shortcomings of outsourcing are still today largely the lack of control on the distribution chain and the lack of market monitoring. However, market monitoring services can nowadays be purchased from consultants and some distributors have decent monitoring systems. In spite of the fast development of distributors, the lack of control is still a problem, especially concerning perishable products. These problems are naturally mitigated as the distributors and distribution infrastructure develop further. Although this strategy carries only little financial risk, dependence on one strong distributor might pose a risk in the case of disagreement between the parties. This simple distribution model is implemented today with thoroughness. Producers have e.g. joint marketing efforts with their distributor.

“We have had them [other partners] before. We ended up with this [distribution system] because of our experience that this dealer can serve all kinds of stores and retail chains. That way there is no need to work with more than one dealer. It would just cause unnecessary competition, if you had many dealers selling the same products. Price speculation and other things like that.”

“Actually at first we used several importers, but we decided after a while that as our goal is to create a strong and well-known brand, we need to concentrate all our strength to one importer. Then we chose this one that felt the most suitable at that time, and it was exactly the right decision.”

Using the distribution network of a big producer. Although operating “under the aegis” of a bigger producer could be regarded as operating with a single distributor, it is useful to separate the two due to strategic considerations. Roughly speaking, working with a firm that operates mostly in the field of distribution, e.g. a wholesaler, exposes the producer to competition with other producers’ products in the wholesaler’s portfolio. But working with a bigger producer, who has been able to create its own distribution system due to its size, exposes the smaller producer to a threat of competing with its partner, should the partner decide to start to produce a similar product. There is a clear strategic difference between these two options. The most obvious negative factor of the latter is probably the increased vulnerability: the small producer might lose its distribution channel completely if the bigger partner starts congruent production. On the other hand, the day-to-day competition within the portfolio is smaller since it is unlikely that the big producer has as much competing products in its distribution portfolio as some big wholesaler.

In the case of the interviewed Finnish firms, the bigger partner is usually a major Western producer that has a large distribution network in Russia. Motivations for selecting the particular partner were long-term cooperation and failing to find a suitable Russian partner with as large a distribution network. The prerequisite for this kind of cooperation is naturally the non-existence or at least very small number of competing products between the two producers. There is a built-in problem of clash of interests in this system since the resources have to be divided between the distribution of both producers’ products. Thus, activeness is required from the smaller partner in every respect.

This strategy has also several benefits. First, wider distribution coverage than could be obtained through a Russian wholesaler. Another positive thing is the increased negotiation power towards retailers. The arrangement makes the smaller producer’s products also more attractive to retailers since they are in the same portfolio with a big international brand. Market monitoring information can be received through the

bigger partner's distribution system and through ordering distribution monitoring from consultants.

“The biggest benefit is of course distribution that covers the whole country, a very large sales network and through that numerous daily contacts with retailers, for which we would have no chance otherwise. And then there is the fact that if the products do not compete with each other, the mutual synergy and growth of negotiation power in relation to the retailer are benefits.”

“Well, of course you'll have to constantly fight for your role. We have to remind them [of ourselves] and make for example promotion campaigns. So it isn't blissful. You'll have to work all the time, whatever means [of distribution] you use.”

Network of local distributors. This was the most commonly used solution among the interviewed Finnish firms. Furthermore, this category included the widest scope of implementation, in the sense of commitment to the market. Minimal commitment is represented by a producer who does not have any marketing in Russia and whose Russian export agents come to pick up the merchandise and take care of everything. In the other end there is a producer who has a nationwide distribution network including own warehouses as well as TV and magazine advertising.

The problems with this model are mostly the same as in the case of one local distributor concerning lack of control and market monitoring. The characteristic problem of this model is, however, the mutual competition between the distributors. This might cause problems, for example in pricing of the product, if the distributors compete with each other. Mutual competition can be mitigated, however, e.g. by defining clear geographical operating areas for the distributors. On the other hand, the producer can deliberately aim at creating mutual competition between the distributors in order to force them to develop their activities and to reduce their power towards the producer.

The networks are created for example by searching for active distributors at exhibitions. Usually an important selecting criterion is sufficient store coverage. Furthermore, the distributor has to bring clear additional value to the distribution chain; mere storage facility is not enough. The producer expects logistical services as well as trade promotion from its distributors.

“The distributors are all Russian and our main rule is that there must be at least two distributors per city. In St. Petersburg I guess we have four distributors and in Moscow five. But anyway, the minimum amount is usually two, so that no one has exclusive distribution rights. If that was the case, they could determine the terms... A little bit of competition between them is needed, because if the distributor is too content, they are inclined not to develop the system.”

Subsidiaries. Here subsidiaries refer to those units that are established solely for distribution purposes. Firms that have mainly production subsidiaries are included in the “own local production” group of distribution systems. Some of the interviewed Finnish producers have subsidiaries in Russia but at least at the moment the main motivation for these is not arranging the distribution, and thus only one of the interviewed producers can be regarded as using this model. Russian operations are not crucial for the producer and the subsidiary has also independent activities within a different product category. According to the interviewee, this creates difficulties since at times the interests of the two companies clash. On the other hand, this depends on the case. If the subsidiary has originally been established to handle the distribution, such conflicts are unlikely to rise, but if the subsidiary is an existing firm having other activities, then conflicts of resource allocation understandably emerge.

“We discussed different options and reckoned that this one is the best of these alternatives. So, we do not compete with this operator, we rather complement each other. This felt reasonable as the thing is that we are not in a joint venture there, but it is specifically these sales- and distribution activities that need to be taken care of.”

Own distribution network. Two of the interviewed Finnish producers have their own distribution network in the sense that they have their own distribution equipment (transport vehicles, warehouses etc.). Additionally, they both use a network of local suppliers. Both also produce perishable goods, which is probably the main reason for the distribution solution since it gives maximum control over the distribution chain. Maximum control is one clear benefit of this model, another is potential for extensive market monitoring. Along with the increased control and information come expenses from building and maintaining the system.

A firm has to consider the rationale for having such a heavy and expensive system since it is not self-evident why a producer should have its own transport equipment. If a producer wants to concentrate on its core operations (production, brand building), it could benefit more from using a network of local distributors. If, on the other hand, the producer wants more control over the distribution chain, then an own distribution network could be the right solution. There are two important factors that justify the use of one's own distribution network. First, the inevitable dominance of retail chains in the future in Russia, as well as elsewhere. Chains increasingly want to operate directly with producers instead of wholesalers and demand direct delivery from the producer. Second, sufficiently big producers might gain scale benefits from having their own distribution system. A good example of this is Coca-Cola, which has its own nationwide distribution system in Russia.

“Yes, we are planning to use more transport services in the future because it is not our primary business at all. We intend to outsource it [transportation] completely when it becomes possible.”

“Well, the problem is that our own control is too small. And in that sense our distribution system is not ready.”

Own (or licensed) production. Although own production cannot be regarded as a distribution system as such, it is highly relevant in this respect since it shortens the distribution chain as the merchandise does not have to cross the border. Four of the interviewed Finnish producers have their own or licensed production in Russia. Most advantages from this system are related to the absence of the need to cross the border. Exchange rate risks are minimised as well as problems from customs procedures (bureaucracy, corruption) and trade policy (e.g. Kauppalehti 19.09.03). Especially the latter problem erupts at times causing major problems for exporters. The latest major example of this is from summer 2004 when Russia momentarily prohibited the import of some food supplies derived from animals (Kauppalehti 4.6.2004). There are also production cost advantages especially concerning labour and energy, as well as firm-specific advantages. For example in the case of products with extremely short sales time it is almost obligatory to locate production near the customers.

One of the most evident shortcomings is the large amount of capital needed for establishing production facilities. In the case of internal investment funding, the investment requires a large part of the firm's capital stock. On the other hand, receiving external funding is far from evident because of the country risk. These issues are problematic especially for a small firm. Other common problems related to investing in production facilities are e.g. acquiring the required licenses, land (in case of greenfield investment) and finding the right partner. Since there is a lot more to be lost in case of a crisis, the production volumes have to be sufficient so that the risk is worth taking and the day-to-day operation is profitable. Licensed production in Russia can bring additional market information as well as increase commitment in the Russian partner's side. The downsides are more difficult quality- and other control. Shifting the responsibility more and more to the Russian partner was generally considered important at least in the longer term.

"When you produce according to the local forecasts, you can see how much goods there are in storage and when you'll have to produce and so on. The other benefit is

the ingredients that are bought locally. Their price level is maybe lower than in Finland, or elsewhere. And, of course, the local organisation is committed in a different way when they produce themselves. That way they control the system in its entirety.”

“Well, the thing is, that always when your products are produced somewhere else, packaging is ordered from Russia and the goods are produced and packaged there and so on, the process is slower and somehow more difficult to control from here as the owner of the product, or trademark, actually.”

Mixed models. Five of the interviewed firms can be regarded as having a mixed distribution system, meaning that two or more distribution models can be clearly distinguished in the firm’s whole distribution system. Generally speaking, producers using a mixed model have relatively large operations in Russia. The motivation for using a mixed model is to customise the system for the firm’s specific needs. It can e.g. compensate for the lack of capital needed for larger investments. If the firm has local production and a strategy of nationwide coverage but not enough resources for this, it can act in cooperation with a larger producer with an existing distribution network. If the firm’s activity is concentrated on certain areas, it can use its own distribution network in those areas, and other distributors in less strategic areas. Finally, if a firm produces both perishable and non-perishable products, it can ensure the proper conservation of the former through own distribution and let other distributors take care of the distribution of non-perishable products. All these options can be found among the interviewed Finnish firms.

4.4 Conclusions and future prospects

Distribution in Russia’s food trade is still young and in a state of flux. Although the distribution sphere is quite disorganised at the moment, major improvements have taken place in recent years. Before the 1998 crisis, the huge demand and supply created possibilities for various kinds of operators in the field of distribution. The

1998 crisis had a cleansing effect as the number of opportunist and inefficient actors plummeted due to the toughening of the market environment.

In the retailers' end of the distribution chain, the development has been fast and linear after the 1998 crisis. Retail chains, although still a clear minority, are taking over the retail markets at a fast pace at the expense of unorganised forms of trade. This strengthening of chains is increasingly shifting the negotiation power on their side. This is reflected in toughening trade conditions for distributors and producers. This concerns especially the smaller actors. The shortening of the value chain and the emergence of distribution centres are currently strong tendencies in the trade in foodstuffs. Retail chains' demands for stronger co-operation may prove to be difficult for smaller producers but the larger ones may welcome this as it helps them to control the prices and their brands. The emergence of distribution centres helps the delivery of products directly from the producer to the retail chain, as they may be delivered to one point, although this is still a too heavy requirement for many producers. The delivery reliability is still considered to be a problem and each chain has dealt with it in its own way. From the retail chains' point of view, the problems are usually caused by the different links in the value chain between the producer and the wholesaler, and thus it is only natural for them to try to shorten the chain. How this will affect the future of the wholesalers and distributors remains to be seen. However, a shake-up period in the distribution sphere, leaving only the most efficient actors is probable in the future.

The strengthening of the retail chains seems to be shrinking the role of distributors as the chains increasingly want to work directly with the producers. Only the best distributors will survive and many wholesalers are likely to transform into firms offering only logistics services. The emergence of private label products is also a result of the expansion of the retail chains. Finnish producers do not yet see them as a major threat but they are monitoring the situation. A good brand is a strong counterforce against the chains' increasing power since retail chains are increasingly taking into consideration the consumers' preferences, and people want

good brands. Although the business is toughening in Russia, good interpersonal relations can still help in trade negotiations.

In the case of Finnish producers, the development of distribution systems has been somewhat less linear. Exporting to Russia before the 1998 crisis was easy due to the huge demand for foreign food products. This might have created a fallacy of endless profits in the minds of Finnish producers, which in return resulted in poor preparation for more difficult times. Many of the interviewed Finnish producers had more elaborate operations in Russia before the crisis, and basically every firm had to downsize their operations in Russia due to the crisis. Firms had different strategies for overcoming the crisis period. Some have succeeded in regaining sales volumes while others are far from the pre-crisis levels. However, although some producers have had to return to more simplistic forms of operation, their distribution systems seem to be working better than previously. For example, nowadays producers have quite good information about where their products end up, which often was not the case in pre-crisis times.

At the moment, Finnish producers use basically six alternative distribution models or a combination of them. Currently the most popular model is using a network of local distributors. Only a few firms have their own production facilities or own distribution networks in Russia. The smallness of Finnish producers plays an important role. Both risk intolerance and problems in finding necessary funding are exacerbated in the case of small producers. Nevertheless, there have recently been signs of increasing activity by Finnish food producers also in starting up local production in Russia. One example of increasing activity and commitment to market is Valio's recent investment in a customer service centre near Moscow (Valio).

5 RUSSIAN CONSUMERS

In this chapter the discussion turns to marketing related aspects in Russian retail, as it is an important non-physical aspect of the distribution chain. The chapter begins with a description of Russian consumers' buying behaviour. Marketing of food products, the consumers' thoughts on domestic and foreign food products and the image of Finnish food products in Russia will also be covered. The chapter ends with a brief discussion on what the results of this chapter imply for the Finnish producers.

In the Soviet Union, quality was not emphasized in production. Because there was scarcity, also products of inferior quality could be sold. Nowadays there is no shortage of supply and the Russian consumers have a wide variety of high-quality products to choose from, if their incomes allow it.

Russians appreciate quality and they are willing to pay for it. At the same time, Russians are very price-conscious consumers. They are not willing to pay for overpriced products. These points came up in almost all of the Finnish and Russian interviewees' answers. According to a poll conducted among 1500 Russian consumers, 44 % of the respondents considered price as the most important factor affecting their buying decision of food products, 52 % found quality the most important factor, and 4 % declined to answer (FOM 2002). Russian consumers are more polarised on the basis of income than in Finland. Price is still the decisive factor in choosing between different products among the consumers belonging to the lowest-income segments. Also consumers in the higher-income segments are price-conscious: if there are products that are perceived to offer similar value, the consumer will think carefully which one he/she is going to choose.

The different consumer segments are sometimes difficult to define in Russia. Many interviewees talked about the emergence of a middle class, but there is no single definition for the middle class. It is difficult to define the middle class in terms of

income, although it would be the most easily quantifiable measure. Income is the most often cited criterion for belonging to middle class, but opinions on the level of income needed to belong to the middle class vary widely. In a poll carried out by the Russian Public Opinion Foundation, the level of monthly income needed for belonging to the middle class (when asked from respondents) varied from 1000 rubles to 3000 dollars (approximately 85,500 rubles⁸) per person in a family. According to the respondents' subjective opinion, in February 2004 43 % considered themselves as belonging to the middle class, which is a surprisingly high figure. 49 % considered that they did not belong to it and 8 % declined to answer. The share of people considering themselves as belonging to the middle class had risen considerably from 1998 and 1999, when similar polls were carried out (FOM 2004). As a curiosity it can be mentioned that the average monthly salary in Russia in 2004 was 6828 roubles (Bank of Russia). For comparison, in St. Petersburg the average monthly salary in December 2004 was 10705 roubles and in the Leningrad province it was 7052 roubles in November 2004 (Economic Monitoring). According to Colliers International, in 2003 approximately 37 % of St. Petersburgians' spending went to food products (product.ru 25.3.2004, Vedomosti).

"I would say that the Russians are quite demanding. Or, let's say that they are more European as consumers than the Finns."

It was also pointed out that the Russians are not very brand-loyal and they like to try everything new. In the future quality will become even more important as the consumers' incomes rise. If the middle-class grows in Russia, it might affect the discounter chains more than others, because their competitive edge is low prices, and not so much quality. It is also important for Russian consumers that the product is natural in the sense that it is free from food additives etc. Because of this preference for natural products, local products are favoured in mayonnaise and milk, for example.

⁸ Calculated using the official exchange rate of Bank of Russia in the beginning of February 2004.

According to Bezrukova (2005), the consumers in different parts of Russia differ markedly from each other. This became clear in the interviews also, as the interviewees discussed the differences between the consumers in St. Petersburg and Moscow. The basic difference between St. Petersburgian and Muscovite consumers is that St. Petersburgian consumers are more conservative in the sense that they do not change their consumption habits so easily. Muscovites, on the other hand, like to try everything new. Because of this conservatism, new products have a harder time penetrating the market in St. Petersburg than in Moscow. It was also claimed that St. Petersburgians are more patriotic consumers than Muscovites. As an example of yet another difference, an interviewee from a discounter chain explained that there are higher-income consumers in Moscow, who would never buy from their outlets, “*all they need is Sedmoj Kontinent*” (a more expensive Moscow-based retail chain). But, it was added, there is no such mentality in St. Petersburg, where more affluent people buy from cheaper retail chains as well. An opinion was also presented that Russians in general do their shopping quite impulsively. But this is also expected to change in the future as people learn to plan their spending more carefully.

5.1.1 Marketing of food products – interviewees’ opinions

“Our marketing [in Finland and Russia] does not differ in basic positioning of the products. The products are positioned as suitable for the whole family, beginning from purity, quality and all that. But the implementation of marketing is different. We are doing Russian advertisements, for Russians and by Russians.”

Also marketing and advertising have developed rapidly in Russia during the past decade. Compared to Finland, the Russian consumers are more sensitive to advertising. This is obviously due to their shorter period of being exposed to it. Chains expect the producer to actively advertise its products in order to secure sufficient circulation speed of merchandise. This is naturally beneficial to the producer as well, but some regarded the trade promoting requirements overwhelming given the producer’s size and resources.

In foodstuffs, as in consumer goods in general, television advertising is the most important marketing channel, but it is more expensive in Russia than in Finland. The general director of Pjaterochka, Sergej Lepkovich, told the Torgovets magazine that *“everybody knows that most of the price of a branded product consists of television advertising costs”* (Torgovets December 2004).

Due to resource constraints, Finnish producers’ ability to use television advertising is smaller than that of many of their large international or Russian competitors’. Additionally, Finnish firms spend less money on advertising in Russia than in Finland, as Finland is their primary market. The role of newspapers or magazines is marginal in foodstuff advertising in Russia.

As television advertising is continuously becoming more expensive, the producers have increasingly shifted the emphasis on in-store promotions. This provides an effective and more cost-efficient channel to reach the consumers also for smaller producers. An opinion was presented that previously up to 70 % of the advertising budget was spent on television advertisements and 30 % on in-store promotion of products, but nowadays the situation has reversed.

The “grapevine” was mentioned as having a large influence in Russia, i.e. if a product has good perceived quality, news about it will spread through interpersonal networks. However, it was also mentioned that it works that way in Finland, too, so that might not be a big difference between advertising in Finland and Russia. Further, it was added that *“it is a lot more effective than grapevine if you put an ad on television for heavy rotation.”* Television in general was thought to be an effective means for advertising, although there was an opinion that it is difficult to differentiate from others on television.

The “Russification” of marketing was considered important. *“When in Rome, do as the Romans do”*, as one interviewee said. The basic positioning of products is

usually the same in Russia as in Finland, but the advertising is made more Russian. A clear difference between Russian and Finnish advertising is that Russians use colors less conservatively. They like to make things colorful, and product packages are no exception. Bargain sales are also a good way of marketing, as people love them. They are still a comparatively new concept in Russia. Even better is, if the retailer can offer something for free on top of the purchase.

"All of the advertising is done from a Russian point of view nowadays. I don't know if there are any serious actors in the market anymore who would do so-called translated advertising. The starting point with all the larger actors is that Russia is such a large market that solutions will be made for it separately from other markets."

One aspect of marketing is also the adaptation of products to local tastes. Especially in foodstuffs, national tastes differ so much that adaptation to local consumer tastes is essential in achieving a considerable market share. It seems that the more ready-made the product is, the more it has to be adapted to local tastes. Basic products like flour, pasta etc. do not have to be adapted, but more ready-made products need to be.

5.1.2 Domestic vs. foreign food products

In the 1990s, when the market opened, buying Western food products was trendy, and it was also a way of showing wealth and status. Today foreign products⁹ are not regarded as so special anymore. The domestic products started to win the shelves of the stores back after the financial crisis in 1998, as the consumers started to use them once again, partly because of financial necessity.

⁹ A noteworthy point here is that the division of products into foreign and domestic is not exactly clear-cut, because foreign products may be either imported or produced in Russia by a foreign firm. In the latter case, they are not strictly foreign, but it was not always clear, which type of product the interviewees were referring to, when they spoke of foreign products.

Most of the interviewees thought that Russians appreciate their domestic food products genuinely and not just because of the lower price. The reason offered was that people in all countries usually like to buy domestic food products. It was claimed that the most wanted products are those that are produced in Russia in co-operation by Russian and Western producers, because in those products the price-quality ratio is perceived to be the best.

In a poll conducted in 1996, 1361 Russians were asked about their consuming preferences regarding food products (FOM 1996). The results were that other things being equal, 70 % of the respondents preferred to buy domestic food products. Only 5 % of the respondents wanted to buy imported products and to 18 % the products' country of origin did not usually have any importance. 7 % of the respondents did not answer the question. There could be some error in the results of this study as people might be inclined to answer in a more "patriotic" way than they behave in reality, but the results were still clearly in favour of domestic products.

The favouring of either domestic or foreign products depends on the product category in question. It was suggested that the current buying behaviour is such that consumers buy mostly domestic food products and imported products are bought to "fill in the gaps" in the shopping basket. It was also claimed that consumers in Moscow and St. Petersburg are more international than others, so that consumers in other regions buy more often domestic products than consumers in those two cities. However, the lower incomes in the regions might play a role as well.

5.1.3 Image of Finnish food products – interviewees' opinions

"The image is good. And, in my opinion, it would pay for us [Finns] to stress more our nationality, not only in Russia, but elsewhere, too. We have this weird belief that if there are two slogans and the other one reads: "Good international quality" and the other one: "Good Finnish quality", then it is better to use the first one. "International quality", there is no such a thing. There are no international markets. There are local people, who think locally."

According to the interviewed Finnish food producers and Russian retailers, the image of Finnish food products in Russia is considered good or very good. Additionally, there was an opinion among the Russians that Finnish food products are considered to be of better quality than Russian food products. In the past, foreign origin of a food product was a sign of quality and so was Finnish origin of a product. The Finnish origin of the product still signifies quality, but now the situation has changed so that foreign origin is not special anymore. But, one comment was that as Finns are so close neighbours, the Finnish products have maybe a bit better image than other Western products. Additionally, before the *perestroika* almost all of the imported food products in St. Petersburg and its surroundings were Finnish, which still has some significance. In the stores of one retail chain about 3 % of the products are presently Finnish (it is a more expensive supermarket chain), but the share could be higher. Finns should promote their products more.

“The Finns are close neighbours and therefore the image of Finnish products is maybe slightly better than that of other Western products. Before perestroika, almost all of the imported products in this area [St. Petersburg and surroundings] were Finnish, and it still matters.”

“Finns should exploit more the image of Finland in Russia. In Europe, we don’t have the quality image of Norway or Switzerland, but in Russia we do. I would say that in this case [Russia], Finland has a better starting point than in many other cases. And the associations that the Russians have of Finland are mainly positive.”

Concerning the knowledge about Finnish food products in different parts of Russia it was mentioned that the Finnish food products were thought of as safe and high-quality at least in Moscow and St. Petersburg. Elsewhere it depends more on the category of products in question. On the other hand, a differing view was presented that doubted whether Finnish food products would be well-known in Moscow. They

are probably known in St. Petersburg and thought of as being high quality products, but probably not known very much farther in Russia.

“For example in Yekaterinburg, the director of a wholesale company said to me, as I presented our products, that ‘I guess we need to take them into our assortment, because you have come from so far away’. So that was a good criterion.”

Although Finnish food products have a good image, so do German and Swedish products and the Finnish label does not give any extra value for the product. Although one opinion was that Finns should be able to better exploit their good reputation in Russia, it was generally not considered an easy task to penetrate the Russian markets anymore. This will be discussed in more detail in Chapter 6.

“In my opinion, the Russians think that Finnish products are ok. ... Good products, good quality, but so are the German and Swedish products and others.”

Also according to a poll that was conducted for the purposes of this study at the Russian ProdExpo fair among Russian professionals working in the food sector (see section 6.3.2.), the image of Finnish food products is good. The most common answers were that Finnish food products are of high quality, or simply that they are good. It was also mentioned that the products are ecologically friendly. The respondents were also asked about the price of Finnish food products. Most respondents said that the price was either average or higher than average.

5.2 Implications for Finnish food producers

In general, Finnish food products are considered to be of high quality, and Russian consumers appreciate quality. However, price and quality have to match. If a product offering similar value with a cheaper price can be found, Russian consumers will buy the cheaper one. Also, the fact that products are of Finnish

origin is not likely to give them any substantial added value over other Western products.

Finnish food producers usually target consumers belonging to mid- or high-income segments. This is no wonder, as imported Finnish food products might cost over three times as much as domestic ones in Russia. The producers having local production in Russia have a wider segment of potential customers, as they can produce both lower- and higher-priced products. In the future, the highest buying potential will come from the growing middle-class. This is a segment that the Finnish food producers are actively targeting.

Russian consumers also seem to value domestic food products. However, there are differences depending on the product category and the consumer segment. In some categories, foreign products are valued clearly more than in others. For example, functional food products are a product category where foreign products dominate, at least for the time being.

6 CURRENT AVAILABILITY OF FINNISH FOOD PRODUCTS IN RUSSIA AND MEANS FOR INCREASING THEIR MARKET SHARE

In Chapter 5 Finnish food producers' sales promotion activity was discussed, and in this chapter the fruits of these efforts are examined, i.e. how good the current availability of Finnish food products in Russia is and how well the products are recognised. First some background on the topic is presented. Second, the topic is examined through foreign trade statistics in order to see the development of Finnish food exports to Russia. The information given by the export statistics is compared to results obtained from two empirical surveys designed for this topic. After the discussion on the availability of Finnish products, the major barriers for further market penetration and means to overcome these barriers are presented.

6.1 Background

A number of Finnish products have a long history in Russia, dating from the times of the Soviet Union. Many Finnish food producers exporting to Russia or having production there have operated in Russia at least since the beginning of the 1990s. The collapse of the Soviet Union provoked a huge demand for Finnish products. This was partially due to the fact that in Soviet times Finnish products were basically the only foreign food products available and the quality image was good. Another explanation is the geographical proximity. It was easy for Russian importers to arrive in Finnish factories and buy in cash anything the producer had to offer.

Thus, Finnish producers had a good take-off to the Russian food markets. However, as discussed in Chapters 3 and 4 (domestic content and history of distribution systems), the Russian financial crisis in 1998 almost stopped Finnish business activities in Russia. Finnish views on the current availability of Finnish food products in Russia are mainly quite pessimistic. The success factors of Finnish

foodstuff exports to Russia include good quality image, cultural similarities with Russians and geographical proximity. These factors date back to the Soviet era and farther. However, long history in the market is not a necessity for success, and there are also examples of recent breakthroughs to Russian markets in a short time (Finpro-magazine October 2004). Nevertheless, the road of Finnish food products into the hands of Russian consumers is much rockier now than in the early years of the 1990s.

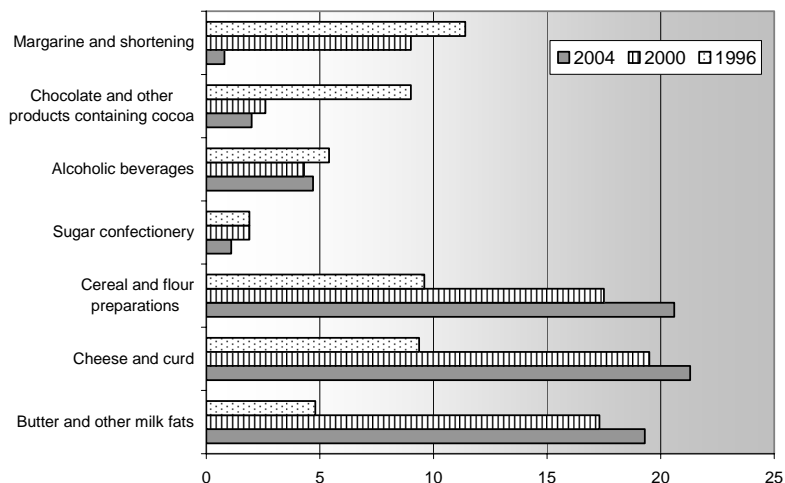
6.2 Statistics on Finnish food exports to Russia

The 1998 crisis had a devastating effect on Finnish food exports to Russia. In 2004, the total Finnish food exports to Russia were 171 million euros, which is roughly a half of the level of 1997. Although the exports have recovered after the crisis of 1998 the direction seems to have been slightly downward again during the last two years. The development of Finnish food exports to Russia from the beginning of the 1990s for the five most important product categories is presented in Appendix 2.

There was a clear drop in all five product categories from 1997 to 1998. The decline continued in 1999. For dairy products and miscellaneous edible products (of which margarine comprised 60% at that time), the drop was even deeper from 1998 to 1999. Another notable feature is the rapid recovery of cereals and cereal preparation exports as well as the dairy product exports from the 1998 crisis. Exports of these products have nevertheless been quite stagnant or even slightly decreased in the recent years. The development of exports of meat and meat preparations, coffee, tea, cocoa and spices and miscellaneous edible products has been much gloomier. In 2004, they were all below the export levels of 1993. Exports of meat and meat preparations to Russia declined some 60% from 1997 to 2000. Since 2001 their exports have recovered somewhat. The collapse of 1998 is remarkable, taking into consideration the so-called “wild years” in the beginning of the 1990s, when exports in almost all food categories experienced immense growth figures until 1997. The

structure of exports in selected product categories is examined in more detail in the cross-section figure below.

Figure 9. The share of selected products in Finnish food exports to Russia, percent



Source: Finnish customs

In 1996, the structure of Finnish food exports to Russia was relatively evenly divided between the different product categories. However, there was a clear trend of centralisation, which was exacerbated by the 1998 crisis. In 2004, three product categories – cheese and curd, butter and other milk derived fats, cereals and flour preparations – constituted almost two thirds of all Finnish food exports to Russia. Already in 2000, their combined share was approximately 55%, whereas four years earlier, in 1996, it was less than a quarter. Alcoholic beverages and sugar confectioneries have maintained their shares roughly at the same level throughout the last ten years.

A dramatic decline has been experienced in margarine and chocolate exports over the years. In 1996, margarine was the most important export item with a share of

11.4 %, while chocolate comprised 9 % of foodstuff exports to Russia. In 2004, the shares were 0.8% for margarine and 2% for chocolate. The turning point was the 1998 crisis, as Russians shifted their consumption into cheaper products. Finnish producers have recently started also production in Russia. For example, local Finnish production of sugar confectionaries has started recently (Kauppalehti 19.9.2003). Taking a slightly longer perspective, the sharpest decline has been experienced in exports of vegetables and fruits. In the beginning of the 1990s, Finnish wholesalers exported large quantities of e.g. bananas to Russia. This transit trade started to decline in 1994 and it practically ended in 1998.

It is also useful to analyze the share of Finland in Russia's food imports. This does not give any direct evidence of the availability of Finnish food products in Russia, because it does not take into account the local production of Russian and foreign producers, but it might give a crude picture of the development of the situation. Table 5 shows the development in 1996-2003.

Table 5. Finland's share of Russia's food imports, percent

	1996	1997	1998	1999	2000	2001	2002	2003
Meat and meat by-products	0.5	0.6	0.4	0.2	0.2	0.3	0.5	0.5
Milk products	7.2	6.9	4.7	2.0	4.0	5.2	12.6	10.7
Fruits and peanuts	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Animal and vegetable fats	2.3	2.7	2.2	1.5	1.9	1.5	1.6	1.4
Meat and fish end-products	2.0	1.2	1.1	1.1	0.8	0.5	0.4	0.3
Sugar and sugar confectionaries	0.3	0.3	0.2	0.1	0.4	0.5	0.6	0.5
Milk and cereals end-products	4.0	3.8	3.8	3.6	2.4	5.0	3.9	3.9
Beverages	1.5	1.7	1.5	2.5	1.3	1.4	1.2	0.9

Source: Russia's Customs

Taking into account the small size of Finland, it has a considerable share of some imports. In milk products, Finland's share was the fourth largest in 2001-2003. After the initial decline of the post-1998 crisis, the share of Finnish imports in milk products has grown rapidly but in absolute terms it is still behind the pre-crisis levels (see Appendix 2 for Finnish food exports). Finland has a notable share also in milk and cereals end-products. In meat end-products the share has not been very high and it has had a clear downward trend since 1998. A downward trend is visible

also in Finnish beverages' share of Russian imports since the crisis, but this is partly explained by the starting of local production.

6.3 Availability, visibility and awareness of Finnish food products in Russia

The previous chapter examined the availability of Finnish food products in Russia through export statistics. However, the export statistics fail to take into account the Finnish production taking place in Russia. Thus, the results of two empirical surveys designed to bring further information about the topic are presented next. The first survey examined the availability and visibility of Finnish food products in Russian retail chain outlets, while the second focused on the awareness of Finnish food products among Russian food sector professionals.

6.3.1 Availability and visibility of Finnish food products in Russian stores

In order to go behind the figures and see the reality also from the Russian consumers' perspective, the availability and visibility of Finnish foodstuffs was observed in six retail chain stores in Moscow. The availability of Finnish products was evaluated on a scale of 0-3 according to the share of Finnish products in a specific product category (0 – no products, 3 – vast selection). Availability in itself is not a sufficient condition for good sales if the product is not placed well. Therefore, the visibility of the products was observed as well. A similar scale of 0-3 (0 – poor placement, 3 – excellent placement) was used. This survey is admittedly quite rough since it includes only six stores in Moscow within a time span of three days. Taking into consideration the Finnish geography, the figures for both variables would probably be higher in stores in St. Petersburg and weaker in regions that lie further east. However, this survey combined with the export statistics should give a better picture of the situation than the export statistics alone.

Naturally, in this kind of a research there is a danger of subjectivity, which was tried to be minimised by negotiating the proper values of the variables between two

researchers. The product categories differ somewhat from the official export statistics classification. The reason for this is the small number of Finnish products per category and also time restrictions for gathering the data. However, caution was taken in planning the data categories in order to ensure their soundness. Table 6 below presents the results.

Table 6: Availability and visibility* of Finnish food products in six retail chain outlets in Moscow

Store	Super-market ^a		Convenience store ^b		Deluxe store ^a		Super-market ^b		Russian hyper-market		Western hyper-market		Product type average	
	AY	V	AY	V	AY	V	AY	V	AY	V	AY	V	AY	V
Meat	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Dairy products and margarine	3	3	1	1	3	2	1	1	2	1	3	3	2.2	1.8
Dry baked goods, cereal products	3	3	2	2	3	2	3	3	3	2	3	2	2.8	2.3
Alcoholic beverages	3	2	2	2	2	2	2	2	2	2	3	2	2.3	2.0
Non-alcoholic beverages	3	3	0	0	2	2	2	2	3	2	2	1	2.0	1.7
Others (e.g. jams and sugar confectionary)	1	2	0	0	2	1	1	1	2	2	1	1	1.2	1.2
Store average	2.2	2.2	0.8	0.8	2.0	1.5	1.5	1.5	2.0	1.5	2.0	1.5	1.8	1.5

*AY = availability, V = visibility

Outlets marked with superscript *a* belong to one retail chain and those marked with *b* belong to another.

The results presented in the table suggest a few things. First, none of the stores visited had Finnish meat products on display. Although their share of Finnish food exports to Russia is currently quite modest due to e.g. the small size of Finnish meat production and the quota system in importing meat to Russia, it is not insignificant. There are also other factors that can explain the poor availability of meat products. First, Finnish meat exports are more concentrated in St. Petersburg than in Moscow.

Second, Finnish meat exports are mostly raw materials to the meat-processing industry and restaurants and thus they never reach the retail chains.

Dairy products and margarine, dry baked goods and cereal products, and alcoholic beverages received the highest availability and visibility figures of the six product categories. Their average availability was more than two, which means that the assortment was relatively large compared to non-Finnish products. Despite the wide assortment, the products were not usually placed on the best-selling shelves, which resulted in slightly lower visibility. This reflected a general trend, since on average the figures for all products in all stores were slightly higher for availability than for visibility. There was actually only one case in which the visibility was considered to be higher than the availability (the category “other products” in a supermarket).

The Finnish non-alcoholic beverages were also quite easy to find in the stores with the exception of the convenient store, which had no Finnish non-alcoholic beverages. The “other products” –category had figures that were slightly lower than expected. The reason could be the extensive assortment of especially sugar confectionary products due to fierce competition, which makes it hard to stand out of the mass.

Comparing the store types, it can be seen that the convenient store had clearly smaller availability and visibility figures for Finnish products than the other stores in the sample. With such a small sample it is impossible to determine the reason for this. It can be a pure coincidence or, on the other hand, it could be related to the smaller assortment of the store type in general, due to which only the most popular products are selected. Finally, it is interesting to note that the only Western store in the sample, a hypermarket, had exactly the same figures on the average than the Russian hypermarket. It is positive to notice that Finnish producers have managed to position themselves also in a Western chain since their role is expected to grow in the future, possibly substantially, and it is important to gain access to them in an early stage. Furthermore, the average figures between all the sample stores except

the convenient store were rather similar, so the penetration of Finnish food products has been quite steady throughout the stores.

In general, the results of the availability survey were slightly more positive than expected on the basis of the views of the Finnish interviewees. However, due to the small sample, the results of the survey can be considered only indicative. The survey represents the researchers' understanding of "good availability", which may differ from the producers' views. Extensive data collection would be needed in order to get more reliable results, but it is unlikely that the retail chains would want to cooperate in this kind of a study. The observations were carried out in retail chain stores but in order to get a comprehensive view on the availability of Finnish food products in Russia also the unorganised forms of trade should be examined.

6.3.2 Awareness of Finnish food products among Russian professionals

The awareness of Finnish food products was also tested in order to get some information on how well Finnish marketing efforts have paid off. However, a slightly different approach from the normal procedure was taken. The intention here was to investigate the awareness of Finnish food products among the people working in the food business instead of "normal consumers". Thus the questionnaire study was carried out at Russia's biggest food exhibition, Moscow's ProdExpo, in February 2005.

The motivation for this approach was that in order to gain more market share, Finnish producers must convince the Russian professionals in foodstuff retail and be recognised by them. Furthermore, if Finnish food producers want to invest in production in Russia, they will most likely need Russian partners in the process. This is why it is important to be recognised by Russian producers also, since good recognition makes it easier to find potential partners. Thus, the people who answered the questionnaire were divided to "production", "trade" and "others" according to the profession they announced. The category "others" included for example advertisers, distributors, representatives of different governmental and

other organisations, and restaurant workers. Only six respondents claimed to be just regular consumers, the rest can be regarded as food sector professionals. Thirteen of the respondents were producers, also thirteen were from the trade sector and 23 were from other sectors. The total number of respondents was 49, of which 22 were male and 27 female.

The questionnaire study was carried out as follows: people were first asked whether they knew any Finnish food products (spontaneous recognition), after this they were shown the names of products on a questionnaire, and they marked the ones they knew (assisted recognition). No pictures of the products were shown because all producers did not have product catalogues. If the producer has one big brand under which it sells an assortment of products, then the brand was displayed and underneath it were listed products that are sold under the brand. If the respondent knew some product under the brand, then it was simply marked that the respondent knew the brand. Depending on the producer, there were either one or several brands. The questionnaire contained products and brands from twelve Finnish food producers.

Only a few strongest Finnish brands were named more than once by spontaneous recognition. However, seven brands were identified by a third or more of the respondents in the assisted recognition. Three producers had brands that were identified by more than half of the respondents. All of these have quite a long history of operating in Russia, but only one has local production. Women generally knew more brands than men. The difference between men and women was most evident in sugar confectionaries and cooking ingredients. On the other hand, men knew alcoholic beverages better than women.

There was no clear pattern in the awareness between professions in the sense that e.g. producers would know more Finnish products that are produced in Russia or that people from the trade sector would know some product category better than others. Largely, the results of the questionnaire seemed to resemble the findings of

similar studies conducted by the Finnish producers. Only one producer was surprised of the low figures for their product. After testing the awareness of Finnish products, the respondents' views on Finnish products were also asked. This issue was discussed in Chapter 5 in the context of the image of Finnish food products.

6.4 Major barriers for Finnish food products in Russia

The Finnish interviewees presented many barriers or curbing factors for increasing the market share of existing products or bringing a completely new product to the Russian markets. These factors can be divided into three categories: Russian authorities, market-related issues and Finnish producers -related problems. The Russian interviewees did not recognise the same barriers as the Finnish interviewees, probably because of their different perspective to the issue. It was claimed by a Russian interviewee that it is no more difficult for foreign products to get to the shelves of stores than it is for domestic products. Tariffs, however, were recognised as an impediment also by the Russians.

Barriers to entry from the authorities' side include customs regulations, certificates and bureaucracy. Russian customs were criticised especially by meat producers. Various import restrictions etc. have been imposed in the past years. The restrictions do not usually concern just Finland, but all EU countries. High custom duties were considered to affect the Finnish price competitiveness negatively. There are also problems with different kinds of certificates, which can become expensive, especially for a small producer. General bureaucracy was also mentioned as being a barrier to a certain extent. However, the situation seems to have improved in relation to the authorities. In previous studies, the public sector has often been regarded as one of the biggest impediments to developing business in Russia (see e.g. Mashkina et al. 2005, Karhunen et al. 2003a, Karhunen et al. 2003b, Kosonen 2002), but in this study most of the interviewed Finnish producers considered the situation with the authorities manageable.

The most important barriers seem to be market-related. They include the small size of Finnish producers and high production costs, the fierce international competition in Russia, fragmented markets and the development of retail chains. Finnish prices would be high even without customs duties. The small size of the producers makes it difficult to have good control over the distribution chain. Related to this, it was said that foreign producers are usually ready to promote their products and to stimulate every link in the distribution chain to achieve better sales. This is something that the domestic producers do not always perceive as important. However, to achieve this, the producer needs to have substantial resources.

The competition is exacerbated by the abundance of supply: all major international producers want to have a piece of Russian markets, not to mention the local producers, of which some are already quite large and powerful. The fierce competition between producers combined with the increasing strength of retail chains leads to an ever-tightening position for producers. Evidence of the strengthening of retail chains included hard negotiations with the retail chains, tough conditions for contracts, increased marketing pressures on producers and high advertising costs. Along with the fierce competition and strengthening of chains come the ever higher entry fees to the shelves of stores. Finally, an opposite force to the development of retail chains is the still fragmented food retail sector of Russia. This aggravates the problem of smallness, as it is harder for a smaller producer to take control over the distribution chain which consists of many links. The producer can control the fragmented market better by focusing geographically or product-wise, but if it wants significant national coverage, fragmentation presents a barrier. However, in spite of these difficulties, it was claimed that entering the Russian market is no more different than entering any other large market, e.g. Germany.

According to some interviewees, there are also barriers related to the Finnish producers themselves. These barriers concern the lack of business skills and over-prudence. It was claimed that Finnish producers, especially smaller ones, have a shortage of marketing know-how and language skills in planning operations in

Russia. There is a certain “Russian goblin” still haunting the minds of Finns as a leftover from previous failures. Furthermore, the Finnish press was said to exaggerate the problems of corruption and crime in Russia; although they exist, for a normal firm with normal business operations they do not create a problem. It was also pointed out that the problem for Finnish producers is that they got too easily to the Russian markets in the beginning of the 1990s and got used to the feeling that their products sold without much effort. However, now the competition is fierce and no easy profits are available. Furthermore, the Russian business environment needs skilful personnel; especially the CEO has to be aware of local business practices. Also previous studies have emphasized the importance of the CEO. In Russia the CEO has to consider liability much more than in Finland (Mäkinen 2005).

“When the market first opened, trucks were just gathered and everybody was exporting something. When I visited Russia, they were asking “don’t you have more mustard to sell?” Anything could be exported in huge amounts. That was like living a dream back then. The firms did not consider any other markets. Everybody was just talking about Russia.”

“The trade in Russia works the same way as everywhere else and there is always room for good brands.”

6.5 Means for increasing Finnish producers’ market share in Russia

Further market penetration was considered to be very difficult by the Finnish interviewees. However, they had some ideas on how to increase the market shares. These depended somewhat on the producer in question but were nevertheless quite general in nature. The ideas can be divided into five categories: normal operations but harder work, focusing geographically or segment-wise, new product types or distribution solutions, local production, and cooperation between Finnish producers.

The Russian interviewees considered a strong brand as the most important factor in getting to a retail chain's assortment. It was pointed out that brands also help the producers to determine their own pricing policy. Some Finnish brands that had been present for a long time were regarded as strong in Russia. However, for some retailers the most important question is whether the producer is willing to produce private labels for them. Good packaging was also mentioned as being important.

Some of the ideas of the Finnish interviewees were related to normal business operations. As discussed in Chapter 5, Finnish products in general have good image in Russia, but this is not enough. All the large international producers have good product images and much stronger brands. Furthermore, nowadays also Russian producers make high-quality products, and Russian consumers increasingly prefer them. It was claimed that Finnish participation in exhibitions is low and that activeness in the markets should be increased in order to get more market information and to find the right partners. One producer also encouraged the producers to keep their eyes and ears open in Russia and to make bold decisions regardless of risks, since passiveness will surely ruin chances for success. Activeness is required also in developing an own product category, creating new flavours and new packages. This way the producer creates an interesting product and can position itself as a forerunner towards retail chains and consumers, who are still quite disloyal to brands. It was also pointed out that if you plan to go to Russia, you have to have some merits in operating in Finland. Then by utilising the methods through which success was obtained in Finland the producer can succeed also in Russia. Russia is a more difficult market than Finland and if the producer cannot succeed at home then it is unlikely that it will happen in Russia. Another claim was that Finnish producers should keep an eye on the trends of Western Europe since they are adopted in Russia surprisingly fast and sometimes even before they come to Finland. On the other hand, hard work and conducting normal business may not be enough when competing against large international players. Money is a big help in getting into the assortment of retail chains due to high entry fees and

unfavourable trade conditions, such as the tough conditions of contracts imposed by retail chains.

“So, if you want to be in the group of most important products in your own product category, you must be able to show that you master the development of the category; that you know, or at least you think you know in which direction it will develop. Also, above all, you must want to control the direction to which the category develops. Smaller packages, larger packages, new flavours, new ingredients...”

“It pays to follow the trends in food products that are growing stronger in Western Europe. The probability of those trends to reach Russia faster than Finland is very big. What the Finns have missed is, in my opinion, the fact that on the individual level Russia has integrated to Europe at a fast pace.”

“You must also be ready to sign a contract that no sane person would sign.”

Since Finnish producers suffer from their smallness, one option is to focus on a certain geographical area or consumer segment. Later on, increasing market coverage can be considered. Conquering the whole Russian market at once is a daunting task even for a big producer. Nevertheless, Finnish producers can develop a good business in Russia by concentrating on a selected niche.

“We have chosen [to work in] the premium segment and we believe that if we are strong in one price segment and do a good job of marketing and focusing on one segment, we can increase our market share.”

Entering the market with a novelty product or innovative business strategy can be easier than taking a share of an existing product category. This could be a viable strategy especially to smaller firms.

One product type in which this strategy could be implemented is ready made meals. The pace of life of Russians is speeding up and less time is left for cooking at home. Although there are already some serious Russian producers also on this field, the product category is still quite young in Russia. Other product categories in which this strategy could be implemented are functional and organic food products. They are not totally new products in Russia but it is safe to say that they are still unfamiliar to the mass consumer segment. Finnish producers have an image of cleanness in the minds of Russian consumers and a strong background in producing organic and functional products. Although the consumer segment buying these products is still very small, it is probable that it will increase as the incomes grow and Western trends penetrate Russia more. According to GAIN (2005) the first stores specialising in bio-products were launched in 2003. Thus, this might be a good time for Finnish producers to position their products belonging to these categories in Russia. With the right kind of procedures Finnish producers might get backing up from Russian authorities to their products, which naturally would be a major benefit. One big benefit in the products of this category is that they have high added value.

The strategy of entering Russia with an innovative distribution solution is probably more difficult to carry out than entering with a new product, but it has been implemented at least by one Finnish producer. The producer entered Russia with a sophisticated distribution concept and this way got a competitive edge in its production category. However, pioneering is never an easy strategy and it holds the biggest risks but naturally also the biggest potential profits.

“Well, I don’t believe in organic products, but functional products might have what it takes. Of course, it is a narrow segment. But there’s bound to be people in Russia who think of these things and can afford those products. I believe there might be a niche to be found, because we Finns are quite good in making those products. Well, actually we are at the top in Europe in developing these functional food products. There might be a niche to be exploited, I’m sure.”

“Maybe some trends can be seen in Russia, which could benefit Finnish food products. An example is that health-related issues are clearly becoming more important in a certain consumer segment. This does not mean that all Russians would be interested in these issues. [But] the segment that is interested in health-related issues grows all the time.”

“In St. Petersburg our growth was aided by the fact that we were the first to move into using a system that served the customers a lot better than the old one. And now our [system] seems to be becoming the standard in our industry in Russia.”

However, the best way to increase one's market share in Russia is to invest in local production. Several motives for investing in own production were presented. First, even if Russia joins the WTO, trade politics will continue to play a role. This can be seen e.g. in the trade relations between the EU and the US, both of which belong to the WTO. Local production does not suffer from unpredictable trade politics, whereas exported goods can get stuck at the border for days. Thus, local production increases delivery reliability as the distribution chain shortens. Simultaneously, transaction costs resulting from border-crossing are cut. In addition to lower transaction costs, also production costs are usually lower for locally produced products. It is also potentially easier for the producer to take into account the needs of Russian consumers when it is acting closer to the market. For a foreign producer to succeed in the Russian markets, the investments need to be big enough. This is not difficult for large firms, but might prove to be difficult for smaller Finnish firms. An advice that was offered by some Russian interviewees was that Finns should also exercise strict control towards the employees in a Russian subsidiary and the directors should be Finns.

However, some producers had reasons for not considering local production as an alternative in the near future. These were the proximity of Finland and Russia, high

risks, insufficient sales volumes and operation in the premium category, in which the price is not a decisive purchasing criterion.

Investments always involve risks and require resources, especially in the Russian market with its peculiarities. One solution is to find a strong local partner (Karhunen et al. 2003, GAIN 2005). Also the Finnish interviewees said that it is necessary to shift most of the operative responsibility to the Russian partner at some point but to maintain the control in the producer's own hands. It was also pointed out that local production should be built on a Russian brand. This argument is related to the discussion in Chapter 5 of Russian consumers' increased loyalty towards Russian brands. It seems that in many cases the operational management sees the local production as a necessity but the owners are still hesitating.

“We [the Finns] go there without doing our homework first, without finding out about things from at least two sources, preferably from three sources. I mean, if we go there with the same mentality as we do business in Finland or as we would go to Sweden, for example, there are bound to be problems.”

“And the [product's] name should also be something else than ‘Finnish butter’ or something like that. It should be a Finnish producer that sells Russian products and definitely under a Russian brand.”

Due to the small size of Finnish food producers, investments are not always an alternative. A more viable strategy could be cooperation between Finnish producers in order to gain scale advantages. The number of Finnish producers operating in Russia's food sector is still very small and they mostly operate in different product categories. Thus, competition is not a big impediment for cooperation. Biggest potential for cooperation exists e.g. in marketing, and in particular in distribution. Some Finnish cooperation in distribution in Russia actually took place before the 1998 crisis (Kauppalehti 29.08.1997). Very recently two Finnish food producers announced a plan for a joint venture in fodder production in Russia (Kauppalehti

6.5.2005), so this strategy seems to have been selected by some Finnish producers. There are also examples of this type of export cooperation of small Finnish producers in the rural areas, but that has not been particularly successful. Biological or functional products could be one field of cooperation in which Finnish producers could approach Russian markets as one front.

“The model that I wish would realise is that Finnish food producers, for example, would find each other and ally. In my opinion, in Finland we have this stubborn way of doing things by ourselves, which is kind of strange. There are examples in the world of firms joining their forces.”

“It is quite a big step for smaller companies to go there [to Russia]. I know that there are these rings [of entrepreneurs] and I have met some people who organise these in the provinces, but there hasn't been anything concrete happening yet.”

“There have been ideas, that there should be more of those kinds of rings where some bigger, already well-established exporters took some smaller ones along with them, but... I bet someone has been thinking about it, but what interest would big firms like Valio, for example, have in taking some smaller firms along with them... It isn't easy, no.”

6.6 Conclusions

The drop in Finnish food exports to Russia during the 1998 crisis was remarkable and for the biggest food categories the export figures are still clearly lower than before the crisis. The structure of food exports has also changed, as it has become more concentrated after the crisis. A rough survey was conducted to study the availability and visibility of Finnish food products on the shelves of Russian retail chains. The results of the survey gave a somewhat more positive picture of the availability of Finnish products than the comments by the Finnish interviewees. This might be a result of different viewpoints or simply a statistical chance. Also the

awareness of Finnish products among Russian food industry professionals was tested with a questionnaire. The results were as expected: the strongest brands with longest history in Russia were recognised relatively well.

The Finnish interviewees presented three categories for barriers of increasing the market share of existing products or bringing a completely new product to Russian markets: Russian authorities; market-related issues such as fierce competition and fragmented market, and problems with the Finnish producers themselves. The means for increasing Finnish producers' market share in Russia can be divided into five categories: normal operations but harder work, focusing geographically or segment-wise, new product types or distribution solutions, local production, and cooperation between Finnish producers. Investing in local production was clearly regarded as the most important strategy. This could be regarded as a viable option for larger producers who can survive the risks involved. For smaller players, the option of focusing on a certain geographical area or consumer segment could be more suitable. Niche markets in Russia should not be underestimated, as for smaller firms they could spell success especially if the size of the particular consumer segment is expected to grow. The interviewed Russian retailers emphasized the importance of strong brands as a way of getting to the assortments of retail chains.

7 CONCLUDING REMARKS

This study examined the distribution systems of food retail in Russia from a Finnish perspective. Both producers' and retail chains' viewpoints were considered, as well as major trends in the field of distribution. The geographical focus was on Moscow and St. Petersburg, but also the recent expansion of retail chains to other regions was discussed. The aim of the study was to investigate the field of distribution from a strategic viewpoint, i.e. how the Finnish food producers could gain a larger market share in Russia's food sector. The study was based on seventeen Finnish and eight Russian semi-structured interviews. The interviewees consisted of producers, retailers, distributors and experts in the food sector. The distribution of food products in Russia was approached by describing relevant background issues, which included retail trade and the development of domestic content in Russia's food sector. The main topic – distribution systems in Russia's foodstuff trade – was analyzed from the retailers', intermediaries' and producers' perspective, and followed by a discussion on Russian consumers. Finally, a summarising theme of Finnish food products' current availability in Russia was discussed.

The competition in the food retail sector in Russia is growing and the future of foodstuff trade belongs most likely to the retail chains. The retail chains in Russia seem to be relatively developed, as they do not differ much from the corresponding Western retail formats. The strengthening of competition is expected to become faster in the near future as more foreign chains will enter the Russian market. Although the share of retail chains of the whole retail trade is at the moment estimated to be around ten percent, they are taking over the markets at a rapid pace at the expense of unorganised forms of trade. Some Finnish producers still have a significant customer base within the unorganised retail trade of foodstuffs but they will have to start taking the retail chains into consideration if they want to expand their business or even maintain it at the current level in Russia.

In the food production sector the competition is fierce, as big Russian and foreign producers want to ensure their piece of the huge demand potential. Thus the largest producers are relentlessly utilising their size: they invest in big marketing campaigns and are willing to pay high entry fees to retail chains in order to secure a place on the store shelves and build a strong brand also in Russia. Geographical expansion of the retail chains has started recently. This might bring possibilities also for Finnish producers to expand their geographical coverage, if they succeed in arranging their distribution accordingly and in convincing the retail chains of the merits of their products.

Information on the domestic content of the Russian food sector is hard to obtain. Thus, the theme was analyzed by discussing the local food industry production and agricultural production, and referring to polls and interviews. The years before the 1998 crisis were characterised by high food imports that were speeded up by the overrated rouble. However, the crisis burst the bubble and the imports collapsed. Food-aid, more or less altruistic, was delivered to Russia by the EU and the US. The decline in imports was especially severe in the processed food sector that was in a slight downward slide already before the crisis.

After the crisis, production facilities were cheap, and modernisation of the food sector started with the help of investments. Domestic production and domestic retail chains started to develop fast and agricultural production started to revive as well. Imports of processed food were increasingly replaced by local production, which was reflected in trade statistics as decreasing imports of processed food and increasing imports of raw materials. Currently, there is a shortage of raw material, which will probably persist for some time. This might become an obstacle for further growth of local production. The referred polls and interviews supported the argument of a growing share of local production. Although there are indications that the growth of food production is decelerating, the long-term trend seems to be towards local production, which is strengthened by the patriotic consumption

behaviour of the Russians. This creates pressure for Finnish producers towards local production.

The distribution systems of retail trade in foodstuffs in Russia was the main theme of the study. It was analyzed from the perspectives of both retailers and producers; also the role of the distributors was discussed. The sphere of distribution is rapidly changing and is currently relatively fragmented. However, major progress has taken place after the 1998 crisis, because the crisis removed inefficient operators from the business. For example, Finnish producers are currently quite well aware of where their products end up. The strengthening of the retail chains is likely to shrink the role of wholesalers as the chains increasingly want to work directly with the producers. Thus, the development of the retail chains requires that the producers pay more attention to them. The wholesalers cope with the increased pressures in various ways: some wholesalers have built their own brands or even invested in production of their own, while some have set up their own retail stores. The strengthening of the retail chains gives them power in negotiations, to which the producers and distributors must adjust. Issues such as store entry fees and chains' private label products must be taken into consideration.

The distribution systems of retail chains have developed considerably since the 1998 crisis. The chains are trying to shorten the distribution chain, similarly to what has been seen in the Western countries. Many of the larger chains are acquiring or have already acquired a distribution centre or centres e.g. to boost efficiency and to control the flow of products. The development of the distribution systems of Finnish food producers has not been linear in Russia. The 1998 crisis forced producers to cut down their operations in Russia. Currently, the most popular type of distribution system among the interviewed firms is based on a network of local distributors. Factors that hinder the starting of local production by Finnish producers include the lack of local infrastructure, qualified staff and risk intolerance. There is, however, a strong consensus on the importance of starting local production in order to be a serious actor in Russia in the future.

Russian consumers demand quality in food products and they will not buy the product, if the perceived price-quality ratio is not right. Advertising, especially on television, is expensive and therefore some interviewees recommended more in-store promotion campaigns. Generally speaking, Russian consumers prefer domestic products. However, this depends on the specific product category in question. A Finnish label does not create added value for food products anymore, as all big Western brands are on the market and the quality of Russian products is rising. Producers should bear in mind the format of the specific retail chains when trying to access their assortment, since there can be discrepancies between the producer's and retail chain's aims to promote themselves to the consumers.

Finally, the study examined the availability of Finnish food products in Russia. Trade statistics show clearly the dramatic effect of the 1998 financial crisis to Finnish food exports to Russia. None of the major export product categories have reached the pre-crisis levels and some have even failed to reach a positive trend after the crisis. A store survey gave a slightly more positive picture of the availability of Finnish products in Russia than the interviews. Although the number of Finnish products is not ample in absolute terms, they have a relatively good position compared to the other producers' goods within different product categories. A questionnaire was carried out with Russian food sector professionals to test their awareness of Finnish products. Seven brands were recognised by third or more of the respondents. As expected, the brands having the longest history in Russia were recognised the best. According to the Finnish interviewees, the major barriers for entry in Russia include the authorities, fierce competition, fragmented market and Finnish producers' heavy production costs. The producers were also blamed for over-prudence and lack of business skills. The suggested strategies for increasing the market share included focusing geographically or segment-wise, working harder, introducing new products, starting local production, and cooperation between Finnish producers.

Two major points worth noticing in this study recurred throughout this report: the crisis of 1998 and the smallness of Finnish producers. The crisis was a definite watershed for food retail: it removed a large number of inefficient operators from the markets and set up the emergence of retail chains and local production, which are the most important factors shaping the distribution systems in food retail at the moment. The 1998 crisis was a force that initiated changes, whereas the smallness of Finnish producers is related to coping with these changes. Smallness was one reason why Finnish producers had to cut down their operations in Russia due to the crisis. Smaller producers had fewer resources to tolerate losses during the crisis. Smallness is reflected also on trade negotiations with retail chains and distributors. It makes it harder to cope with the store entry fees and to differentiate from the mass of products propped up by expensive advertising. Finally, it makes it harder for Finnish producers to start or expand local production since it is more difficult for a small producer to get financing and to tolerate the increased risks. Compensating for the smallness might become the crucial factor determining the future success of Finnish food producers in the Russian market.

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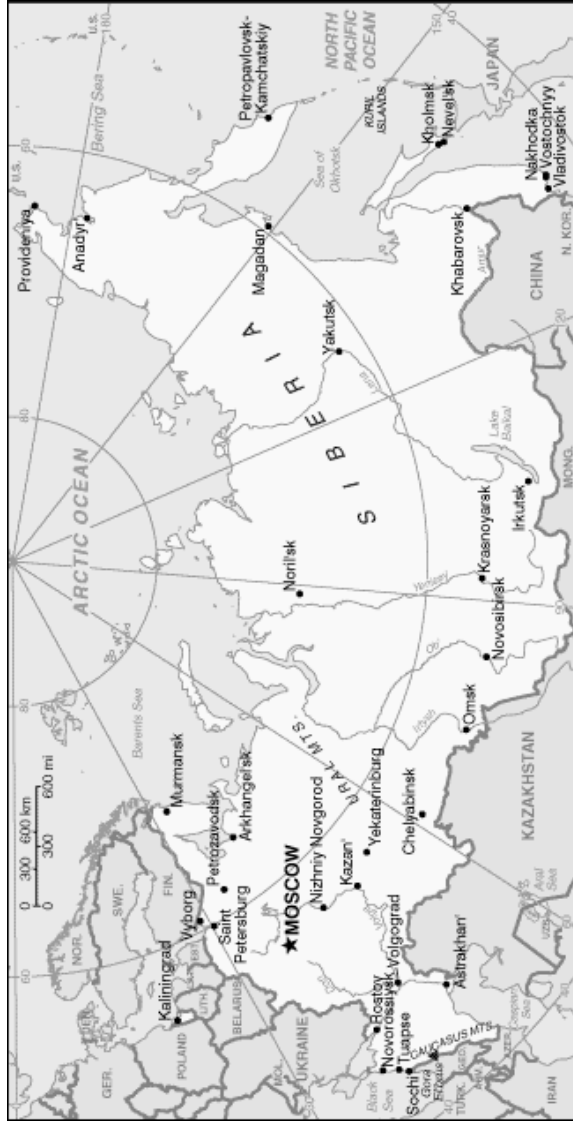
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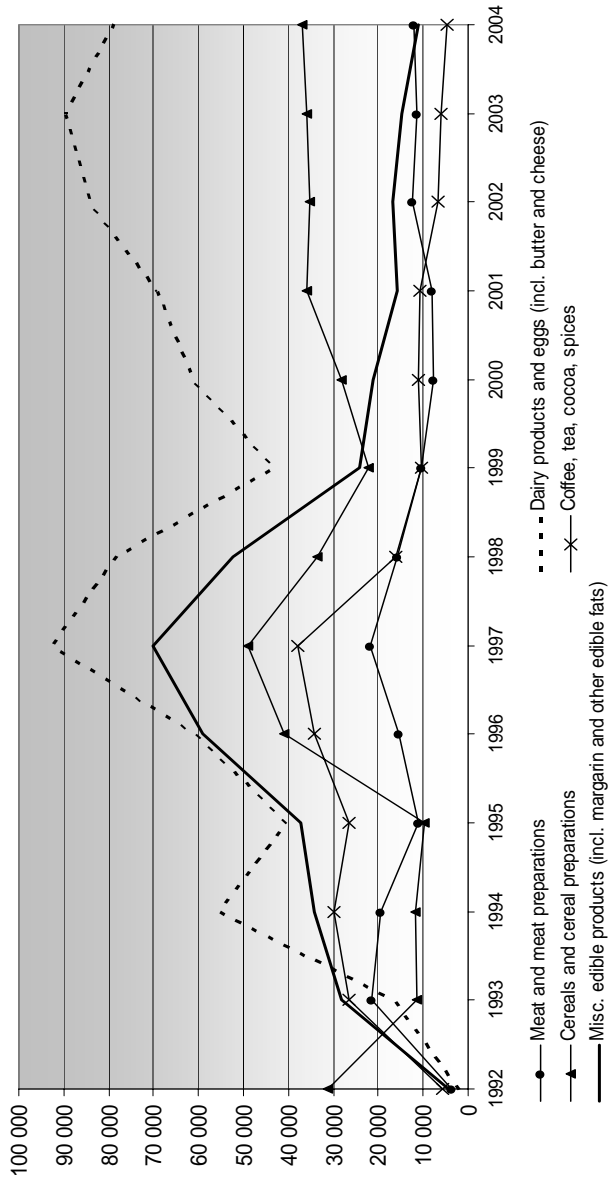
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APPENDIX 1: MAP OF RUSSIA



Source: CIA World Factbook

APPENDIX 2: FINNISH FOOD EXPORTS TO RUSSIA 1992-2004, 1000 EUR



Source: Finnish customs.

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