



WHAT COULD HAPPEN IF RUSSIA REOPENS ITS DAIRY MARKET FOR EU EXPORTERS – POTENTIAL SCENARIOS AND IMPLICATIONS

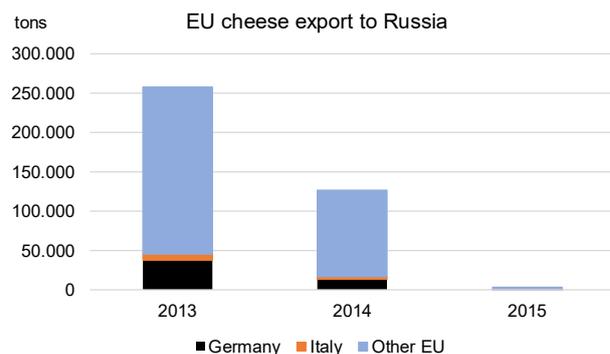
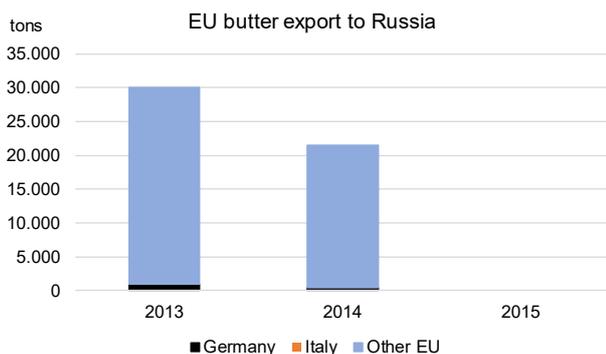
In 2014, the European Union imposed economic sanctions against the Russian Federation. In response, the Russian Federation imposed import bans on agricultural products (including dairy products) from the European Union as a countermeasure. As a result of the bans, EU dairy exports (some annual 30,000 tons of butter, 257,000 tons of cheese, 21,000 tons of SMP and 26,000 tons of whey powder) in total annual value of EUR 1.4bn towards Russia have come to a complete halt. Following the introduction of the sanctions, EU dairy prices (butter, cheese and SMP) continued to decrease significantly.

The EU economic sanctions are effective until the end of January 2020. Nevertheless, lately we have been hearing that the EU and Russia might be reconsidering their current stance. Once these sanctions are no longer in place, we expect a short-term positive price shock to European dairy prices and a significant business opportunity for competitive EU dairy players. The potential cheese import of Russia is currently at around 250,000 tons per annum, where EU producers used to enjoy almost 60% of market share. On a smaller scale, the Russian dairy market also has the potential to open up several tens of thousands of tons of additional butter export for EU producers.



As a response to Russia’s annexation of Crimea, international sanctions were imposed against Russia. The European Union imposed economic sanctions (export bans) in July 2014 targeting its trade relationship with Russia in specific economic sectors (including the dairy sector). In August 2014, as a countermeasure, Russia imposed import bans on agricultural products (including dairy products) from the EU. In July 2018, the EU announced the extension of sanctions until January 2020. Before the sanctions Russia was the fourth-largest trading partner of the EU, and the EU was Russia’s most important trading partner.

As a result of the economic sanctions, EU dairy export to Russia has disappeared. The last full year of export activity unaffected by sanctions was 2013 when the EU exported dairy products to Russia with a value of ca. EUR 1.4bn. In 2013, EU butter (30,020 tons, some 30% of total EU butter export), cheese (257,198 tons, nearly 33% of total EU cheese export), skim milk powder (21,263 tons, some 5% of total EU SMP export) and whey powder (25,459 tons) exports to Russia represented 1.6%, 2.9%, 1.9% and 1.6% of respective EU dairy production. In terms of importance, the cheese export represented the largest part of the EU’s dairy trade towards Russia. The largest EU dairy exporters were Finland, Netherlands, Lithuania, Poland and Germany. Italy was the ninth most important exporter to Russia within the EU. Since the Russian export ban, the United States has become the EU’s largest market for both butter and cheese (a market which has recently been impacted by the introduction of additional import tariffs by sanctions, more on this later).

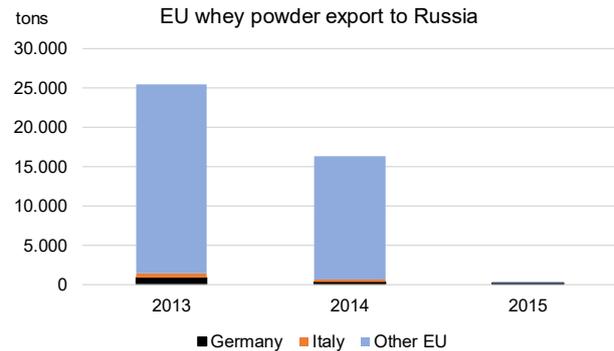




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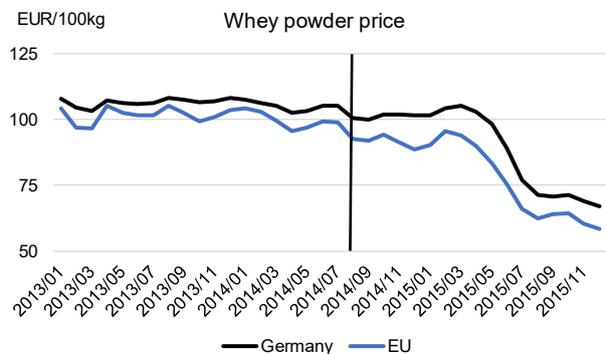
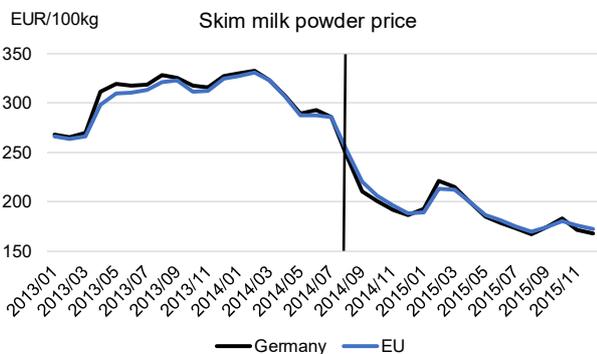
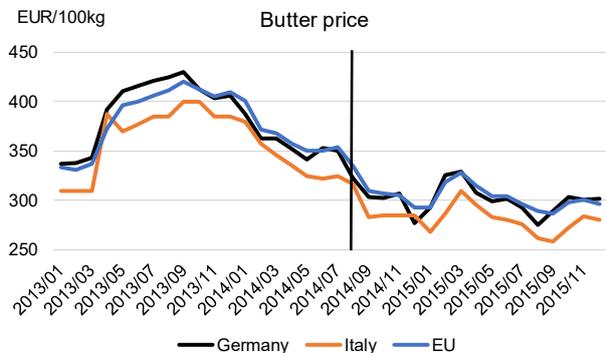
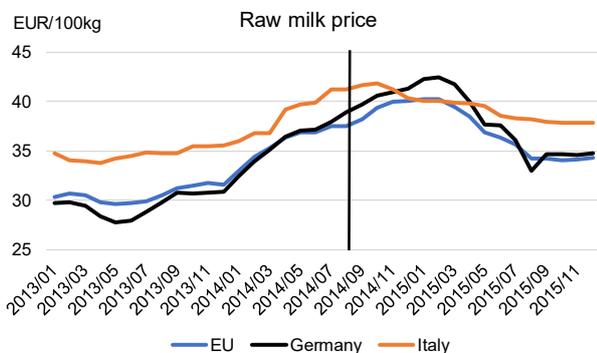
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As a result of the sanctions, Russia has increased its internal dairy production, however, the increase in production was not enough to fill the gap, and to reach a self-sufficient domestic dairy industry. Therefore, Russia has still been relying on dairy imports – although at lower volumes – now predominantly from Belarus (e.g., in 2018, the cheese import from Belarus was 83% of total Russian cheese import).

Following the introduction of economic sanctions, the EU dairy products destined for Russia had to find other markets and customers. Although compared to total EU production these export volumes are not very significant (as we have seen the largest share was recorded with cheese at 2.9%), producers had to find new customers. In addition, the Russian dairy imports from the EU accounted for almost 25% of total EU dairy exports. Consequently, the redirection of Russia sales was meaningful in overall terms of EU dairy export activity, thus the subsequent temporary decrease in export demand might have also contributed to the broad-based decreasing European dairy prices.



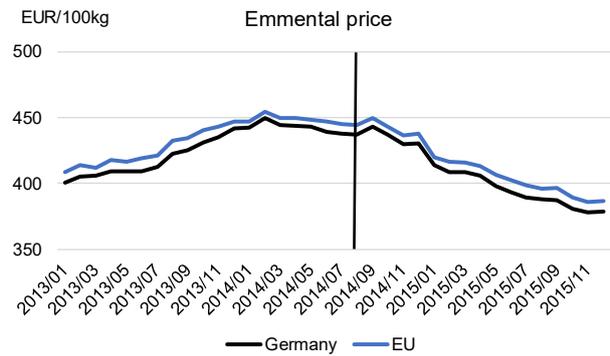
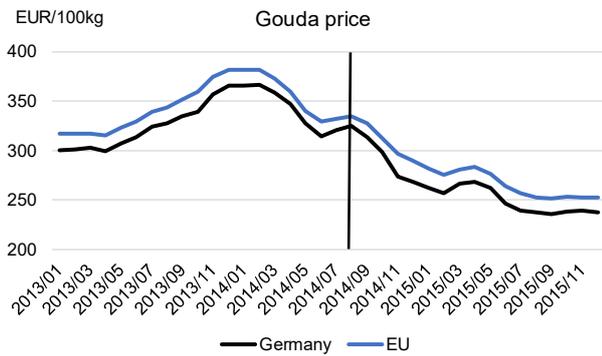
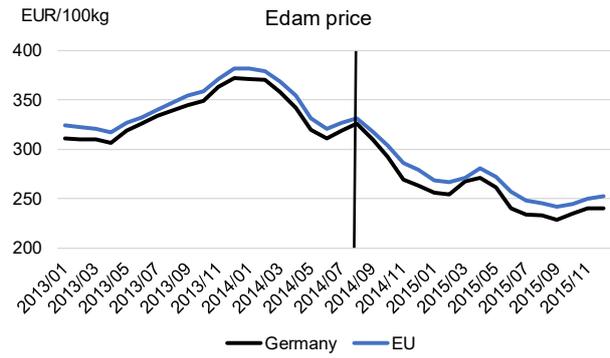
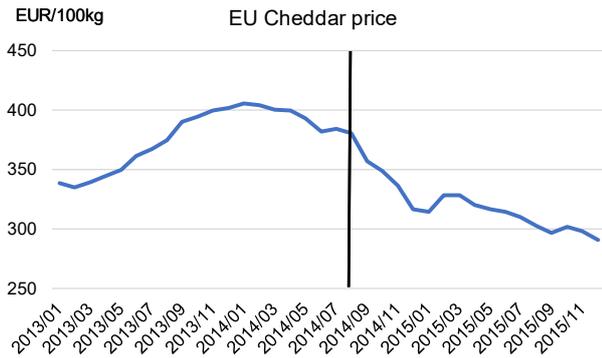
During the year of the newly introduced Russian economic sanctions, the decrease in European dairy prices was less pronounced for whey powder, but significant for cheeses, butter and skim milk powder. Nevertheless, raw milk prices were already increasing in the EU and Germany, but not Italy, where following the introduction of the sanctions one was witnessing some backdrop in prices at the end of 2014.



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The European Union has decided to extend the economic sanctions against Russia by the end of January 2020. Nevertheless, some EU members, most notably Italy, Hungary, Greece, France, Cyprus and Slovakia are sceptical about the sanctions, and have called for a review of them. In addition, due to the recently introduced additional US import tariffs on a wide range of EU products, some key export products (e.g., Italian hard cheese) are facing tough sales conditions. Therefore, it is not surprising that some voices are getting louder and louder to reconsider the EU's overall stance on the economic sanctions against Russia.

Lately, we have been hearing from several trusted sources that the parties might consider changing their positions. It is not clear if this situation is solely driven by economic factors or if political considerations are also in play. It is extremely difficult to foretell the behaviour of actors in such situations, as decisions are often short-sighted and politically motivated (e.g., please see an example of this in the below box).

How China has executed a U-turn in its Canadian pork import policy

China's recently introduced and suddenly lifted import ban on Canadian pork is a good example of how sovereign countries in today's economically and politically dependent world can execute U-turns in their trade policies from one day to the other. Following Canada's arrest of Huawei's CFO on US fraud charges in December 2018, China initiated economic restrictions (as a retaliation) against Canada after claiming to have discovered falsified certificates for meat exports. Independently from these developments, the Chinese pork industry has been hit severely by the African swine fever, which has outgrown itself into a national pork crisis during the course of 2019. Half of the China's pig population has been wiped out despite increased imports. In addition, pork prices have almost doubled, while China still faces meaningful shortages of pork meat. Seeing this situation, Chinese authorities decided in November 2019 to lift Canadian pork import bans from one day to the other. Despite a politically motivated import ban, at the end, China was forced by economic developments to change its political stance towards Canada, and lift import bans on Canadian pork.

As a result of the economic sanctions, the Russian dairy industry has gone through considerable transformation by increasing domestic production (in several cases via government support), and by decreasing import volumes. Nevertheless, in 2018, Russian butter import still amounted to some 90,000 tons, cheese to 250,000 tons and SMP to 95,000 tons. Consequently, the end of the Russian export bans would represent significant business opportunity for well positioned European dairy companies.



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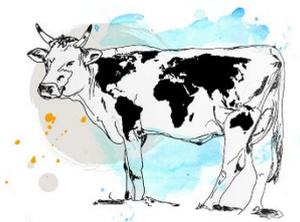
Butter from the EU has been historically very competitive in international markets, and at the moment EU butter is the most price competitive worldwide. Consequently, a potential end of economic sanctions could open the Russian market to EU exporters. We believe EU exporters are well positioned to gain significant export market share (several tens of thousands of tons) at the expense of Belarus (butter import from Belarus represents 76% of total Russian import compared to pre-sanction levels of 30%). The same economic reasoning also holds for cheese, but at a larger scale. The EU used to enjoy almost 60% cheese export market share, while Belarus now has 83% market share compared to ca. 20% prior to the sanctions. EU-originated cheese is currently very competitive internationally, therefore, for EU cheese producers Russia could again be a very important export market. With regards to competition from other exporters, the potential market size is close to 200,000 tons. However, we believe EU cheese producers can rather easily challenge newly established Russian producers as well.

Once economic sanctions against Russia are lifted (or not extended beyond their currently anticipated deadline of 31st January 2020), we also expect European dairy prices potentially to increase in the short term, most probably for cheese, but at smaller scales also for butter and SMP. This potential impact has consequences for proper dairy price risk management as we experience a growing number of potential risk factors (both positive and negative) facing dairy producers.

Sources:

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- "China lifts ban on Canadian pork and beef exports", Financial Times

About L'INTERFORM



With over 50 years of experience and a team of dedicated and knowledgeable professionals, L'INTERFORM is one of the leading independent brokers of dairy commodities in Europe and has direct relationships all over the world with major sales segments such as purchasing organizations for retailers, wholesalers, food service suppliers, and industrial transformers. Throughout its history, our firm has introduced many renowned manufacturers of Europe's dairy industry and their brands to the Italian market and continues to represent exclusively selected European dairy businesses in Italy.

In recent years, L'INTERFORM has expanded its scope of practice and since 2017 has been providing comprehensive financial risk management and advisory services in the dairy and broader agricultural commodities sectors.