Russian Grain Trading and Marketing: Evolution and Struggles

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This paper summarizes some of the work of the senior author, along with Dr. Demcey Johnson, on Russia and the evolution of change in their grain marketing system.

The Russian grain marketing system is going through a remarkably traumatic evolutionary change, the dimensions of which will be potentially unprecedented in the world grain industry. A highly centralized command system, absent of any concept of a market, has been the mechanism for allocating resources within the grain system. Functions were performed exclusively through state-owned facilities, and product distribution was also on a command basis. This article describes changes occurring in the Russian grain marketing system.

Grain Marketing Organization

Grain distribution in Russia was highly monopolized for many years and regulated by the state. Specifically, the Grain Procurement Agency ("Khleboproduct" Ministry, which has changed its name many times) governed grain distribution. Khleboproduct operated under strict supervision of the central government and Gosplan, the State Committee on Planning, based on rigid orders and fixed procurement prices. Today, this monopoly still exists as 100 percent state-owned, shareholding *Federal Contract Corporation "Roskhleboprodukt."*

Prices were specified in five-year annual plans in the grain sector and were fixed. Regional price differentiations were used to account for production conditions (weather and soil conditions, costs of production, and so on). Prices did not reflect supply-demand balances at the regional level but generally covered production costs and some profits for most grain producing units.

Evolutionary Change in Russian Grain Marketing

The Russian grain marketing system has always been controlled through centralized organizations. The principal organization in the Russian grain marketing system is Roskhleboprodukt.[1] Roskhleboprodukt performs functions that the Ministries of Procurement and Agriculture formerly assumed, including procurement and distribution.

Roskhleboprodukt was formed in 1992 and has a number of crucial functions, including: 1) procures grains from domestic production; 2) allocates inputs in conjunction with ministries; 3) distributes grains to mills and bakeries; 4) owns and manages the vast majority of handling and storage facilities; 5) controls imports; and 6) is one of the principle shareholders of ExportKhleb.

Initially organized to export grains, ExportKhleb was founded in the former Soviet Union in 1923. This was its exclusive function until 1963, when the Soviet Union imported large amounts (about 7 million tons) of grain for the first time. Since then, it has been responsible for state grain sales and procurement abroad. These were made

[1] No insinuation is made that these are equivalent, but similar organizations regarding their impact on the organization of grain marketing exist in the United States (the Commodity Credit Corporation), Canada and Australia (the Canadian and Australian Wheat Boards), and France (ONIC).

on behalf of the Council of Ministers of the USSR on food purchases. For most of its existence, it worked strictly on the basis of state orders.

Reorganization of ExportKhleb began in 1988 and changes were adopted by the end of 1990. The change involved two important dimensions. First, ExportKhleb was structured as a joint-stock shareholding company with more than 2,000 shareholders, including state, corporate, and private companies, as well as organizations, associations, and agricultural firms from at least 11 former Soviet Republics.

Second, a number of subsidiaries were created to provide services on the domestic and world markets for what was anticipated to be a broader customer base. These generally included firms and organizations that were trying to promote their own grain operations outside the state distribution system. All of them were organized in the last couple of years and are trying to operate independently on the basis of loose control on ExportKhleb's behalf. Examples of these subsidiaries (or "divisions") include "Bartinvest" (a barter agency), "Zerno" (grain division, which imports on government credit), "Prodsyrje" (imports oilseed, rice, and compound feed), Prodex (specialty grain exports), and an Exchange Department in charge of overseas futures operation. In addition, they have purchased seats on a number of the major Russian grain exchanges. Similarly, ExportKhleb functions have changed. Originally, ExportKhleb was the sole agency responsible for the export and import of grains on behalf of the Council of Ministers and was also involved in international finance and transportation.

In its current role, ExportKhleb has expanded its functions in numerous dimensions. It is the recognized monopoly for grains imported under foreign government credit guarantees. These purchases are made on behalf of Roskhleboprodukt at fixed margins. Other changes that have expanded the scope of ExportKhleb's operations include an increase in the number of commodities traded, its involvement in barter (through "Bartinvest"), its imports and exports on the behalf of individual CIS states on the world grain market, and its increased responsibilities for internal logistics. All of these functions are performed with profit objectives, are typically on a commission basis, and are subject to competitive pressures from emerging companies and organizations.

Obligatory sales (or state purchases), more recently referred to as sales to the Federal or Regional Reserves, have always been an important component of Russian grain marketing. These are obligated sales and are made at somewhat rigid procurement prices established through a political process and administered by Roskhleboprodukt. These purchases have been decreasing for a number of years. State procurements were 33 percent of production in 1986-90, 31 percent in 1991, and 24 percent in 1992. In 1993, state procurement will be an expected 11.8 mmt.

Figure 1 shows the current organization of the Russian grain marketing system. Of particular importance in this figure is the role and function of Roskhleboprodukt, which exerts tremendous control on this system, including 1) administration of a relatively rigid pricing scheme for obligatory sales (30 percent); 2) distribution of some inputs at favorable terms, partially to induce deliveries to the Federal and Regional Reserves; and 3) control of many components of the physical marketing system.

Traditionally, alternatives for distribution outside the state organizations have been limited in the grain sector. Surplus grains could be used on farm in various ways or potentially bartered. During the later 1980s, a system was established to pay incentives for above average production. These, at least in concept, could be sold to ExportKhleb for hard currency. However, this program was largely unsuccessful.[2]

Due to the institutional relationships between Roskhleboprodukt and other components of the system, transactions conducted through grain exchanges and among brokers are generally limited to "Inter-enterprise Sales," which are shown in Figure 1. Generally, these transactions comprise a smaller percentage of trade, and, consequently, grain trading activity on grain exchanges has been constrained.

[2] Reasons for this include "...the procedure of receiving and spending currency, the complexity of this procedure, difficulties in receiving and spending the money...." that led to this program's not being used (Ivashchenko and Klimov, p. 142).

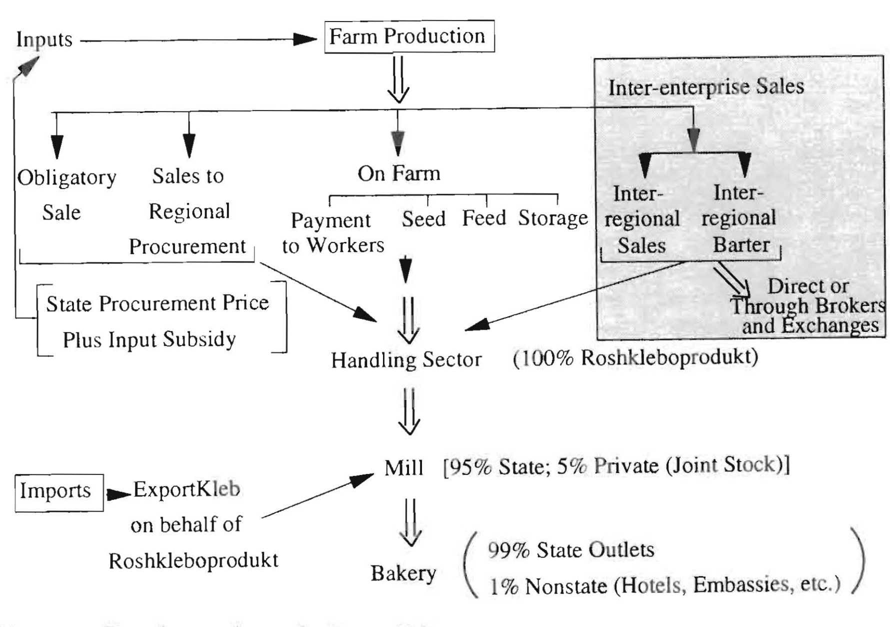

Figure 1. Russian grain marketing, 1993.

The Russian grain market currently has three sets of related prices.

State procurement prices — These are fixed, but state agencies, following the inflationary environment, can change them according to price trends on the commodity markets. In 1992, these ranged from 6,000 to 8,000 rubles per mt up to 12,000 to 15,000; in 1993, they are close to the free market prices — 40,000 to 50,000 rubles per mt.

Commodity exchanges' prices — These are discovered at commodity exchanges and vary through time. Last year, there was a wide spread between state procurement and commodity exchange prices, but it has narrowed this year.

"Free market" (or local) prices — These prices are formed outside the state distribution system and commodity exchanges. These are from 30,000 up to 55,000 rubles per mt, depending on regional supply and demand conditions.

A crucial relationship exists among procurement prices and those established on the market. Ultimately, these must be competitive. However, since Roskhleboprodukt controls some inputs (including seeds and credit)[3] and the handling sector (95 percent), distortions occur between the procurement price and those discovered on the exchanges. Exchange prices normally have to be a premium relative to state prices due to the contingent benefits associated with sales under the state regime.

Two important changes were introduced for the 1993 crop. These are largely in response to the financial crisis and the need for longer term reform in the agriculture sector. First, prepayments would be made to producers to cover a portion of production costs and crop insurance on volumes that would be delivered at harvest. Credit would also be provided at favorable interest rates of 25 to 30 percent compared to commercial rates of 80 to 120 percent per year.

Second, in a revolutionary move in transforming the current grain sector to market conditions, mandatory sale of grain to government reserves would be eliminated. Federal (central) and regional grain reserves will be created on a voluntary basis under contracts with producers. In particular, 50 percent of the grain purchased for the Federal fund will be paid in advance. After completion of the harvest campaign, those producers who fulfill the contracts will receive a 50 percent subsidy on equipment, parts, and fuel purchased this year.[4] The Federal Grain Reserve will be used only to supply deficit regions. The size of the regional grain reserves will be determined in each specific region; the head of the local governments is responsible for forming these reserves.

In late 1992 and early 1993, a new set of laws were being negotiated that would potentially alter the long-term structure of the grain marketing industry. These were referred to as "the Grain Laws" or laws "On Grain." Important features of these include: 1) The state would guarantee at least one-third of expenditures made to plant grains, 2) The government would make 50 percent of the expenditures on storage and harvesting, 3) A minimum guaranteed price would be established for grain procurement, based on world prices, and 4) A 40 percent advance would be made for grains contracted at the beginning of the year, and contracts not fulfilled would be penalized 50 percent of the original contract. Grain traders would have to be licensed, exports would be licensed, and regional authorities could import their own grain, using their own foreign currency resources.

Russian Grain Exchanges

Emergence of commodity exchanges in Russian grain marketing has provided an alternative mechanism for price discovery and transactions. As in other countries, Russian grain exchanges serve two critical roles and functions: price discovery, both spot and forward, and dissemination of price information. Russian commodity exchanges also serve the important role of allocating commodities among buyers and sellers, a point normally omitted in discussing roles of commodity exchanges in the West.

History

Commodity exchanges are not new in Russia. Exchanges existed and functioned before 1930, when they all were closed.[5] In 1991, the centrally planned distribution system collapsed, but a functioning market system and discipline were not yet established. Hence, the pressure to develop efficient means of exchange was immense. Contemporary exchanges began to emerge in 1990.

Most exchanges were founded as "closed type joint stock companies" as opposed to being public organizations. In many cases, large state-owned enterprises, state distribution agencies, or associations of producers started these exchanges. As such, the exchange provided a vehicle to buy or sell its own products.

Estimates of the number of exchanges that exist in the CIS vary from 300 to 700 (Klebnikov) to 1200 exchanges. Two reasons account for this variability. First is the definition. In Russia, a commodity exchange could simply be an organization that calls itself an exchange and periodically functions as an exchange. Most exchanges in Russia are simply bazaars, sometimes referred to as "flea markets". An exchange in its purest form is truly a place (physical) where buyers and sellers meet to transact business. Ulrich distinguishes among three formats which are all loosely referred to as exchanges: true exchanges (including bazaars and auction centers), broker firms, and holding companies.

The second reason is timing. Exchanges flourished rapidly in late 1990 through mid 1992. At that time, 270 exchanges were registered with the State Committee on Anti-Monopoly Policy,

[3] Fertilizer, machinery, and fuel are controlled by the Ministry of Agriculture.

[4] In March 1993, an agreement was made between agricultural producers (represented by AKKOR) and the Ministry of Agriculture and Roskhleboprodukt as follows: 1) average grain prices would increase to 30,000 R/mt (versus 12,000 last year) to be increased through the summer with inflation; and 2) a 50 percent advance would be provided.

[5] Several contemporary exchanges have located in the facilities that were exchanges in the early 1900s.

the authority over these enterprises. Since then, the number of exchanges likely has fallen.

Reasons for the large number of exchanges in Russia are communication technology and competitive forces. The vastness of the country and the primitive communication technology created the necessity for a large number of exchanges — simply in response to the demand for price discovery. Many organizations rushed to establish exchange mechanisms to take advantage of the early growth in this industry. However, growth has slowed, and some exchanges have become more efficient (at handling orders, matching buyers and sellers, disseminating information, and centralizing activities). Still others have linked up as networks (a system permitting trading, margin calculating, clearing, and settling) of trading houses. As a result, 30 principal exchanges, serving a network of subsidiaries, likely will dominate the industry.

Grain is traded as cash contracts — no futures as known in the west are traded on grain. However, futures have recently begun trading in U.S. dollars and "privatization vouchers." U.S. dollar futures began in October 1992 in $10 and $1,000 denominations. During December, trading averaged $200,000 per week. Privatization vouchers (a document issued to each citizen in late 1992 to be used to purchase shares of companies being privatized) also are traded as futures. As a result, these exchanges have developed a margining and clearing system, as well as delivery procedures.

Trading Practices

In the case of grain and other agricultural commodities, these exchanges are fundamentally spot or forward cash markets as opposed to futures in the western countries.

Trading occurs daily on some exchanges but on others it occurs with less frequency (e.g., weekly). Trading procedures differ from those in western exchanges. First, offers to sell including price, quantity, quality, and shipment period (a process which is not standardized) are published and circulated among brokers. The next day, these offers are read, and the first buyer to indicate acceptance receives the item. In case two buyers want it at the offer price, a separate auction between those buyers is held to determine the price and buyer. This exchange mechanism is fundamentally a "matching" process, as distinguished from a "double auction" in western exchanges. For example, the RRMCE publishes and distributes up to 20,000 offers daily. If an offer is not sold after eight days, the offerer must reduce the price or remove it from the list. Complete sales are cleared through the exchange's bank.

Trading companies are charged an income tax of 45 percent, in addition to a 28 percent VAT applied to every transaction.[6] As a result of these relatively excessive taxes, only an estimated 1 to 5 percent of the offers are consummated on the exchange. Many transactions are consummated outside of the exchange due, in part, to this "middleman" tax. This is a principal problem inhibiting commodity exchanges.[7]

Cash Contracts

A principal inhibitor to broad scale development of the grain exchanges was that *bona fide* contract mechanisms were not in place. The number of defaults have been large, and difficulty exists in filling some orders. As a result, a **Model Cash Contract** was developed and has been adopted in principal at many exchanges.[8]

Features of this contract are similar to some contracts used in U.S. cash grain trade, including specifications for quality, quantity, and a specific procedures for arbitration. However, because of the high frequency of default, in part from inflation, special provisions were included for performance guarantees.

[6] In contrast, the corporate income tax is 32% and the personal income tax is up to 60%.

[7] To reinforce a major point is that middleman activities, or, for that matter, speculative activities are still not looked upon as providing positive utility in the Soviet system. Ulrich indicated that "In true Soviet fashion exchange activities were not quite legal-resale at a profit was technically illegal for some time..."

[8] This was developed in conjunction with a USDA AMS project, titled "Moscow Cash Grain Trading Project" (Wilson et al.).

The Future of Russian Grain Trading

The Russian grain marketing system is in a state of transition from a command system to the emergence of commercial mechanisms which could supplant previous regimes. Given the size of the Russian market and the potential for grain production, changes occurring in the market system have important implications for the world grain trading system.

While there are many subtle changes, there are three of particular importance. First, two new firms or agencies have emerged, each with very broad functions. The privatization process in the case of grains in some sense essentially involves transforming a government bureaucratic organization to a private monopoly under the auspices of a "joint-stock" company. Roskhleboprodukt controls the domestic market system and many of the functions, and is a principal shareholder and client of ExportKhleb. The latter has expanded its sphere of enterprises substantially and will, no doubt, evolve to become a dominant trader of numerous world grains and commodities.

Second, trade restrictions (i.e., export licenses) and exploitations of market power by former republics in transport functions preclude full integration of Russian markets with other world markets. Until and unless these are removed, signals throughout the market system will continue to be distorted. Third is emergence of commodity exchanges as alternatives to the state distribution system. At this point, a dual marketing system is operating in Russia. However, it should be emphasized that for many reasons, the state distribution system will continue to dominate and inhibit development of commodity exchanges. The momentum and enthusiasm for development of futures contracts are tremendous. However, it must to be emphasized that viable and properly functioning cash markets are a prerequisite to development of futures.