

Russia on the rise?

Russia is the largest country in the world in terms of area at just over 17 million square kilometres, and covers 11 time zones. It stretches from Europe in the west, through Northern Asia bordering the Arctic Ocean, to the North Pacific Ocean in the east. This means it has relatively poor access to the major sea lanes of the world.

Despite its vast size, much of the country lacks suitable soil or climate (either too cold or too dry) for agriculture, with the result that only 7.17% is available as arable land and 0.11% is under permanent crops (2005). Having said this, it has extensive natural resources, including major deposits of oil, natural gas, coal, minerals and timber. Unfortunately, climate, terrain and the huge distances involved continue to create obstacles to the full exploitation of these assets.

Siberia, where most major oil and gas deposits are to be found, has a particularly severe climate, with sub-Arctic winters and dry summers leading to fires that



Russia's economy at a glance

GDP:	
Purchasing power parity	\$1.589 trillion
Official exchange rate	\$740.7 billion
Per capita	\$11,100
GDP real growth rate	6.4%
Inflation:	3.0%
Unemployment:	7.6%
(plus considerable under employment)	
Budget:	
Revenues	\$176.7 billion
Expenditure	\$125.6 billion
Public debt	12.9% of GDP
Industry:	
Growth rate	4.6%
Exports	\$245 billion
Imports	\$125 billion
<i>2005 estimates</i>	

destroy huge tracts of forest. The prevailing permafrost is a formidable obstacle to extracting these deposits economically and, once extracted, they must be piped huge distances in order to be exported.

The harshness of the environment also means that huge stretches of the country are virtually uninhabited. The total population is only 143 million and is shrinking at a rate of 0.37% per year (2006 estimates).

Russia's economy

2005 witnessed Russia's seventh straight year of growth, having averaged 6.4% annually since the financial upheavals of 1998. Although high oil prices and a relatively cheap rouble have played a key role, investment and consumer-driven demand since 2000 have played an increasingly important part. Real fixed capital investment has achieved average growth in excess of 10% during the same period, and real personal incomes have risen on average more than 12%. Poverty has also been steadily reduced, and the middle class has continued to expand.

At the same time, the country has also managed to improve its international

financial position, with its foreign debt falling from 90% of GDP to around 31%. Higher world oil prices have boosted export earnings and allowed a massive increase in foreign reserves from a mere \$12 billion to some \$180 billion at the beginning of 2006. These considerable achievements, together with renewed efforts by the government to stamp out corruption and effect structural reforms, have raised confidence in Russia's long-term economic prospects.

Some real problems still exist however. Economic growth slowed to 5.9% in 2005 and inflation remains high. Oil, natural gas, metals and timber account for over 80% of exports, leaving the country at the mercy of fluctuations in world prices. There is no under-pinning by a strong manufacturing sector which, to all intents and purposes, is moribund and will need complete modernisation if the country is to achieve broad-based economic growth.

Indeed, official statistics since 2002 reveal a worsening scenario. The automobile industry has probably been worst hit as the decline in output has been accompanied by a rapid increase in imports. A similar though less pronounced trend can be seen in textiles, clothing ►

and footwear, where imports have grown at a rate of 50-150% per annum against a falling population of consumers.

Other negatives include a weak banking system, a business climate that discourages both domestic and foreign investors, corruption and a general mistrust of institutions. In addition, investigations into a major oil company, the arrest of its CEO in 2003 and the subsequent acquisition of the company by a state-owned firm, have led many to believe that President Putin may be turning a blind eye to sections within his government that would like to reassert state control over the economy. Underlying all of this is the fact that little has been achieved in building the rule of law, without which a modern market economy cannot be developed.

The changing face of retail

Only a few years ago, life in Russia was one of long queues and little to buy at the end of them. Now, all the top world brands can be found—at least in Moscow. There are essentially two markets in Russia: the regular stores and the bazaars. The bazaar section is still much loved but is shrinking fast, especially in the bigger cities. In Moscow alone new shopping centres are spreading, with many centred around big stores such as Ikea. Danish footwear giant ECCO for a time boasted that with fifty stores in Moscow, it had more outlets than McDonalds.

According to ispo, the major sports exhibition organiser, the sports business alone is worth around \$3.5 billion and growing at 30% per annum. Having been present in the market for over 30 years, adidas is market leader, followed at a distance by Nike, Reebok and Puma. The luxury goods market is also growing as the middle class rapidly expands. However, to buy in a department store requires an income of \$400 a month, so while this richer segment is developing, low entry-cost sports items, such as soccer and running, are taking the lead.

So, bearing in mind the country's relatively low average per capita GDP, who actually buys these products? Well certainly in Moscow, shopping centres are crowded every weekend with ordinary families buying groceries, the latest DVDs and computer games, and enjoying a pleasant day out. Perhaps Muscovites use retail therapy to forget the many day-to-day problems that continue to affect their lives.

Ryazan Tannery



The leather industry

Like much of Russia's manufacturing sector, leather production has fallen during the past few years. 2005, however (the most recent year for which figures are obtainable), showed a marked slowdown in this decline, and overall apparent consumption would appear to have stabilised. There is also evidence that 2006 may show some slight growth when figures become available. The future, however, remains uncertain.

One reason is the supply side. The national herd shrank by more than 6% in 2005, leading to a 12.5% fall to 8.3 million in the number of hides available for export or tanning. This in turn led to a sharp increase in hide prices to bring them broadly into line with average European levels, with exports falling and imports rising. Overall revenue from tannery sales nevertheless grew by 12.7% during the year to around \$800 million, reflecting the increase in raw material prices.

The major output is chrome-tanned materials as might be expected. There are, however, two other important products. The first is 'juft' leather for work and military footwear—which is unique to Russia—that combines high substance, heavy fat-liquoring and hard wear with low cost. Traditionally popular with local

shoemakers, its manufacture is now concentrated on only twelve tanneries and output fell by 20% in 2005. The second is soling leather, the production of which has declined dramatically over the past few years and fell a further 15% in 2005. A major reason has been increasing footwear imports, and as a result, many soling tanners have switched over to producing chrome leathers.

Leather production 2005 (million sq.ft)

Chrome	26.91
Juft	2.13
Soling	1.01

As the legal position improves, more investment is likely in the leather sector where prospects for profit currently look very good. Recent events in the oil industry have scared off some foreign investors, and although industry experts do not feel they are likely to ever impact the leather industry, most investors are likely to be domestic.

There are 29 large tanneries producing chrome-tanned leathers. Amongst them, Zao Russkaya Kozha (Ryazan) and Ostashkovsk produce over 50% of Russia's output. Ryazan is said to be the biggest. It is located in the city of Ryazan some 180 km south east of Moscow and was first established in 1916. It covers 480,000 square metres and employs 2,300 people to process bovine hides. It produces over 40% of Russia's finished leather, crust, wet white and wet blue hides. The main markets are for footwear and furniture. Garment leather is also made, and last year, it began to ➤

Overall leather market (million sq.ft)

	2004	2005
Output	30.40	30.04
Export sales	4.79	3.32
Domestic sales	25.61	26.72
Imports	3.88	5.11

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produce automotive leathers.

Ryazan is a major player in the Russian raw hide market. It processes over 40% of all hides, collecting them through some 21 established centres spread throughout the country. It purchases more than three million hides per year this way and soaks some 8,000 every day. It is also equipped with the latest in Italian technology and pays great attention to testing its leathers.

The footwear industry

The Russian Tanning and Shoe Union totals 53 members from 30 regions of Russia as well as from Belarus and Kazakhstan. These cover tanners, footwear manufacturers, chemical plants, the Central Research Institute of the Leather & Shoe Industry, two institutes and the Association of Light Industry Enterprises.

Statistics are hard to come by, but it is quite obvious that Russia has an enormous demand for leather and leather goods that local supply is unable to meet. Although tanners have held their own to a certain extent, footwear production fell from around 780 million pairs in the mid-1980s to only 45 million in 2005. Given a population of around 143 million, one can see why there has been a massive surge in imports. Needless to say, China supplies a major part of these missing shoes and according to the China Leather Industry Association (CLIA), 325,000 pairs of leather upper shoes worth \$3.95 million were exported to Russia in the first nine months of 2006—24.9 times the volume exported in the same period of 2005.

Footwear statistics (million pairs)

	2001	2002	2003	2004
Production	*65.5	*41.2	44.7	45.0
Exports	1.4	5.2	2.0	2.2
Imports	*145.9	*144.0	*145.0	170.0
Consumption	210.0	180.0	187.7	212.9
*Estimates				
Source: SATRA				

Formal and informal trade

For a number of years, there has been a large 'informal' trade in shoes through Ürümqi in the extreme north west of China. This was covered in some detail in the November/December 2005 issue of *World Footwear*. It essentially involves buyers from southern Russia crossing over into China and placing orders with a 50% cash deposit in US dollars. The order is delivered to Ürümqi where the customer pays the balance.

But there are still difficulties even for 'legitimate' trade due to customs problems caused by some 'less than honest' Russian customs clearance companies that have sprung up since the end of the Soviet Union.

Seven shoe companies from Wenzhou have now grouped together to build a joint production operation inside Russia. A total of \$252 million has been earmarked to create an industrial zone that will contain a whole spectrum of shoe and component manufacturers. The idea appears to be one of shipping part-made shoes for completion in Russia.

A weakened industry fights back

Until relatively recently, Russia's footwear manufacturing capacity was still mostly in the hands of state-owned corporations. In most cases, investment had been stagnating for years, so equipment was out-dated and badly worn. There was also extensive over-manning which, combined with the poor plant, saddled them with a high cost base. While local hide prices remained low, this was partly concealed. Once they had risen to European rates, there was no way these large factories could survive. Management was also stuck in a state-controlled mindset and lacked the initiative to fight for change.

The past two years, however, have presented something of a turn around. The large state-owned corporations have been privatised and are now operated by either new young owners or managers with far more entrepreneurial flair. Moreover, their average size has been reduced from between 1,500 to 2,000 employees down to around 300 to 500. In addition, a considerable number of small companies have been set up, reflecting the new-found confidence in the country's economic prospects.

Most factories started out by producing footwear with either stuck-on or sewn construction soling. Those that could raise the necessary investment have quickly moved on to direct injection moulding in order to produce safety, military and casual footwear.

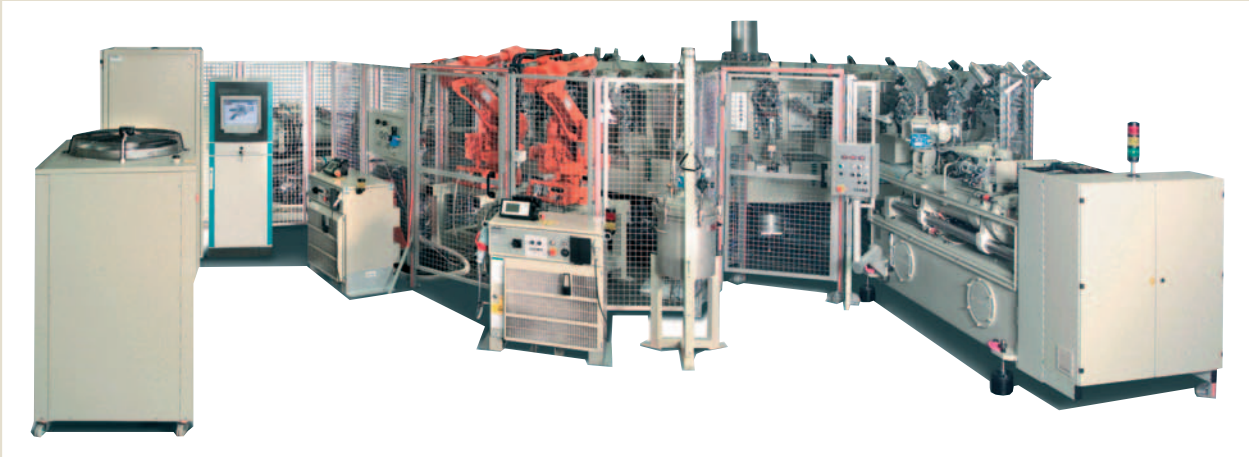
After prolonged evaluation, the Ministry of Defence finally decided that only direct injected soling would be accepted for combat boots. This provided a further boost to companies that had already invested in this type of technology. It also finally brought Russian soldiers into line with their American and Western European counterparts.

Safety footwear has also taken a leap forward. In the past, there were no companies specialising in the manufacture of safety footwear. So, all work and safety products were imported. As a result of co-operation with Western European manufacturers and machinery suppliers, a number of factories now specialise in this growth market. In addition, companies producing and supplying work clothing have also started to manufacture their own safety footwear, again mostly by injection moulding.

Quality assessment of wet blue at Ryazan



Dual density rubber moulding machine as installed in several Russian factories making military boots.
Image courtesy of Klockner Desma Schuhmaschinen GmbH



The past three years have shown an above average investment in injection moulding machine technology, led by the following companies:

- *LegPromProgress* – single and dual density rubber moulding for military and safety footwear
- *Technoavia* – TPU/PU direct injection for safety footwear
- *Donobuv* – single density rubber moulding and TPU/PU direct injection for military and safety footwear
- *Mira* – single density rubber moulding for military footwear
- *Borobuvspezprom* – single density PU direct soling for safety footwear
- *Yachting* – single density rubber moulding and dual density PU for military and safety footwear
- *Pariskaya Komuna* – dual density rubber moulding for military and safety footwear
- *Partner Technology* – TPU/PU direct injection for safety footwear

These shoemakers which, have seized the opportunity to invest in new equipment as a result of the government's economic reforms. They have also seen where the best markets lie and have specialised. The military always needs boots, and governments are never keen to buy from outside. As industry begins to grow once more in Russia, so the market for safety

products will grow. As for the main retail consumer market, the Chinese will remain only too happy to sell millions of pairs of cheap shoes to Russia as it does everywhere else.

"The Russians are coming"

A few years ago, a cry like this would have created near panic in Western countries. Now, the bad news would be "the Russians are not coming". Instead of

posing a threat, hordes of Russian buyers have descended on suppliers in Eastern Europe and Asia. That they have also been warmly welcomed is no surprise, as they bear hard currency. To manufacturers inured to ever-downward price pressure by Western buyers—who also demand good paperwork and transparency—these invaders, who pay in cash on the spot and have a positive aversion to leaving a paper trail, are a blessing.

Following the global trend, fur is most definitely back in fashion in Russia. (image Vilnius Kailai, Lithuania).



The rapid demise of the Soviet Union exposed huge shortfalls in the production of even quite basic goods. Massively under-capitalised and incompetently managed factories offered poor quality and design at high prices. As the Soviet Union disintegrated, Russian traders began to look for suppliers overseas in order to plug the gaps. Clothing—including leather garments and footwear—was a primary target.

Turkey was one of the first to benefit. It was geographically convenient and its economy a mix of modern design, good quality and the more traditional approach of not asking too many questions or insisting on too much paperwork. Its leather industry flourished until its new-found friends moved on. Next was Pakistan, which offered many of the same advantages but even cheaper. Its leather industry also flourished until once more, Russian buyers found a better deal. ►

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The China connection

The Chinese economy began its spectacular growth at the same time that Russia's sank. Although there had always been trade between the two countries the border had previously been quite tightly closed and the two states were not infrequently on the verge of open warfare. Once things eased, small-time traders from Russia began doing regular business with China. Many arrived with large suitcases, filled them up, paid in cash and returned home. While this method of doing business

did not last long overall, much of the trading at the low-end of the market is still conducted in this way as it meets the needs of Russia's less affluent eastern provinces.

A growing number of Russian buyers from the western provinces are now seeking levels of quality and design similar to Western markets. There is money to pay for it and the buyers themselves are in a better position to travel. Moreover, the cost of moving goods between Russia's eastern and western regions is apparently greater than importing directly from

overseas. It is therefore no surprise that this has led them to Hong Kong and increasingly, China. But, whereas much of the business was initially with towns along the border, now they go to places such as Shanghai, Wenzhou and Guangzhou.

Changing circumstances

The fur trade offers a typical insight into how this works. Hong Kong has become the global centre for processing fur, because many of the refugees who fled from northern China to Hong Kong when the Communists took over in 1950 were in the fur business. They set up shop in the territory, catering initially for a tiny local demand and then for tourists and visitors. They soon developed export markets, where they exhibited a marked feature of Hong Kong business people: an ability to learn and understand the different requirements of different markets.

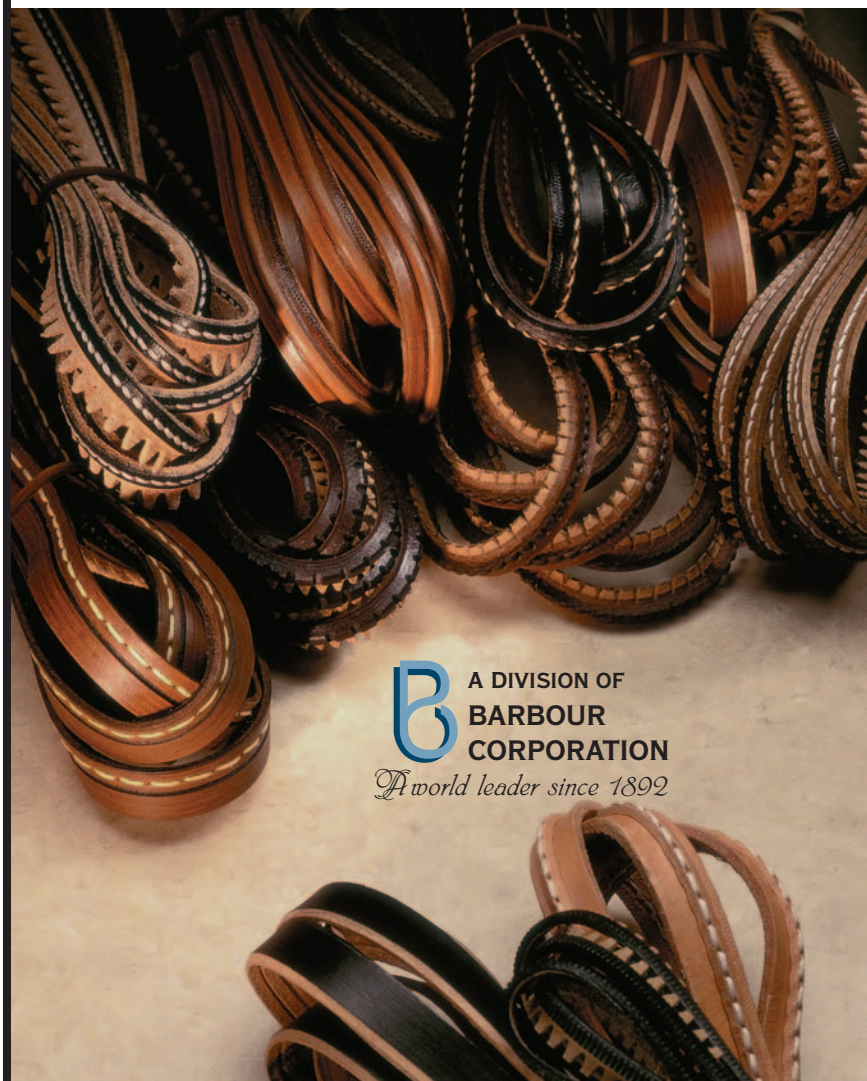
Their big break came with the opening up of China's economy, the development of which began in the south, adjacent to Hong Kong. The fur businesses relocated manufacturing to the mainland. This offered an enormous price advantage, whilst at the same time they could keep abreast of market developments in Hong Kong. It was not always easy. During the 1990s, the anti-fur campaigners triggered a downturn in the sector throughout much of the high-end Western markets. While continuing to be popular in cold climates such as Japan, Korea and parts of North America, it was faux fur that captured much of the market elsewhere.

Fur has now re-emerged as a fashion material. This also happened to take place just as Russia became a major new market for quality furs, and as with leather garments, Russian buyers descended on Hong Kong.

The upside of this was that overseas buyers could deal with experienced Hong Kong companies while still enjoying low prices. The downside was that sooner rather than later, those same buyers would seek out mainland-based sources able to offer even lower prices. Initially, such prices came at the cost of uncertain delivery schedules, variable quality and enormous amounts of red tape. That has all changed, and now China has a good number of excellent fur manufacturers. But where will the fickle Russian buyers and their bulging wallets go next? 

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