Russia in the Finnish Economy

Simon-Erik Ollus & Heli Simola

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Executive Summary

Trade between Finland and Russia has flourished throughout the present decade and Russia has risen back to being among the most important trading partners for Finland. Finnish exports to Russia in particular have boomed, but according to our calculations at least a quarter of them are actually re-exports. The income and employment effects of re-exports are considerably smaller for Finland than those of its own exports. But even excluding re-exports, Russia has been the fastest growing export market for Finland. In trade with Russia grey schemes are still commonly used and are reflected in the large discrepancies between Russia's import statistics and its trading partners' export statistics. For Finland the discrepancy was nearly 60%, which is higher than for most other EU countries. After excluding re-exports from the trade, Finnish exports still lose a third of their value at the Russian border, mainly due to double invoicing. Exports to Russia employ about 34,000 people in Finland.

Transit transport through Finland to Russia is another large and growing area of Finnish-Russian economic relations. According to our calculations, already a quarter of total Russian imports are transported through Finnish territory. Finland has so far been competitive as a transit hub for value goods, especially to Northwestern Russia, as the Finnish corridor is reliable, safe, and effective. However, as Russia's own infrastructure as well as that of other competing countries improves, further development of the transit transport infrastructure is needed to maintain the current position. In contrast to imports, Russian exports through Finnish territory are small, accounting for only about 4% of total. The impact of the Russian transit traffic on Finland is twofold: on the negative side, it erodes Finnish transport infrastructure, but on the positive side, it employs about 4,000 Finnish people.

Since the demise of the Soviet Union, economic relations between Finland and Russia have deepened, also in reciprocal investment activity. Finnish investments to Russia have increased rapidly, especially in recent years, as Finnish firms have seized the opportunity provided by the vast potential and strong growth of Russian markets. Finnish firms have invested in Russia mainly

for production aimed at local markets rather than outsourcing for cheaper labour. Expanding to Russian markets has brought Finnish firms additional sales and supported their competitiveness, and the investments have been fairly profitable. The Finnish firms have also invested in fields, not considered strategic from a Russian perspective, and hence the political risks are smaller.

The number of Russia-related companies in Finland has also grown considerably recently, especially in the field of trading and transportation. These companies are located in Southeastern Finland and the capital region and are mainly rather small. They employ about 8,000 people in Finland and increase Finland's tax revenue.

The trade in services with Russia is increasing; especially in travel and construction services. In 2005, nearly 1.7 million journeys from Russia to Finland were undertaken and 400,000 visitor visas were granted to Russian citizens. The trade in services employed nearly 11,000 people in Finland in 2004.

The total employment effect of economic activities related to Russia is roughly 50,000 people or 2% of the employed. The effect therefore is significant, although more modest when compared to the effect of Sweden or Germany on the Finnish economy. But Russia is the large fastest growing market in proximity of Finland, so the potential future effects are worth noting. Russia offers Finnish firms a prosperous, growing market, despite some worrying elements that ought to be tackled effectively. Thus, Finland and Russia would be able to fully benefit from reciprocally fruitful economic co-operation.

Foreword

In year 2005 Russia took the leading position as Finland's biggest foreign trade partner. During the preparation of Finland's economic strategy for Russia in 2005 the expert group concluded that the official statistics present only volumes of the export-import operations but do not disclose the real content of the trade. In this report the research team has for the first time tried to analyse the content and impact of the foreign trade with Russia on Finnish economy.

Research team Mr. Simon-Erik Ollus and Ms. Heli Simola from Bank of Finland, Institute for Economies in Transition, took this major challenge and now in this report they are revealing Russian trade's measurable effects on Finnish economy.

As a part of Sitra's Russia Programme 2005-2007, Sitra is proud to publish and present this pioneering report.

Sitra hereby expresses gratitude to the authors and Bank of Finland for realizing this very interesting analytical report on a high professional level.

Helsinki 31 August, 2006

Maaret Heiskari
Executive director
Russia Programme
Finnish National Fund for Research
and Development Sitra

Contents

Preface

Recently Finnish-Russian economic co-operation has again been intensively in the spotlight. The Finnish firms are growing rapidly in Russia and various strategies have been written on the possibilities Russia offers Finland. Through our work we have also had to participate in the current boom, by providing information about current macroeconomic situation in Russia and Finnish-Russian trade issues. Hence, we came up with the idea of compiling the various issues we have spoken and written about during the last year into a comprehensive report, to serve a wider public: What is the Russian effect on the Finnish economy?

The aim of this report is to comprehensively explain the real impact of Russia on the Finnish economy. We hope it can serve as background information for policy planning and as teaching material for students of Finnish-Russian economic relations. We also want to offer some new aspects for a wider audience interested in the development of Finnish-Russian economic relations during this decade.

The report is based on various sources and numerous discussions with different parties over the last years. Hence, we decided to write the report without any references in the text. The most important written sources are found at the end of the report, but due to confidentiality and the parties not always knowing the purpose of our discussion, we do not add any list of interviews. Many interviewees did not want their name mentioned in public, especially when it concerns the negative effects of Russia. However, we are grateful for all the valuable help we have been offered from so many people during this process.

We want to thank especially Matti Heiniemi, Tommi Kivilaakso, Mikko Laitinen, Juha Niskanen and Jorma Tuomainen at the National Board of Customs and Markku Hirvonen at the National Board of Taxation for all their valuable information and comments during the process. Other people worthy of special mention are Hannu Hernesniemi at Etlatieto, Virpi Herranen at Cursor Ltd and Ilkka Lampinen at the Southeastern Finland Employment and

Economic Development Centre. We also want to thank Merja Tekoniemi at the Bank of Finland for kindly drawing us the maps presented in Section 4. And finally, we wish to thank Vesa Korhonen and Pekka Sutela at the Bank of Finland for many valuable comments to the manuscript and Louise Park-Ahonen for polishing our English.

We are grateful for our employer, the Bank of Finland, which let us concentrate on this project for the whole summer of 2006. We also want to thank the Finnish National Fund for Research and Development (Sitra) Russia programme for their genuine interest in the topic and the publication of the report itself. And finally we need to remind the reader that all the opinions expressed in this report are those of the authors and do not necessarily reflect the views of the Bank of Finland or Sitra.

Helsinki 15 August, 2006

Simon-Erik Ollus and Heli Simola

1 Introduction

Russia still arouses contradictory opinions in Finland. On one hand, already as the Soviet Union as well as nowadays as Russia, it provides huge market potential for Finnish business, which has been eagerly exploited. On the other hand, the historical tensions and pressure, as well as its different market environment and problems with, e.g. corruption, criminality and more recently road accidents related to heavy Russian transit traffic inside Finland, dominate the views of many Finns regarding Russia. It is clear that this large neighbour has an influence on Finland and our economy, but what kind? The aim of this report is to cast more light on the question from an economic viewpoint.

We have concentrated our analysis on the trade of goods and services, investments and transit during the first decade of the 21st century. The scope of the analysis naturally does not cover all possible fields of economic influence, but we decided to limit the analysis in the most important areas of economic interaction. Thus, the results are not comprehensive, but still indicative of the meaning of Russia to the Finnish economy in recent years.

In Section 2, we briefly outline the historical development of the economic relations between Finland and Russia for the past century. The goal of the section is to put the current state of affairs in historical perspective. This section mainly concerns trade relations between the countries, as in the past interaction in economic field was mainly concentrated on bilateral trade. It presents the long-term development of trade as well as briefly describing some general characteristics of trade. In addition, some other aspects of economic relations between the countries are raised.

After the brief review of history, we move to the present situation. In Section 3 the focus is on goods trade between Finland and Russia. First, we present the recent development and structure of trade and some additional characteristics. Then we discuss some worrying issues related to Finnish-Russian trade: impediments to trade, re-exports and grey schemes. We present our calculations on the size of the re-exports and the scale and scope of grey trade, which are more thorough than earlier similar estimates. Finally, we

present and discuss some calculations and estimates of the effect of trade with Russia on Finnish economy.

Section 4 discusses the transit traffic between Russia and Finland. The section presents recent trends in transit and explores why Finland became such a significant transit hub for Russia. The characteristics and competitiveness of the Finnish transit business are also discussed and some perspectives for the future are raised. Finally, we present an evaluation on the effect of the business for the Finnish economy.

Section 5 focuses on the investment activities between Finland and Russia in recent years. We present the characteristics and motivation of Finnish investments in Russia and discuss their effect on Finland. Attention is also paid to Russian investments and entrepreneurs in Finland. Earlier studies on Russia-related firms in Finland have not used the National Board of Taxation's thorough database, and hence the section also presents some new aspects about Russia-related firms in Finland. Finally the economic and employment effects of the mutual investments for Finnish economy are evaluated.

Section 6 outlines the state of trade in services between Finland and Russia. The section presents the most important sectors of services trade and picks up particularly the travel sector. The section also examines the significance of trade in services with Russia to the Finnish economy.

Finally, in Section 7, the total effect of Russia on the Finnish economy is summed up and discussed. It presents a rough estimate of the Russian employment effect in Finland as well as bringing up some future aspects of the Russian effect on the Finnish economy.

2 Review of pre-21st century Finnish-Russian economic relations

Russia's effect on the Finnish economy before the Second World War

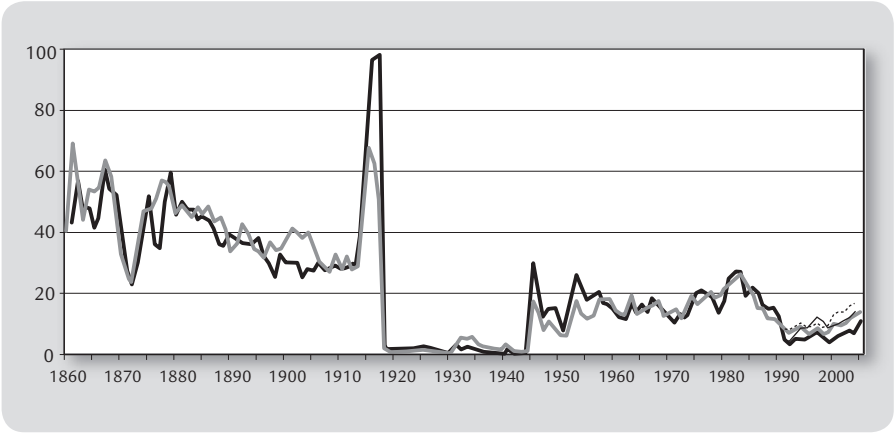
The size of Finnish trade and other economic activities with Russia and the Soviet Union has varied considerably in the last centuries.[1] During the time when Finland was an autonomous region of the Russian Empire, Russia's share of the Grand Duchy of Finland's foreign trade was about 40% in 1860–1916. Russia was, at that time, Finland's largest trading partner.

Exports consisted mainly of wood and engineering products. In the 1880s, the paper industry accounted for half of all Finnish exports to Russia and one third of the Russian paper consumption. The Finnish engineering industry mainly served the Russian army's demand. The paper industry also found markets in Western Europe at end of the century. When the Russian revolution took place in 1917, the demand for Finnish paper and wood in Europe grew rapidly as Russia stopped exporting these products. Much of the Finnish imports from Russia during the autonomous time consisted of consumer goods and raw materials. Russia was also an important source for grain for Finland. This trade, however, came to a halt in 1917 as Finland became independent and the Bolsheviks closed Russia's foreign trade, following the revolution. Trade with Russia collapsed and Finland had to reorientate its trade towards the West.

In the period following World War I, the Soviet Union's share of Finnish trade was marginal, as were other forms of economic co-operation. In the pe-

[1] A comparison of Russia and the Soviet Union is not fully correct, but as there are no proper statistics available for Soviet Russia's trade with Finland, the figure for the whole USSR is used. Soviet Russia was, however, clearly the largest trading partner for Finland of the Soviet republics.

Figure 2.1 Share of Russia and the USSR in Finnish foreign trade 1860–2005, %.



*All the former Soviet states in 1992–2004

Source: Bank of Finland, National Board of Customs.

riod 1917–1944, the share of Finnish foreign trade with the Soviet Union was on average 2%. Some wood export to the USSR occurred and it grew slowly towards the end of the period, but still stayed at a marginal level. After gaining independence, Finland decreased its dependence on grain imports by developing its own agriculture. In the period between the World Wars, Great Britain was Finland's largest trading partner. The small trade with the Soviet Union collapsed totally when the Winter War, following the Soviet invasion of Finland, broke out in 1939. After the war a trade regime was negotiated, but it collapsed again, when hostilities were resumed as the Continuation War began in 1941.

Finnish-Soviet clearing trade – 40 years of bilateral trade with the Soviet Union

Trade started to boom after the Second World War. War reparations and the clearing trade regime developed together with the Soviet Union accounted on average for 16% of Finnish foreign trade in 1945–1990.[2] The share was at its largest in the early 1980s, when about a quarter of Finnish foreign trade was conducted with the USSR.

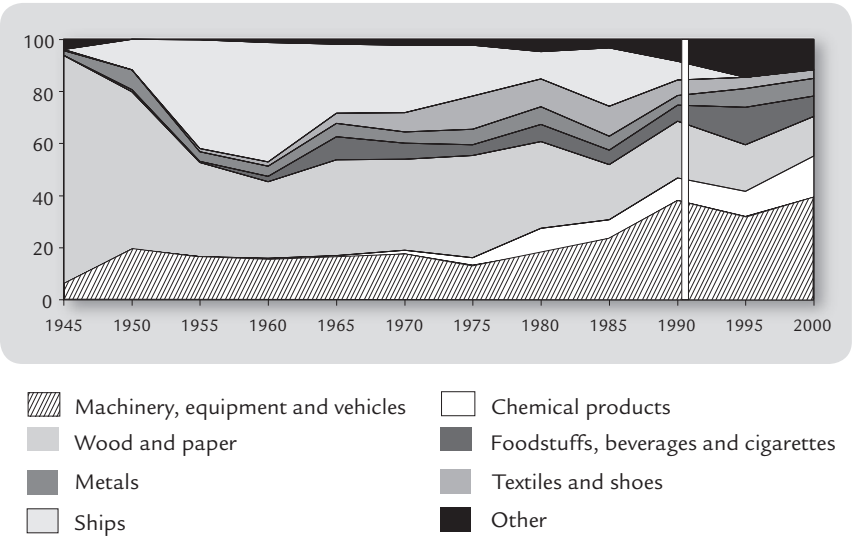
[2] After 1945 the definition of the Soviet Union also includes Estonia, Latvia and Lithuania.

After the Second World War, Finland was obliged to pay the Soviet Union heavy war reparations. Reparations consisted of goods and material for Soviet industry. In 1952 Finland had already paid its entire war indemnity and payment developed into a mutual economic co-operation. The first limited trade agreement between Finland and the USSR came into force already in 1945, but the real foundation for the subsequent 40 years of bilateral trade was agreed upon, when the first five year trade agreement was signed in 1950. Finland became the first market economy to sign a five year agreement to exchange goods with the Soviet Union for 1951–1955. Later, seven further five year agreements were signed. Bilateral trade ended in 1990.

The exchange of goods was based on clearing trade, where financial claims were settled against each other and reduced to a single net balance. The clearing system between Finland and the Soviet Union was centralised, intergovernmental and the trade was handled through bilateral clearing accounts, which were originally supposed to be kept strictly in balance. On the Finnish side the account was handled by the Bank of Finland. The general terms of trade were agreed on at state level between the countries, but in the end on the Finnish side it was an interactive process between companies and the State.

Finnish exports to Russia consisted mainly of forest products, ships and machinery, equipment and vehicles. Exported forest products were mainly pa-

Figure 2.2 Structure of Finnish exports to the Soviet Union/Russia 1945–2000, %.



The observations are in 5 years intervals. Years 1945–1990 reflect the structure of Finnish-Soviet trade, while 1991–2000 reflect the structure of Finnish-Russian trade.

Source: Bank of Finland, National Board of Customs.

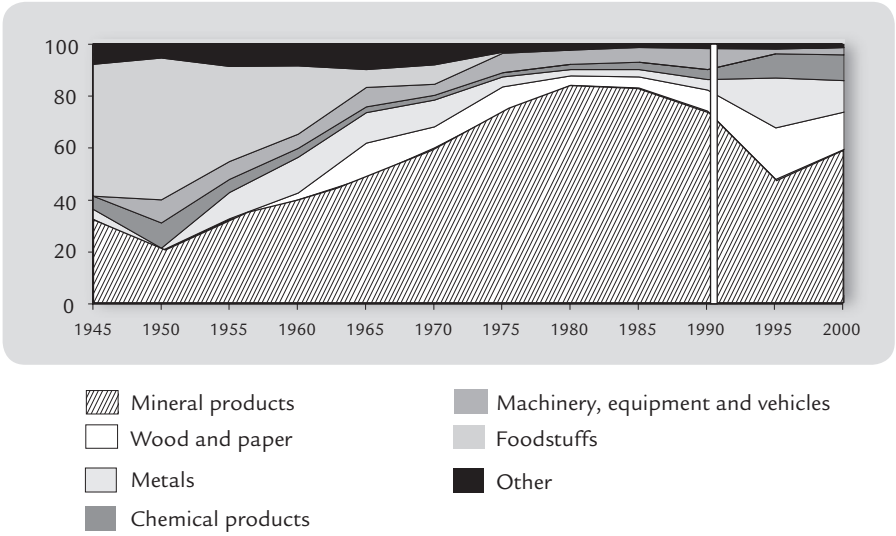
per and paperboard. After paying off the war reparations and still in the early 1970s, ships were the largest single item in exports to Russia. Their share, however, declined from nearly half of the exports in 1950s to about 20% at the end of the period. Machinery, equipment and vehicles accounted for over a third of exports by the end of the bilateral trade period. Other important groups in the exports were metals, chemicals, footwear, textiles, clothing, foodstuffs and beverages.

Mineral – mainly energy – products dominated imports from Russia. The share of crude oil was about one third in the 1970s and at the end of the 1980s. During the oil crises and in periods of high oil prices in early 1980s, it accounted for half of the Finnish imports. Adding to that the share of oil products of about 20% of the imports and that of other energy products (mainly gas) of 10%, meant that the total share of mineral products was significant. Other imported items were mainly wood material and machinery, equipment and vehicles. Before 1970s foodstuffs imports were also important.

Other economic activities with the Soviet Union

As the Soviet Union was a closed economy, investments and other kind of economic activities between Finland and the USSR were rare. Beside trade in

Figure 2.3 Structure of Finnish imports from the Soviet Union/Russia 1945–2000, %.



The observations are in 5 years intervals. Years 1945–1990 reflect the structure of Finnish-Soviet trade, while 1991–2000 reflect the structure of Finnish-Russian trade.

Source: Bank of Finland, National Board of Customs.

Table 2.1 Large Finnish construction projects in the Soviet Union

Project	Where	Contractor	Time-table	Value in million FIM
Mining industry facility	Kostamuksa	Finn-Stroi	1977–88	6,500
Wood processing facility	Svetogorsk	Finn-Stroi	1972–82	2,700
Cellulose and paper factory	Vyborg	Finn-Stroi	1984–88	1,100
Harbour and grain facilities	Tallinn	Portal Group	1983–86	450
12 Eye clinics in the Soviet Union		Polar	1986–88	420
Hotel Pulkovskaya	Leningrad	Polar	1978–83	400
Enlargement of Hotel Metropol	Moscow	Perusyhtymä	1986–88	350
Railway wagon depot	Tosno	Haka	1982–85	300
Storage facilities	Togliatti	YIT	1982–84	270
Foodstuffs terminal	Talinn	EKE-yhtiöt	1983–86	250

Source: Research Institute of the Finnish Economy, 1986.

goods, some state level agreements of participation in mainly construction projects on both sides of the border were also agreed upon.

The largest construction project involving Finnish participation was the building of the Kostamuksa mining facility and its surrounding infrastructure, in 1977–1985. Other large construction projects were the wood processing facility in Svetogorsk in 1972–1984 and the cellulose and paper factory in Vyborg in 1984–1988. Some other large collaborative projects are listed in Table 2.1. These projects were usually quite profitable for Finnish construction companies.

The Soviet Union also participated in construction projects in Finland. For example, the gas pipeline network in Finland and the large part of the Loviisa nuclear power plant are Soviet built. Also the Teboil petrol stations in Finland were Soviet owned. Moreover, a number of Finnish tourists visited the Soviet Union every year, but as very few Soviet tourists came to Finland, the overall effect of tourism on the Finnish economy at that time was small.

Effect on the Finnish economy of bilateral trade

For Finnish enterprises, participation in the clearing trade offered a relatively stable export market. As the general volumes of trade were agreed in five year agreements, acceptance to the arrangement offered a fairly predictable market. Indicative target volumes were agreed on beforehand and significant

advance payments were made in certain periods to some sectors. Hence, the firms did not need complicated export credit systems for larger and more expensive goods, such as in shipbuilding. In shipbuilding, the advance payment was normally a quarter of the final price, which was paid when the agreement was signed, often years before the delivery of the ship.

On average, Soviet exports were also more profitable than exports to other markets. According to calculations by the Finnish Ministry of Finance, in 1985 the export prices to the USSR were 9.5% higher than the export prices to the West.[3] The differences in export prices were highest in non-metallic sector, foodstuffs and forestry. Moreover, the quality of the products for Soviet exports was not always as high as in Western markets and usually had no demand on other markets.

According to a study by the Research Institute of the Finnish Economy from 1986, the direct and indirect employment effect for Finland of the clearing trade with the Soviet Union was around 130,000 people in the early 1980s. The employment effect doubled from the early 1970s, and if the effect of the construction projects in the USSR and trade of services are included the figure was as high as 150,000 in 1985 and averaged at 140,000 during 1980–1985. This was equal to 6% of the total workforce that time. The employment effect of exports to Russia was especially important for metallurgy, clothing and textile industries.

Bilateral trade was more concentrated than the rest of the Finnish foreign trade during the period. In 1989, the number of Finnish exporters to the Soviet Union was 1,688, of which the five largest exported about 40% of total exports. The fifty largest companies' share was already nearly 80%. The high concentration is explained by the centrally-agreed nature of the trade and the common use of production alliances in the trade with the USSR. In imports, the concentration was even higher, as only a few energy companies were responsible for most of the trade. However, similar figures to those of exports are not available.

On average, bilateral trade grew faster than Finland's trade to the West in the 1970s and 1980s. Especially the two oil crises in the beginning of 1970s and mid-1980s increased the export volumes, as oil prices grew significantly and Finland had to increase exports in order to balance the imports. In the early 1980s, a quarter of Finnish trade was already with the Soviet Union. The Finnish trade surplus with Russia started to grow in early 1980s, and after oil

[3] The calculations were presented in discussion paper by Kajaste under the name "Soviet trade and the Finnish economy: A retrospective analysis of macroeconomic effects of the clearing system in trade between Finland and the Soviet Union" at the Ministry of Finance in 1992. The calculations only concern the year 1985, when the oil crisis fuelled the volumes of export. But few similar calculations have been presented.

prices started to fall fast after the second oil crisis in the mid-1980s, the USSR had increasing problems balancing the trade. This led to a growing Finnish surplus in the clearing trade. The Soviet Union did not pay any interest on the receivables before 1988. When the Soviet Union fell at the end of 1991, the Finnish claims of about EUR 600 million (at current prices) from bilateral trade were transferred to Russia in the Paris Club of debtors in 1993.[4]

The effect of the bilateral trade has much been discussed among scholars. Some of the effects affected only some small sectors, while others affected the economy as a whole. Most of the studies of the bilateral trade regime, however, argue that it was clearly positive for the Finnish economy.

In the following we present some of the main positive effects for Finnish economy: Firstly, bilateral trade had a counter-cyclical effect on Finnish trade, and served to increase Soviet demand, when oil prices were high. Also a large share of the trade in the 1980s reduced cyclical behaviour in the Finnish economy. Secondly, the trade was profitable, stable and predictable. Thirdly, Finnish exporters used the Soviet market as a springboard to Western markets. Fourthly, the employment effect was significant. Fifthly, the unit costs of Finnish exporters to the USSR were lower than in trade with other countries because of the economies of scale and low marketing costs. And finally, the centralised management of the trade reduced transaction costs and it was managed so as to avoid excessively hampering the development of the Finnish market economy.

Bilateral trade was, however, not always argued as being positive. Some of the main arguments presented against the trade regime are: Firstly, it caused an excessive dependency on Soviet trade and a negative image cost in the West. Secondly, Finnish exporters to the Soviet Union were protected from external competition which made exporters lazy. Thirdly, the exports favoured less competitive industries and biased the production structure in Finland. Fourthly, difficulties in balancing the clearing trade increased the Soviet debt at the end of the trade, especially as the debt was without interest until 1988. Finally the bureaucratic and corporatist nature of the trade discriminated against SMEs in Finland in particular.

Collapse of bilateral trade

Bilateral trade stopped at the end of 1990, when no new trade agreements were signed. Already in the late 1980s the Soviet Union had found it hard to

[4] Russia repaid the last Soviet-era debts to Finland in August 2006, ahead of schedule. After rescheduling the debts in the 1990s, Russia was due to pay off that debt in the period 2002–2020. However, as Russia's large oil income has improved the financial position of the Russian Federation, Russia has paid all rescheduled Paris Club debts in advance.

fulfil all the obligations of the agreements, as the trade surplus had grown and many enterprises, as well as authorities in the USSR started to favour hard cash payments instead of clearing. In 1991 the Soviet Union collapsed and a new Russia was formed. The fall of the trade with the Soviet Union, when Finland was simultaneously hit by the worst recession seen in any industrialised country after the World War II, was dramatic for the Finnish economy. The Finnish GDP declined over 10% in 1990–1993 of which 6.2% alone was in 1991.

According to some estimates by the Bank of Finland and the Ministry of Finance, the collapse of the Finnish-Soviet trade contributed to some 2–3 percentage points of the decline of Finnish GDP in 1991. The total increase in unemployed in Finland in 1991 was about 150,000 persons. According to one estimate, the total effect of the collapse of exports to the Soviet Union would have accounted for 30,000 – 40,000 of the overall increase in unemployment that time.[5] However, the main reason of the economic crisis in Finland was the economic bubble created in the late 1980s, asymmetric financial liberalisation and overfull employment. The simultaneous collapse of the trade with the USSR worsened the crisis.

The end of bilateral trade also affected some branches more severely than others. For example, most of textile industry collapsed in Finland due the fall of the trade and the severe economic recession. Today there is little textile industry in Finland, although in the 1980s it was still the fourth largest industrial sector in Finland. Also many industrial sectors, which had mainly concentrated on serving Soviet demand – such as the shipping industry – had to go through severe restructuring.

Trade with Russia in the post-1991 period – A chillier era of trade relations

As the clearing trade regime ended in 1990, a chillier area of Finnish-Russian trade relations began. In the 1990s Russia's share of Finnish foreign trade was a moderate, 6% on average and Germany became Finland's largest trading partner.[6] Trade started to grow quite soon after the establishment of the new Russia, but the 1998 economic crisis in Russia halted the development. After

[5] Honkapohja and Koskela estimate in an article from 1999 that perhaps 30,000 – 40,000 of the total 150,000 increase in the number of unemployed in 1991 could be attributed to the collapse of exports to the USSR.

[6] The other former Soviet states' (excluding Russia) share of Finnish foreign trade was 3% on average in 1990s. Hence, the correct comparison to the Soviet trade figure in 1980s is Russia's share combined with these countries share, which altogether was 9% on average in 1990s.

the 1998 recession, trade volumes to Russia have increased rapidly to the current high levels.

Most of the economic activities were concentrated on the foreign trade of goods. The demand for Western quality goods grew in Russia after the collapse of the Soviet Union, while the domestic production of such goods was poor. As bilateral trade had been agreed on a political level and probably grew beyond what its natural level might have been, its decline in the early 1990s was significant. Moreover, the transition to a market economy in Russia forced the country to restructure its production. Also the lack of foreign currency to pay for the imports of goods reduced trading possibilities. It is also worth noting, that the recession in the early 1990s in Finland affected production levels and the country's export potential.

Consumer goods exports were proportionally larger to Russia than other export markets during the 1990s. Other markets were more dominated by investment goods. The largest category in exports to Russia was machinery and vehicles, accounting for about a third of the exports during the 1990s (see Figure 2.2). The second largest category was wood and paper and then came food and beverages and chemical products. However, at the end of the decade the food and beverage exports' share declined, while chemicals' share increased. The 1998 devaluation of the rouble gave Russian domestic food production a significant domestic price competitiveness advantage. Also mobile phone exports to Russia started to grow rapidly during the end of the decade, and their share of exports was 11% in 2000.

As before, mineral products dominated imports from Russia (see Figure 2.3). About 2/3 of imports were minerals, of which alone oil was the most important item. Wood and paper accounted for little more than 10% of imports through the 1990s. Chemicals and metals accounted for about 10% each. The rest consisted mainly of machinery, equipment and vehicles. As in other Russian foreign trade Finnish imports from Russia were dominated by raw materials.

The dominant feature in the trade during the 1990s was cash and prepayments, as Russian markets were undeveloped and it was difficult to get trade finance. Russia's international debt reliability was low, as the country had inherited huge debts from the Soviet era. As it failed to meet all obligations in 1998, reliability decreased further, which made foreign trade with Russia hard to finance on trade debt. The practise of advance payments or direct cash payments decreased risks for the exporter, but of course, the demand was often higher than the cash available by the buyer, so more sophisticated payment systems could have raised the trade volumes.

Finnish enterprises made nearly no investments in Russia during the Soviet time and the investment levels continued to be very moderate until the 1998 crisis (for greater detail see Section 5 and Figure 5.3). Most of the Finnish investments in Russia were concentrated in Northwestern Russia in this period.

The investment climate in Russia was considered very poor and foreign firms generally invested only limitedly in Russia during the whole of the 1990s. A certain amount of trade in services with Russia occurred, especially in the field of tourism. Russian tourism to Finland started to increase in the 1990s.

Conclusions: Russia and the Soviet Union in the Finnish Economy

Through history, the effect of Russia on the Finnish economy has been significant. Firstly, Finnish institutions were formed during the autonomous time under Russian rule. Secondly, Finnish forest industry developed rapidly and found international markets as the Soviet Union closed its foreign trade after the revolution. Thirdly, the payments of war reparations developed into a bilateral trade regime that lasted for 40 years. During which time the trade regime with the Soviet Union became a significant engine in developing Finnish industry. In addition to which, the employment effect in Finland of bilateral trade and the construction projects in 1985 accounted for 150,000 Finnish workplaces. Subsequently the share of employment declined slightly, until 1990–1991 when it plummeted, due to the recession

During the post-war period Finland also built up its welfare society and achieved some of the fastest growth records of any OECD countries. As Finnish growth was export driven and the USSR one of the fastest growing export markets and a profitable one, the trade regime has also had an important affect in constructing the Finnish welfare society.

Most of the economic co-operation in the pre-2000 period was foreign trade and very few investments have in fact been made by Finns in Russia in that period. Investments in Russia started to grow after the 1998 recession. Also other kind of economic activities have been small in the previous decade and the huge growth in them has first occurred during this decade.

Historically speaking, Russia has been the largest trading partner for Finland three times. Russia was the largest trading partner during the Grand Duchy period. Later, the same situation occurred during the bilateral trade regime in 1951–1990, trade being especially large in the early 1980s. The third time Russia again became Finland's largest trading partner occurred on the autumn of 2005.

3 Finnish-Russian goods trade in this decade

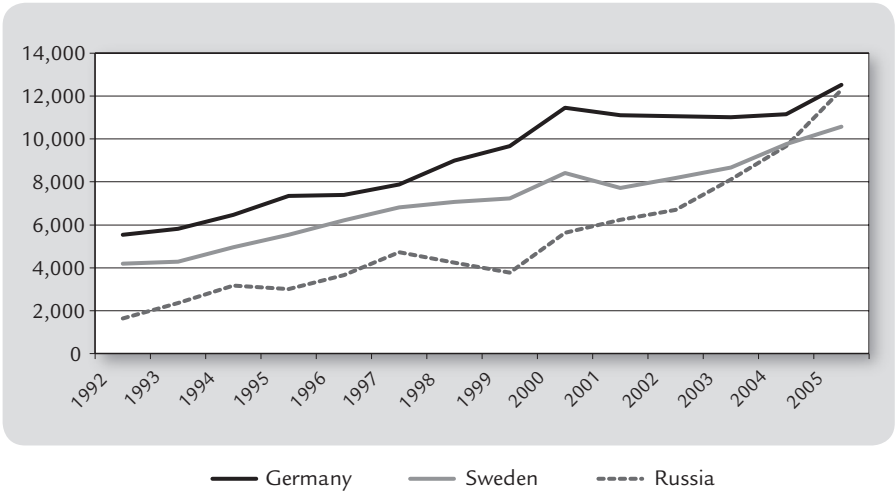
Russia becoming the largest trading partner for Finland

The development of Finland's foreign trade has been rather sluggish over recent years. In 2000, Finnish exports peaked at nearly EUR 50 billion, but in the next years all global trade slowed down and Finnish exports took a downwards turn. The fall was more severe for Finland than globally, since exports began to grow again only in 2004. The recovery of Finnish exports was especially complicated due to the unfavourable market conditions for the most important Finnish export product, paper. The development of Finnish imports was similar, but the changes were less dramatic than in exports.

Measured by the trade turnover, i.e. the sum of exports and imports, Russia has become one of the largest trading partners for Finland during this decade. In autumn 2005, Russia already climbed to first place, but after the weaker development of the last quarter, it fell behind Germany in the figures for the year overall. Russia's share of Finland's total foreign trade was 12% in 2005, whereas it was the most important export market with a share of 11% and the second largest import market with a share of 14%. The trade balance between the countries has shown a deficit for Finland throughout the decade. However, Finland's deficit has decreased, as Finnish exports to Russia have grown faster than its imports from Russia.

Finnish exports to Russia have continued to grow at a two-digit percentage pace throughout this decade. Russia's import demand has increased rapidly as booming oil revenues have enhanced consumption and investment possibilities in recent years. The growth in demand has been concentrated on investment goods and consumer durables. Russian production in these sectors is not large and many consumers appreciate foreign products more than domestic ones, which has led to rapid growth of Russian imports. Finland has

Figure 3.1 Finland's trade with Germany, Sweden and Russia in 1992–2005, EUR million.



Source: National Board of Customs.

been able to respond to this growth in demand rather successfully, as the value of Finnish exports to Russia has nearly tripled in 2000–2005, as also total imports of Russia. On average, Finnish exports to Russia have grown by a 25% annually in this decade, whereas the growth of total exports has been only 5%. In 2005, the exports to Russia grew 32% and the value of them reached to EUR 5.7 billion

Finnish imports from Russia have doubled in value in 2000–2005. On average, Finnish imports from Russia have grown a 20% annually, whereas the growth in total imports was 8%. The development of imports from Russia has varied greatly. In 2000, the growth was over 60%, but already the following year Finnish imports from Russia diminished. After that, imports again began a positive trend and in 2005 they increased 22%. However, the growth in value of Finnish imports from Russia is mainly due to considerable hikes in energy and raw material prices, whereas the changes in volume of import have been more moderate. The value of Finnish imports from Russia climbed to EUR 6.5 billion in 2005.

Russia and Finland complementing each other in the global distribution of work

Russia and Finland have very different roles in the global production environment. Finland mainly exports processed and high value added goods, for the production of which it imports raw materials and energy products. Contrast-

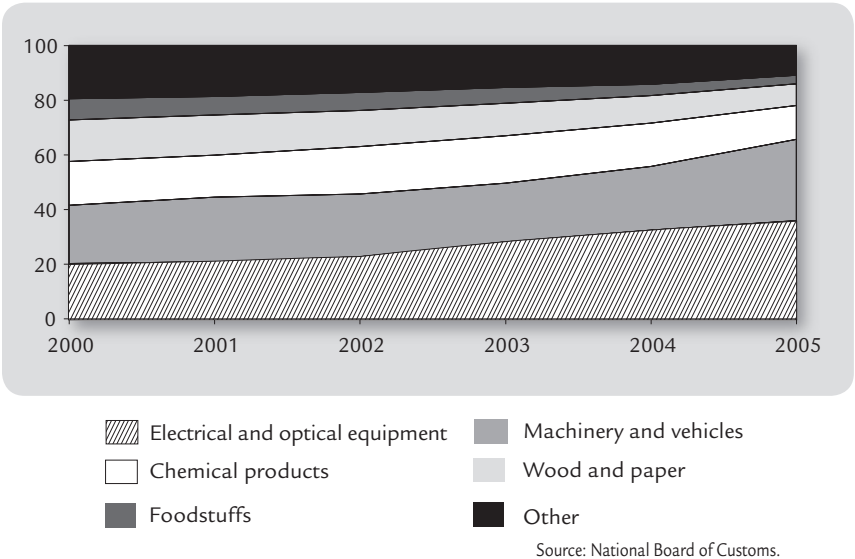
ingly, in the global economy Russia acts primarily as a provider of energy and raw materials and a purchaser of more refined goods produced abroad. Thus, the countries are not competitors in the international markets, but rather their production structures complement each other.

Finnish exports to Russia are composed somewhat differently to total Finnish exports. Traditionally significant Finnish export products like paper and metal products are not that important in exports to Russia. In addition, mineral products are exported from Finland in clearly larger amounts to other markets than Russia. This is natural since Russia is fairly self-sufficient in many of those products with its abundant resources and traditional emphasis on those sectors of industry. In fact, Finland mainly imports raw materials for the above mentioned products from Russia and refines them into products exported on to Western markets. On the other hand, machinery, equipment and vehicles, as well as chemical products and foodstuffs play a more important role in Finnish exports to Russia than in general. This kind of development is partly due to re-exports, but also reflects historical and geographical factors.

Finland exports mobile phones, imports energy

Nowadays Finland exports mostly electrical and optical equipment to Russia and their share in exports has increased from 20% in 2000 to 36% in 2005.

Figure 3.2 Structure of Finnish exports to Russia in 2000–2005, %.



Source: National Board of Customs.

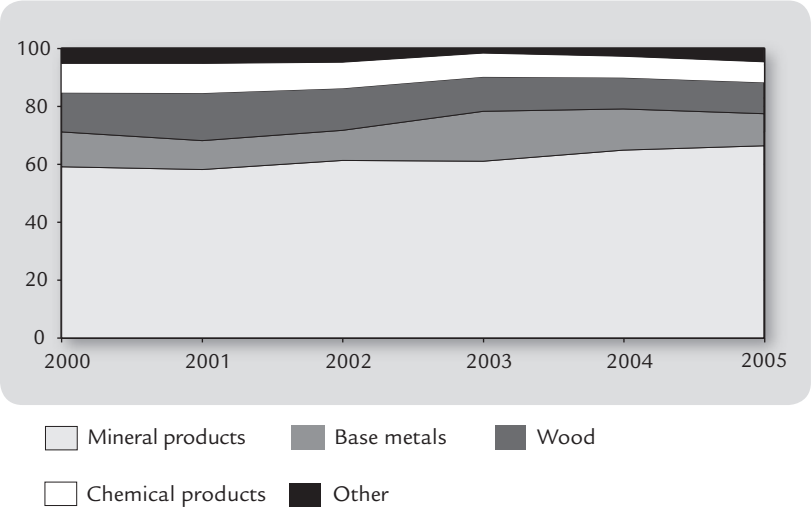
Inside the group, mobile phones are the most important export products, accounting for over a fifth. Moreover, in 2005 Russia became the largest export market for Finnish mobile phones, as every fourth mobile phone exported from Finland was destined for Russia. The Russian telecommunications market has grown quite rapidly past years, as the increase in their disposable income means that Russians in urban areas in particular have been keen to acquire mobile phones and subscriptions. Finland has become a port of mobile phone imports to Russia, as most major mobile phone producers import their phones to Russia through Finnish territory either as transit or re-exports. Thus, it has to be noted that there has been some problems with the trade statistics of mobile phones, which will be discussed later. Other electrical equipment, such as telephonic and telegraphic switching apparatus, television sets and vacuum cleaners have also become a significant part of Finnish exports to Russia.

Machinery and mechanical appliances, as well as vehicles, have traditionally been important in Finnish exports to Russia. In 2005, their share grew notably reaching 30%. In context with these product groups arises the issue of re-exports, which will be discussed in detail below. Domestic appliances constitute about one third of the exports in this group and washing machines are actually among the most important products in Finnish exports to Russia. In addition, computers and computer parts are also exported to Russia in fairly large amounts. Paper machines as well as forestry and agricultural machines were the most important products of this group that are actually produced in Finland. Of vehicles, the top export products of Soviet times, namely ships, have been replaced by passenger cars, which in 2005 already accounted for 7% of Finnish exports to Russia.

Chemical products have increased their importance in Finnish exports to Russia in this decade, although their share diminished in 2005 by some percentage points to 12%. Chemical products exported to Russia from Finland consist mainly of pharmaceuticals, paints and varnishes as well as plastic and rubber products. Pharmaceuticals alone accounted for about 4% of Finnish exports to Russia in 2005. Finnish exports of pharmaceuticals to Russia have indeed grown very rapidly in past years and Russia has risen as their main export market. The share of paper products has declined constantly in this decade, ending up at less than 8% in 2005.

Although foodstuffs are relatively more important in Finnish exports to Russia, than other markets, their share continued to diminish considerably still into this decade, and now stands at a mere 3%. Generally, Finland has not been a net exporter of foodstuffs, largely due to unfavourable climatic and geographic factors, including the long distance to Central European markets. However, in the extraordinary competition environment in Soviet market, foodstuffs gained an important role in Finnish exports, which has served to

Figure 3.3 Structure of Finnish imports from Russia in 2000–2005, %.



Source: National Board of Customs.

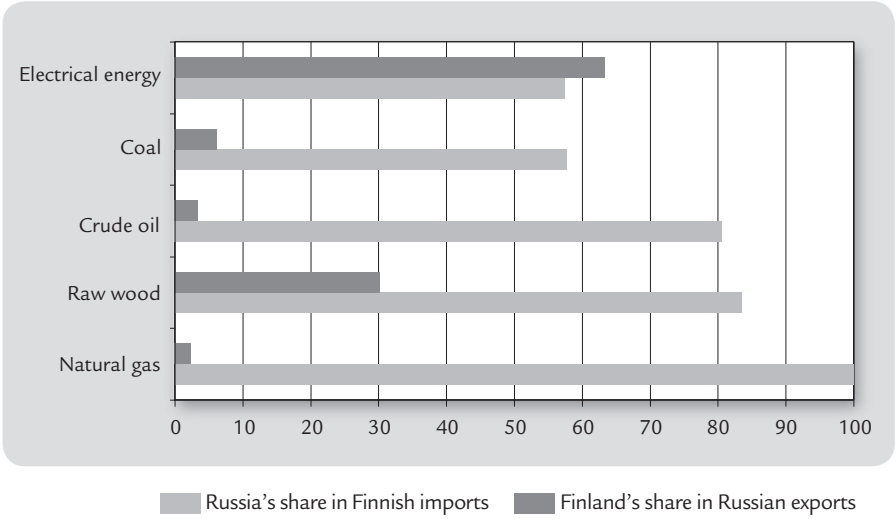
give Finland some advantage also in Russia's foodstuffs market. The proximity of markets is another advantageous factor in exports of foodstuffs that are highly perishable, such as dairy products, which form a major export category of Finnish foodstuffs. Russia has remained the most important export market for Finnish foodstuffs together with the other neighbouring countries Sweden and Estonia.

Finnish imports from Russia still basically consist of energy products and raw materials, such as wood and metals. Those products formed about 90% of Finnish imports from Russia in 2005. In these main product categories, Russia is also a major provider of Finnish imports, as we can see from Figure 3.4. Natural gas was imported to Finland solely from Russia, and in 2005 Russia provided already over 80% of Finnish crude oil imports as well. Russia is also a significant supplier of raw wood for Finnish forest industry. According to the Finnish Forest Industries Federation, in 2005 about a quarter of wood used by Finnish forest industry was imported and the vast majority of imported wood came from Russia.

Russia an important export market for small and medium-size enterprises

Russia is certainly an important export market for Finnish companies, since over a quarter of export companies were involved in exporting to Russia in

Figure 3.4 Finland's share in Russian exports and Russia's share in Finnish imports in some products in 2005, %.



Source: National Board of Customs, Russian Customs.

2005. Nearly half of large Finnish export companies exported to Russian markets, whereas the corresponding share for small and medium size companies (SMEs) was a quarter. The export market Russia was especially important for the smallest Finnish export companies (so called micro enterprises).

In general, SMEs have played quite an important role in Finnish exports to Russia. In 2005, there were over 3,700 companies exporting to Russia and more than 80% of them were SMEs. Of the total value of Finnish exports to Russia, SMEs accounted for 17%. When compared to the total exports of Finland, the share of SMEs was somewhat larger in terms of the number of companies, but somewhat lower in the value of exports. This can be explained by the more active role played by medium size enterprises relative to total exports. In addition, in exports to Russia, the average value of the exports of the smallest companies was clearly higher relative to total exports.

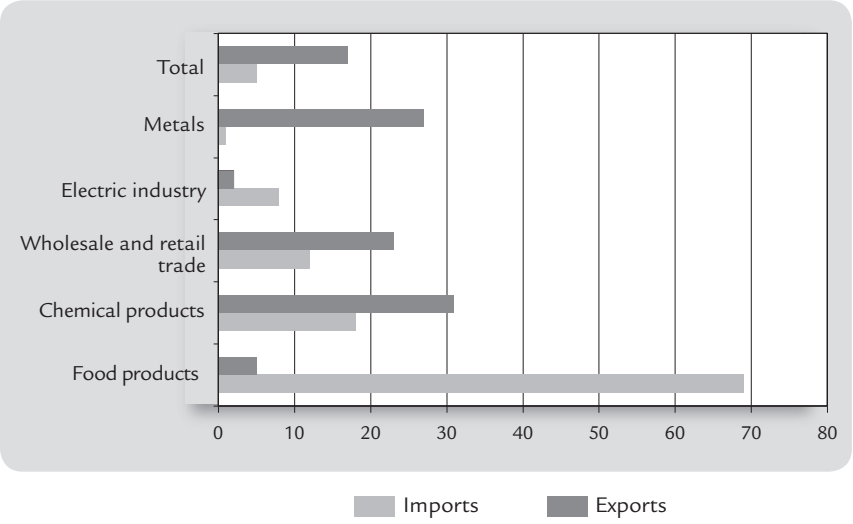
When looking at Finnish industrial sector exports overall, SMEs are most important in the sectors of machine and equipment manufacturing, chemical industry and metal industry, accounting for roughly a third of the exports to Russia of those sectors. In terms of total Finnish exports, these sectors were clearly more concentrated on large enterprises. In exports to Russia, SMEs had the smallest shares in the electronics industry and in the foodstuff industry. The value of exports of SMEs was highest in the machine and equipment manufacturing. That was also one sector where the exports of SMEs grew fastest.

In the chemical and metal industries exports of all SMEs grew rather modestly, but it is worth noting that the exports of the smallest companies operating in these industries experienced strong growth.

Russia as an export market was most important for SMEs operating in the wholesale and retail trade sector. Nearly a third of the exports in that sector were destined for Russia. Exports in this sector seem to be largely re-exports and in part conducted by entrepreneurs of Russian origin, as the largest share of Russia-related companies in Finland are operating in this sector (see Section 5). In Finnish exports to Russia the share of exports conducted by the wholesale and retail traders was actually three times larger than in the total exports of Finland.

In terms of Finnish imports from Russia, however, SMEs are not such significant participants. Over 70% of the 1,300 companies importing from Russia were SMEs, but they accounted only for 5% of the value of the imports. Imports from Russia are clearly more concentrated on large enterprises than exports, as well as on a smaller number of enterprises. Less than 3% of the SMEs involved in import activities were importing from Russia, whereas the figure was 15% for large enterprises. When considering the value of imports the percentages were roughly the same. The share of SMEs in total Finnish exports was significantly larger measured both in the number of companies and in the value of imports.

Figure 3.5 Share of SMEs of the value of exports to Russia in the largest export sectors in 2005, %.



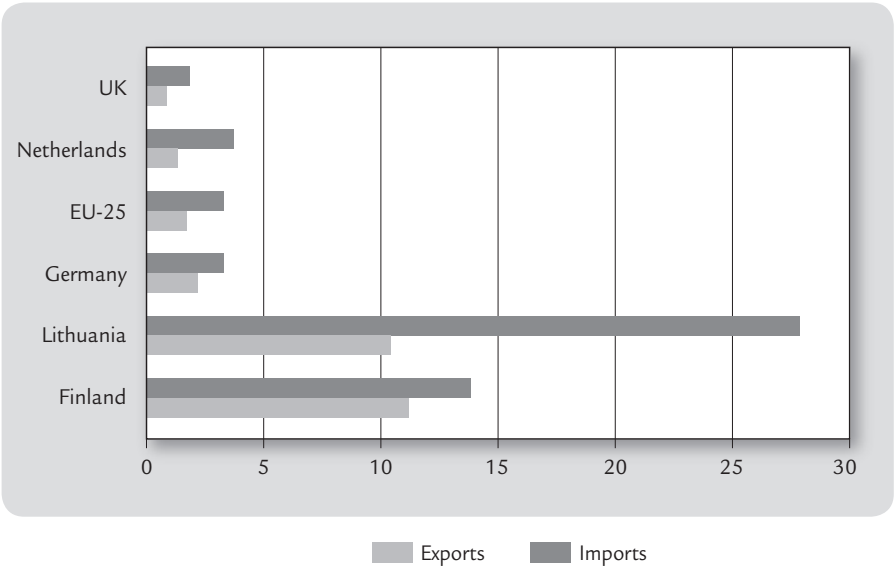
Source: National Board of Customs.

In some industrial sectors, such as the foodstuffs and textile industries, SMEs are actually conducting the majority of import activity from Russia, but the share of these sectors in total imports is negligible. In all the significant industrial sectors, as well as in wholesale and retail trade and electricity and gas sector, the imports from Russia are mainly concentrated on large enterprises. Russia is only a significant import market for SMEs operating in the manufacturing of sawed and wooden products. In this sector, nearly half of the imports of the SMEs came from Russia. In other sectors, the share of Russia in the imports of the SMEs was only a few percent.

Among the EU countries exports to Russia most significant to Finland

Russia is considerably more important as a trading partner for Finland and the Baltic countries—especially Lithuania—when compared to other EU countries. In 2005, Finland was in fact the EU country with the largest share of exports oriented to Russian markets. In imports, Russia's share was by far the largest in Lithuania. Russia's large share in trade of the Baltic countries and Finland is partly explained by their geographical proximity to Russia. Russia's neighbouring countries are also widely used as transit corridors in its foreign trade, which

Figure 3.6 Share of Russia in foreign trade of selected European countries in 2005, %.



Source: Eurostat.

can cause some confusion in trade statistics, as part of this trade probably comprises re-exports.

Russia is clearly more important for the EU countries as a source of imports than as a destination of exports. However, Russia is not that significant a trading partner for the European Union as a whole, having a share of just a few per cent in the total trade of EU countries (including intra-EU trade). Russia's share in the external imports of the EU was 9% in 2005, and in external exports 5%, although the shares have been growing in recent years. Whereas Finland mainly exports electrical equipment to Russia, the other EU countries have concentrated on machinery and vehicles. In addition, Finland exports relatively more paper but fewer foodstuffs than the other EU countries. In imports from Russia, mineral products have a smaller share in Finnish imports when compared to the other EU countries. Instead, Finland imports relatively more wood and chemical products.

Impediments to trade

Despite the rapid growth, trade between Finland and Russia does not always run smoothly. According to surveys conducted by the Foreign Ministry of Finland and the Finnish-Russian Chamber of Commerce, Finnish companies have repeatedly encountered several barriers to trade in Russian markets. The problems encountered are various and disturb practically all sectors conducting exporting or importing activity with Russia. The surveys highlight the main problems that Finnish companies have regarded most common and severe:

- **Customs procedures:** Finnish companies have perceived one of the most troublesome features in trade with Russia as being the slowness, inconsistency and unpredictability of the customs procedures at the Russian border. Companies have complained, for example, about the occurrence of obscure and unexpected changes in the documentation required for customs clearance.

- **High customs tariffs:** Especially companies operating in fields of construction and furnishing, forest industry, textiles industry, chemical industry, as well as machinery and equipment manufacturing considered high tariffs as impediments in their trade with Russia.

- **Technical barriers to trade:** For Finnish companies problems arose above all from the certificate requirements in Russian markets. The Russian certificate standards differ from the international standards and companies have found it expensive and complicated to get the

certificates required. Electronics industry, manufacturing of machinery and equipment and metals industry were the sectors that were the most troubled by certification problems.

But rapid economic growth, increasing purchasing power, as well as the vast number of consumers make Russia's market potential attractive to Finnish companies and they are willing to participate in the markets despite the difficulties. Russia's probable membership in the World Trade Organization (WTO) will probably help in the medium term; there are no instant solutions on the horizon. Many of the problems should also be tackled in the framework of EU-Russian cooperation, e.g. when renegotiating the Partnership and Cooperation Agreement (PCA agreement).

Re-exports typical in Finland's trade with Russia

Finnish exports to Russia have been growing on a remarkable pace throughout this decade, but many of the fast growing export products are produced in Finland on only a moderate scale or not produced at all. Thus, they are re-exported. Re-exports in their purest form refer to products that are first imported to a country and then exported further to another country by an intermediary trading company, without processing, assembling or similar operations performed. In principle, re-exports should not be included in a country's trade statistics at all, since they are merely passing through the country and should be accounted in transit statistics. However, many products re-exported from Finland do appear in Finnish import and export statistics, since they are customs declared for free circulation in Finland.

Partly comparable to, but still a separate from re-exports phenomenon are the outsourcing and off-shoring activities of domestic companies. When Finnish companies outsource part of their export-oriented production abroad, Finnish exports grow faster than Finnish production, as also in consequence of re-exports. However, the income effects of outsourcing and re-exporting are slightly different. With outsourcing, some final production stages and the research and development work are often performed in Finland, and thus they impact positively on Finnish income and employment. When considering re-exports, the income and employment effects are based on the intermediary trading company. Similarly as in transit freight (see Section 4), also Finnish companies providing dispatching and warehouse services benefit from re-exports.

The outsourcing activity is in some measure related to Finnish exports, especially in the field of electronics. In Finnish exports to Russia, however, re-

exports dominate. The main reasons that the re-exports are concentrated on Finnish exports to Russia are the somewhat exceptional market environment in Russian foreign trade and Finland's geographical proximity to Russia. In addition, as the demand for consumer and investment goods, not even produced in Finland, grows very rapidly in Russia, it must be satisfied from other sources.

Basically, there is not much difference between re-exporting and transiting goods, providing that the traded goods are not subject to customs fees in the EU. When considering products that can be imported to EU countries duty free, it may even be somewhat more advantageous to deliver the goods to Russia as Finnish exports rather than transit freight, as the costs of warehousing are slightly lower in ordinary warehouses compared to customs (or free-zone) warehousing. In addition, when the goods are customs declared as imports to Finland, there is no need to specify the final destination, transport routes and timetables as when the goods are delivered by transit. Finally, the preference for re-exports instead of transit might in some cases be related to grey schemes still present in Russian foreign trade, which will be discussed later on.

At least a quarter of Finnish exports actually re-exported

It is rather difficult to estimate the "real" value of Finnish exports to Russia, excluding the re-exported products. We have calculated an estimate for the minimum value of re-exports in Finnish trade with Russia by comparing the statistics of Finnish production and Finnish exports to Russia for some products (see Appendix 2). The products are considered as re-exports, if the exports to Russia exceed domestic production in Finland.

It is clear that our method has some limitations. First, we consider only the largest product groups. Second, some products, such as mobile phones, are produced in Finland in significant quantities and with our method it is impossible to distinguish between domestically produced and re-exported products. This is why we shall discuss the re-exports of mobile phones only later and they will not be included in our first estimate of re-exports. Third, since we compare the Finnish production only with the exports to Russia and not with total exports, the true amount of re-exports may be underestimated. Despite the limitations of the estimate, it turned out to be rather high. According to our calculations, in 2004 the minimum value of re-exported products in Finnish exports to Russia reached almost EUR 750 million, accounting for about 17% of the total exports. Since Finnish industrial production figures for 2005 were not available at the time of writing this text, the analysis on re-exports is limited to 2000–2004.

The growth of re-exports has been clearly faster than the growth in the actual exports. In 2000–2004, the value of re-exports has grown, on average,

64% annually, whereas the value of the "real" exports has grown by only 16%. The special peak in growth of re-exports dates to 2004, when their value doubled in one year. This was, however, largely due to the increase in re-exports of passenger cars. Still, the growth in "real" Finnish exports to Russia was less than a fifth that year.

Vehicles, predominantly passenger cars, form a large part of re-exports. Passenger cars were actually the second largest product group in Finnish exports to Russia in 2004, but if we take into account that the few passenger cars produced in Finland are not exported to Russia, but rather to Western markets, it seems that all cars exported from Finland to Russia are actually re-exports. The exports of passenger cars peaked strongly in 2004, because of a change in Finnish customs practises. From 2004 onwards, the importer of a car no longer needs to pay the customs duty in the time of the import to Finland, but only upon exchange of ownership of the car. Passenger cars are mainly imported into Finland from Japan and Germany, so it is probable that the cars re-exported to Russia come from these countries.

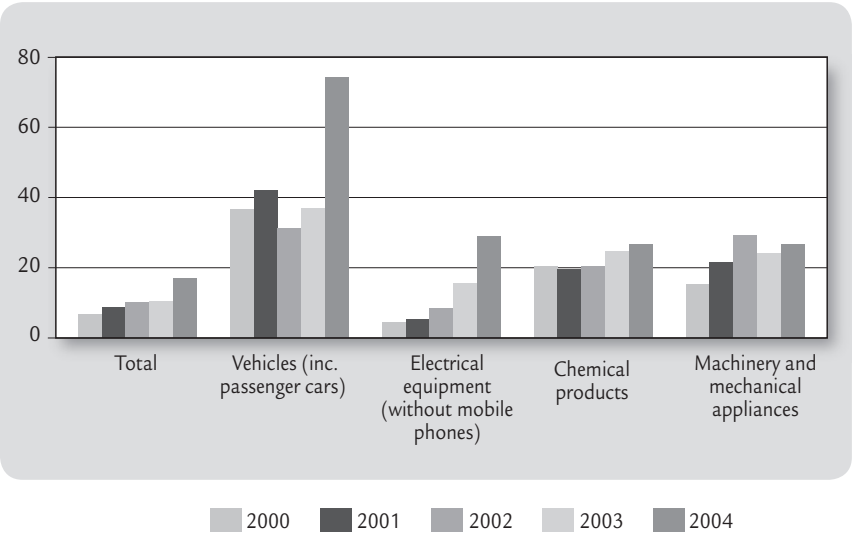
According to Russian customs statistics, the value of Russian passenger car imports has grown over tenfold in 2000–2004. Since the recently heated demand for passenger cars has been greatly directed towards Western models, the production of which is only starting up in Russia, imports have boomed. This boom has certainly also been visible on the roads, especially in Southern Finland, where numerous car transporters can be spotted on their way to Russia. These transfers consist largely of transit freight, but a fraction of them are also registered as exports from Finland. In 2005 this fraction accounted for about 6%. Finnish car dealers clear their stocks to some extent onto Russian markets, since there the structure of demand differs somewhat from that in Finland. But major part of Finnish car re-exports to Russia is conducted by small intermediary companies of both Russian and Finnish origin (see Section 4 for more about car transit and exports to Russia).

When looking at chemical products, re-exports have also formed a rather large part of overall exports during the whole decade, but their share has not grown as fast as in other groups. The largest group in this category is pharmaceuticals, some of which are also produced in Finland. In recent years, Russia has clearly been the most important market for the pharmaceuticals exported from Finland and their export has grown rapidly. The growth peak was in 2002, when the exports of drugs and medicaments to Russia grew nearly sixfold in only one year, but this growth was largely attributable to the increased exports of domestic production. However, after that the value of re-exported medicaments started to grow faster than that of the domestically produced. In 2004 the share of re-exports in drugs and medicaments was about a third, still less than at the beginning of the decade. Painters' fillings and lubricant products exported from Finland to Russia are also largely re-exports.

To the group of machinery and mechanical appliances are included many different products that are re-exported, but the most important of them are washing machines, computers, refrigerators and freezers. The vast majority of washing machines exported from Finland are destined for Russia, whereas the other most important export countries are Ukraine and the Baltic countries. For example in 2005, about 370,000 washing machines were exported from Finland to Russia, although Finnish production levels were negligible. Re-exports of electrical equipment have also grown rapidly, even without taking into account mobile phones. They include products such as telephonic switching apparatus, televisions and microcircuits.

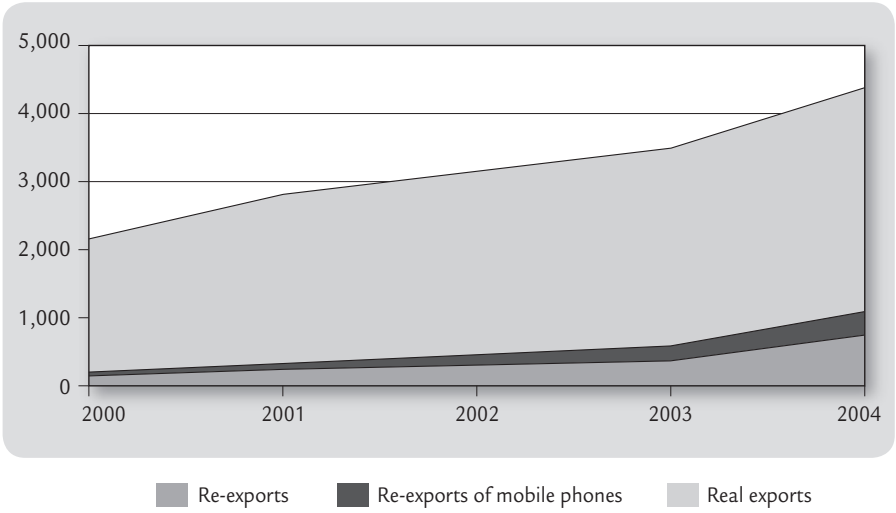
Nowadays, Finland acts as an important hub for mobile phone exports to Russia for all phone companies. It is clear that part of the mobile phones exported from Finland to Russia is re-exported. We cannot specifically identify that part with the method used above, as mobile phones are also produced in Finland. But because the mobile phones have such a large share in Finnish exports to Russia, it is important to gather some kind of estimate for their re-exports. We used, as an approximation, the average share of re-exports, which was roughly 50% (see Appendix 2 for details). As Finnish mobile phone exports to Russia were worth EUR 686 million in 2004, the value of re-exports would have been EUR 343 million. Thus, when taking into account this rough as-

Figure 3.7 Minimum share of re-exports in some product groups of Finnish exports to Russia in 2000–2004, %.



Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

Figure 3.8 Finnish exports and estimated re-exports to Russia in 2000–2004, EUR million.



Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

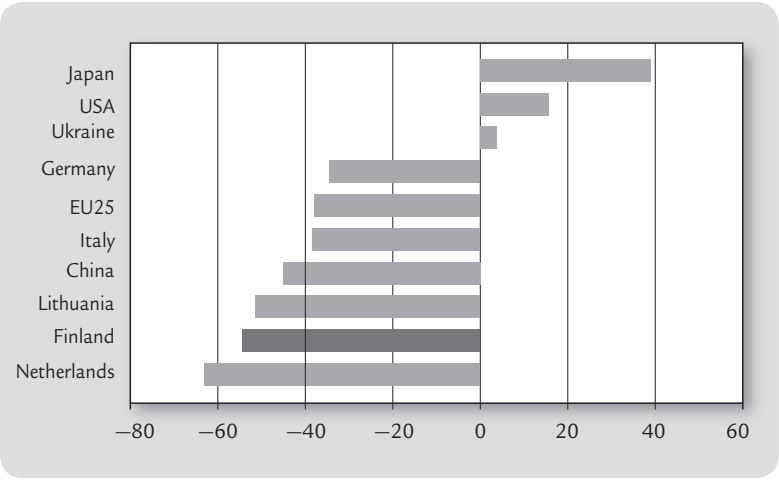
sumption on re-exported mobile phones, the value of our minimum estimate for re-exports from Finland to Russia in total reached roughly EUR 1.1 billion, accounting for a quarter of total Finnish exports to Russia in 2004.

Grey schemes in trade

While the trade between Finland and Russia has been flourishing, side effects related to the grey economy have also occurred. One indicative way to evaluate the amount of grey activity is to compare the Russian trade statistics with the respective statistics of its partner countries. As we can see in Figure 3.9, Russian import statistics tend to report lower values than the corresponding export values of its trading partners. For example, the value of total exports of the 25 EU countries to Russia in 2005 was EUR 56.4 billion, whereas the Russian Customs reported it to be only EUR 35 billion. However, it must be taken into account that the difference cannot, as such, be considered as an indicator of the amount of grey imports into Russia, since there are various reasons for discrepancies between trade statistics of different countries.

Finland is by no means the only country to "lose" some of the value of its exports in light of the statistics, but it is among the ones experiencing the largest "losses". Nearly all EU countries, as well as China, have reported higher

Figure 3.9 Difference between Russian import and partner countries' export statistics in 2005, %.



Source: Eurostat, national customs statistics.

export figures than the respective Russian import figures have been. This kind of discrepancy has been observable in the trade between European countries and Russia throughout this decade. The development was even degenerative until 2005, as the differences in value grew larger every year. In 2005, however, the discrepancies became generally smaller. Contrary to the EU countries and China, the Russian import figures have exceeded the corresponding export figures of Japan and the US.

Finland is, however, among the countries that have the largest discrepancies between their statistics and Russian trade statistics. As we can see in Figure 3.10, in this decade Russian import statistics have recorded only about half of the value recorded in Finnish export statistics, every year. The discrepancy between the trade figures was EUR 1.1 billion already in 2000 and by 2005 it had tripled.

When examining the discrepancies between Finnish export and Russian import figures on the level of product categories, we can observe that the discrepancies have been present in the majority of them. The product groups showing the largest discrepancies both in absolute and percentage terms have been electrical equipment, machinery and mechanical appliances, vehicles and pharmaceutical products. In 2005, the Russian import figures were 55–90% lower than the Finnish export figures for these product categories. In pharmaceutical products the discrepancy has grown more than threefold in past few

Figure 3.10 Finland's exports to Russia and Russia's imports from Finland in 1996–2005, EUR million.

Source: National Board of Customs, Rosstat.

years, but for the other product categories it has stayed in more than a half during the whole decade.

How much of discrepancy between statistics is grey trade?

As mentioned already, there are several reasons for the discrepancies between trade statistics. First, the export and import statistics are based on varying valuation. Export statistics are compiled on the basis of FOB (Free On Board) values, whereas import statistics record the CIF (Costs, Insurance and Freight) values of the merchandise flows. Although this would imply the imports are reported at a higher value than exports, this is often not the case in other countries' statistics either. In addition, the discrepancies can be caused, e.g. by the exchange rate variations, different timing of reporting the trade transactions as well as confidentiality of the data.

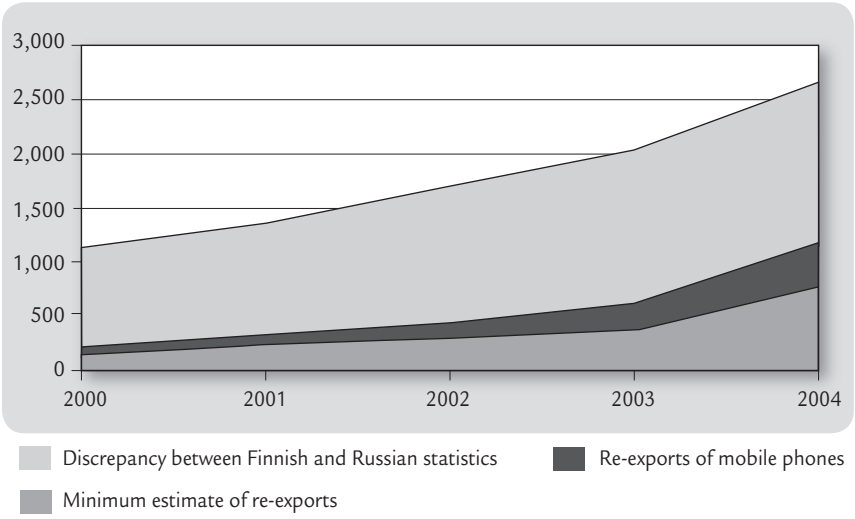
Differences might also occur as a result of country of consignment and country of origin being different, such as in the case of re-exports. In this case, the goods are recorded in Finnish export statistics as Finnish exports, whereas in Russian import statistics they are recorded as imports from the country of origin. This is an important reason when examining the discrepancies between the statistics of especially some countries, like Finland and Lithuania, acting

as major gateways for products exported to Russia. The Russian Customs has also claimed this as the main reason for the discrepancies.

We can take a closer look to this aspect of the problem, as we already have calculated an estimate for the amount of re-exports included in Finnish exports. As noticed before, the product groups showing the largest discrepancies are actually the same as the main ones containing re-exports. In these product groups a rather large share of the discrepancy could be explained by the estimated re-exports, reaching from somewhat under 40% in pharmaceutical products to over 85% in vehicles for the year 2004. When considering the loss of value in the total Finnish exports to Russia, the share possibly explicable by re-exports reached over 40%.

The scale of discrepancies is, however, so large for the part of Finland and also some other countries that it is virtually impossible that the discrepancies can be explained solely by the above reasons. When the estimated amount of re-exports is excluded, Finnish exports still "lost" 32% of their value in 2004. In comparison, the discrepancies between Finnish export statistics and the import statistics of its other main trading partners during this decade have been mostly positive and on average less than 15%. There have been only a few countries other than Russia that have systematically reported lower import figures than the Finnish export ones, even so, the negative discrepancy has reached at most only about a third of that in trade with Russia (see Appendix 3).

Figure 3.11 Discrepancy between Finnish export and Russian import figures, and the amount of it possibly explained by re-exports.



Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

Double invoicing as the main problem

Grey schemes are by no means a new phenomenon, and already appeared at the beginning of the 1990s, when the Soviet Union collapsed. In new Russia, at first there was a dearth of appropriate legislation or administrative and operative organs for monitoring foreign trade. Thus, some entrepreneurs seized the opportunity and took advantage of the difficulties in creating the new mechanisms needed for conducting foreign trade on a market economy basis. Gradually, as customs practises evolved and developed, the participants in the grey sectors of the economy have also changed the nature of their operations towards more complex and elaborate schemes. Corruption is also still reported as a problem in Russian Customs. Grey trade is by no means confined to Finnish-Russian transactions, but it is a wider phenomenon in Russia's trade. Neighbouring countries to Russia, such as Finland, are often used as transport corridors for traded goods and are thus more exposed to grey schemes.

The motivation for engaging in grey activities in foreign trade is obviously money. Several products are still subject to rather high export or import duties according to Russian legislation. Thus, the traders can save considerable sums, if they are able to evade or at least lower the custom duties. In addition, if the products are imported to the country without any records, the seller can also avoid other tax payments by selling the goods on the black market. Grey schemes are mainly used in imports of more valuable products to Russia, e.g. mobile phones, television sets and domestic appliances. However, they are also used when exporting various raw materials, subject to export duties from Russia.

Several techniques are used in grey trade in order to deceive customs officials. Especially when the Russian foreign trade opened, a common way to avoid customs duties was simply to bypass customs control, as the Russian customs organisation was still in its infancy. The method is still used at present, but more elaborate techniques are now needed for succeeding in grey operations. Goods intended for importation into Russia, e.g. mobile phones, are purchased from Finnish or other European supplier, usually by an intermediary (e.g. Russian owned company in Finland) and not the actual importer. First, they are stored to a warehouse in Finland. Then the shipment is divided in smaller fractions or sometimes complete equipment can be taken to pieces. Some low value products, such as table tennis balls are then added to the shipment. These new shipments can be transported around several Finnish and even Baltic warehouses before they cross the border to blur the route of goods. Transportation across the Russian border is carried out with lorries or passenger cars in order to delude customs officials. In Russia, the more valuable part of the transfer is taken to black warehouses, whereas the low value goods are declared to customs. Some part of the transfer may even remain

circulating in the black markets inside the EU in order to collect VAT refunds on false grounds (known as the carousel fraud).

Other techniques commonly used in grey trade are double invoices and falsification of the commodity code of the products imported. Double invoices refer to two different types of documents that the carrier of the import shipment has with him. The carrier presents the correct documents in the Finnish customs, but after crossing the border he produces the Russian customs other documents recorded with a notably lower value and possibly also a smaller quantity of products. Since Russian import duties usually depend on the price of the imported products (i.e. a higher duty is levied on more expensive goods), the use of double invoicing can reduce the value of customs duties paid considerably and hence improve the price competitiveness of the goods on the Russian market. Counterfeit documents are also used when transfers of valuable products, such as electronics or computers, are declared to Russian customs as containing some other products with lower import duties and lower value. For example sometime in the previous decade, the Russian customs statistics showed that rubber gloves in quantities enough for the whole population of Russia were imported from Finland. In reality, Finland was not a major producer of rubber gloves, but instead car tyres were imported from Finland to Russia in rather large amounts.

According to Finnish customs, in context with their special operations in this decade, on average 80–90% of the inspected deliveries were subject to double invoicing or commodity code falsification. In cases of double invoicing, the value declared in the counterfeit documents averaged merely one fifth of the actual value of the shipment. The Russian customs have reported that 60% of shipments coming to Russia from Finland are endowed with double invoices. It is usual that in the chains of grey trade are involved several intermediaries, often registered in tax havens or several countries, in order to blur the traces of the main accomplices and locations related to these activities. Agencies and companies exist that have specialised in conducting activities related to grey trade, such as providing falsified customs documents, or acting as an intermediary in the monetary transactions of other companies.

Consequences of grey trade

It is clear that Russia loses tax income due to grey schemes but why is it harmful to Finland? In principle, by using grey schemes the Finnish export products become cheaper for Russian consumers because of the tax burden they thereby avoid. However, the Finnish sellers still get the same price, so one might even argue it to be “beneficial” for Finland. It has actually been brought up sometimes that it would hurt the competitiveness of Finnish exports, if Finland alone, acting without other EU countries, would effectively combat these grey activities in

trade with Russia. It has been argued that exports and other shipments would then be simply relocated to other, less strictly controlled countries. It is true, that the problem should be tackled at EU level, since it is not merely related to Finland's trade with Russia, but also to other European product flows.

In the following we have gathered some of the negative effects of the grey schemes in foreign trade with Russia:

- **Carousel trade and refunds of VAT on false grounds:** The effects are EU-wide, since the grey trade to Russia is also connected to the so-called carousel trade. Carousel trade refers to moving traded goods either physically or on paper across European countries to blur the real transactions and to collect VAT refunds on false grounds. It has been evaluated that the losses in potentially collected value added taxes are substantial for the EU.

- **Exposure of business life to international organized crime:** International criminal organisations are often also involved in grey schemes in Russian trade. Thus, companies operating in Finland that are related to grey trade, either knowingly or unknowingly, are exposed to the influence of international organised crime. This kind of exposure may increase the risk of corruption and blackmail in the Finnish business life, which so far has been considered very clean in international studies.

- **Distortion of competition:** Since some trading parties are willing and able to evade the proper customs fees and thus sell their products at a lower price, they acquire a competitive advantage in comparison with law-abiding traders. This way the competition between parties is not based on their effectiveness, but rather on their ability to evade the law. This kind of distorted competition environment seduces more parties into the grey trade and may even force law-abiding parties to close down their business because of their competitive disadvantage. It also makes it more difficult to get rid of the grey schemes, since it requires all parties to cease grey activities jointly in order not to damage their competitiveness.

Measures resisting grey trade

There have been efforts by both Finnish and Russian officials to root out grey activities in the trade between Russia and Finland. Already in 1994 an agree-

ment on co-operation and mutual assistance between Finnish and Russian customs was signed. Finnish customs officials have conducted several operations by themselves and in cooperation with customs of other countries to reveal grey traders. Operations have resulted in the confiscations of grey shipments and Russian customs being able to collect avoided customs fees amounting to millions of euro. However, the problem is not likely to be abolished solely with these operations, since the volume of shipments is vast, and the operations require a major investment in time, meticulous work and other resources, and thus can only be concentrated on limited incidents.

Another device in battling grey activities is legislation. It has been realised that temporary Finnish laws do not enable Finnish customs to effectively prevent the use of falsified documents at the border. At present (in mid-2006), only a customs tort clause exists in Finnish legislation, which is not a part of the criminal code and thus does not allow the customs to use effective coercive means. Thus, the punishment for presenting falsified documents to Finnish customs officials is merely a fine for the carrier of the transfer. Since the activities in grey trade often cannot be substantiated as tax fraud or some other crime already included in the criminal code, it has been proposed that a customs clearance crime would be introduced to the Finnish legislation providing customs with more effective measures in the investigation and punishment of criminal activity in international trade.

An important project was launched in 2002, when the customs of Sweden, Finland and Russia started officially to develop a system of electronic customs clearance between the countries. This Green Line was implemented in 2004 for facilitating the border crossing of transport shipments to Russia, as well as for simplifying the customs procedures required. Export companies located in Finland can apply for admission to the system with some prerequisites, such as well-established export activity and customer relations with the Russian consignee. In mid–2006, there are only two companies accepted to the system and the applications of a dozen more are pending. So far the Green Line has not aroused wider interest among companies. Broader implementation of the Green Line would abolish the intermediaries in trade and make it more difficult to use double invoices or counterfeit documents.

The Russian customs have also conducted their own operations. In autumn 2005, for example, a major confiscation of illegally imported mobile phones was implemented. The operations and confiscations have also continued in spring 2006, although with varying results. Russian retail traders have even complained that legally imported transfers have been confiscated and sold on the black market for the benefit of corrupt officials. Russian customs has also gone through some structural reforms during 2006 and the problems related to grey trade have been highlighted at the highest levels of its administration. The president of Russia has recently criticised the corruption of

Russian customs and demanded improvements in its activities. In May 2006 he removed the Federal Customs Service from the subordination of the Ministry of Economic Development and Trade (to which it had been transferred in 2004) and restored its status as an independent body reporting directly to the government. In addition, the head of Customs was changed and some other customs officials were charged with bribery.

The effect of exports to Russia on the Finnish economy

We have presented both the flourishing development of the trade between Finland and Russia and the more worrying phenomena related to it. What do we get when we combine these somewhat contradictory tendencies? First we look at the development of the "real" Finnish exports, cleaned of re-exports. Then we calculate and discuss the significance of exports to Russia on Finnish output and employment.

Re-exports growing faster than actual exports

Re-exports are not a negative phenomenon as such, but they naturally diminish the positive effects of exports on Finnish economy. Especially since the share of re-exports was already at least 25% in 2004, their impact should be acknowledged. However, even excluding re-exports, Finnish exports to Russia have experienced the fastest average growth in 2001–2004 compared to Finland's other major trading partners. "Real" exports to Russia have grown on average 14% annually, whereas Finnish exports to Sweden have grown 4% and exports to Germany diminished 4% on average. However, in 2003-2004 Finnish exports to Sweden grew already faster than the "real" exports to Russia.

Re-exports also influence the development of the Finnish exports' market share in Russia. Russia's total imports have grown on average 23% annually in 2001–2004, which is clearly faster than the growth of 14% of the Finnish "real" exports. Thus, Finnish products seem to have lost their market shares in Russia. In addition, the re-exports have grown considerably faster than the "real" exports to Russia, as the average growth in re-exports was 54%. If the average growth rates would continue the next years, the value of re-exports would exceed the value of "real" exports already in 2009.

Many of the largest product groups of Finnish exports to Russia consist partly or completely of re-exports, as can be seen in Table 3.1. In addition, several re-exported products are among the ones having experienced fastest average growth in exports. It should be taken into account that the fast growth in Finnish exports to Russia does not and probably will not implicate as large income and employment effects on Finnish economy as before, since much of

Table 3.1 Largest product groups in Finland's export to Russia in 2005.

	Value of exports in 2005 (EUR million)	Average growth 2000–2005, %
Mobile phones	1,296.8	60
Passenger cars	373.4	101
Therapeutic and prophylactic medicines	222.3	128
Printing paper	199.1	18
Television receivers	188.2	101
Computers	146.9	48
Line telephony and telegraphy apparatus	140.2	64
Petroleum oils	115.3	29
Washing machines	101.7	25
Newspapers and journals	69.2	5
Paper machines and their parts	66.3	32
Electronic integrated circuits and micro assemblies	59.4	59
Painters' fillings etc.	50.1	10
Transport vehicles	49.6	60
Refrigerators and freezers	47.3	25

Grey = produced in Finland in significant quantities. Source: National Board of Customs.

the growth is attributable to re-exports. However, some of the fastest growing product groups are also partially produced in Finland and have experienced continuous growth. As presented in Table 3.1, the fastest growing product groups partially produced in Finland include therapeutic and prophylactic medicines, transport vehicles and mobile phones.

Exports to Russia increasing Finland's output by several billions

Despite the worrying issues related to Finnish-Russian trade, it certainly has a positive effect on Finnish economy. As Russia is one of the largest export markets of Finland, the exports to Russia clearly increase the demand for Finnish products. Thus, both Finnish output and employment become larger than without the exports to Russia. Exports have both a direct and an indirect effect on Finnish output. The direct effect accrues to the sector that finishes and

sells the exported products, but the indirect one is due to input of other sectors in the process of manufacturing products. In 2004, exports to Russia corresponded to 3% of Finland's GDP. This figure does not, however, cover the indirect effects of exports. The total effect can be measured by using the input-output tables provided by Statistics Finland (see Appendix 4).

The indirect effects are actually quite significant. When they are taken into account, the total effect of exports to Russia on Finnish output has been higher by over a half than the mere value of exports (re-exports excluded). The significance of exports to Russia has also grown gradually during this decade. In 2000, Finnish output would have been about 1.5% lower without exports to Russia. But in 2004, the effect of exports to Russia on Finnish output reached over EUR 5.5 billion or 2.1% of the value of the output. It should be noted, however, that the effect of Finnish exports to both Germany and Sweden was over 3% of the value of the output.

Exports to Russia are naturally the most important for the Finnish manufacturing sector due to their direct impact. Exports to Russia accounted for 8.9% of the manufacture exports of Finland and for 4.5% of the output of the Finnish manufacturing sector in 2004 (including the indirect effects). Exports to Russia have the largest impact on the production of textile and leather and chemical industries, with a share of about 8% in both sectors. Exports to Russia play a rather important role also in the manufacturing of machinery and equipment as they accounted for 6% of the sector's production. The share of Russia in the exports of the above mentioned sectors was also over 10%.

In other industrial sectors the impact of the exports to Russia on their output varied between 3–4.5%. The food industry is exceptional, as over a fifth of its exports were destined for Russia in 2004, but their impact on the output of the sector was only few per cent. This can be explained by the fact that the share of exports is not very large in the sector.

The effect of exports to Russia is more moderate on other sectors, as the direct impact is very small or does not exist. However, the indirect effects are fairly important in the sectors of mining and quarrying as well as agriculture, forestry and fishing. As these sectors provide raw materials for the manufacturing sectors exporting to Russia, the indirect effects are much larger than the direct ones. In 2004, the output of both of these sectors would have been about 3% lower without the effect of exports to Russia.

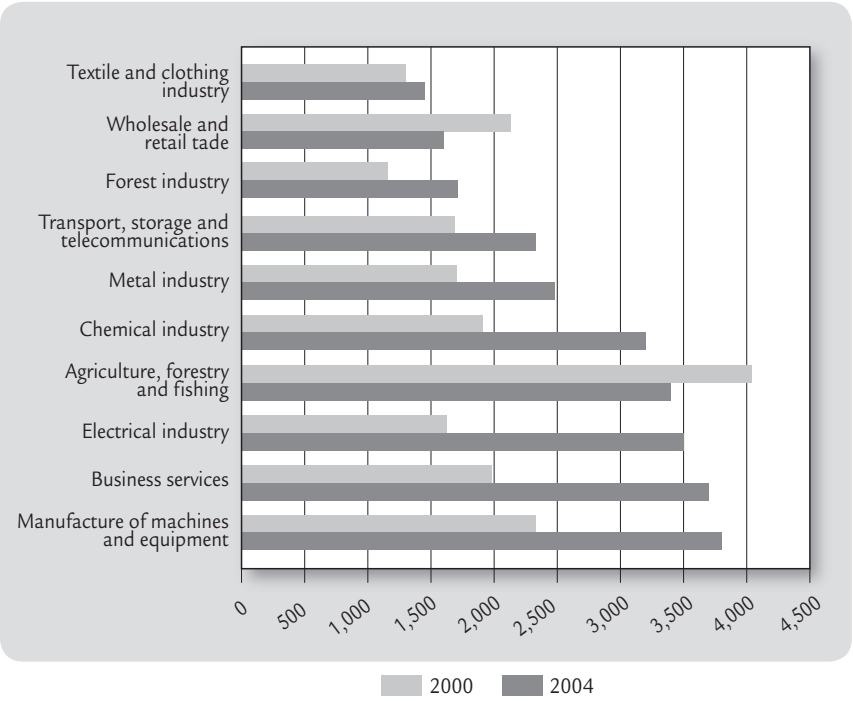
Goods exports to Russia have also an indirect, if modest, effect on the Finnish service sector. In 2004, the indirect effect reflected in the output of the service sector was 0.5%. The largest effect of 1.7% was observed in the sector of electricity, gas and water supply. In addition, the exports to Russia accounted for slightly over 1% of the output in the sectors of transport, storage and telecommunication services as well as finance and insurance services. The effects on other service sectors were less than 1%.

Exports to Russia employ tens of thousands of Finns

As the exports to Russia are rather significant in Finnish output, they also have a positive effect on Finnish employment. The employment effect is, however, slightly more moderate than the effect on output. In 2000, the total employment effect of exports to Russia was more than 25,000 persons, accounting for 1.1% of the total Finnish labour force. The slightly rising trend has prevailed also in the employment effect, as in 2004 the exports to Russia employed already more than 34,000 persons, or 1.5% of the labour force. In comparison, the employment effect of Finnish exports to both Germany and to Sweden in the same year was nearly 50,000.

Relatively speaking, the employment effect of exports to Russia is the most important in the manufacturing sector. Moreover, the employment effect of exports to Russia has clearly increased during the last years, despite an overall decrease in industrial employment in Finland. The employment effect

Figure 3.12 Employment effect of exports to Russia in 2000 and 2004 by sectors, persons.



Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

of exports to Russia was almost 5% in the manufacturing sector in 2004, corresponding over 20,000 persons. As we can see in Figure 3.12, the employment effect in manufacturing sector was largest in production of machinery and equipment, electrical industry and chemical industry. In all of these sectors exports to Russia employed more than 3,000 persons. In these sectors the employment effect has also grown considerably during this decade. In addition, it should be noted that in the textile and clothing industry the employment effect of the exports to Russia is relatively the most important.

Although the relative significance of exports to Russia is lower both in the agriculture, forestry and fishing sector and in the service sector (3% and 0.5% of the employed, respectively), the employment effect is rather large when measured in terms of persons. The service sector is by far the most important employer in Finland and relatively many people are still employed by the agricultural sector also. The employment effect of goods exports to Russia was nearly 3,500 persons in the sector of agriculture, forestry and fishing in 2004. In the service sector the indirect effect of exports to Russia on the employment totalled more than 9,000 persons. Employment effects were the largest in the sectors of business related services, transport, storage and telecommunications as well as wholesale and retail trade.

Conclusions: Economic effect of exports to Russia significant despite unpleasant issues

It is clear that also Finland has benefited from Russia's strong economic growth during the present decade. Trade between the countries has developed very favourably. Finnish exports to Russia in particular have increased considerably during the past years and Russia has risen back to being among the most important trading partners for Finland. Actually, among EU countries, Finland has already become the most dependent on Russia in terms of exports. The significance of Russia as a trading partner to Finland has also been strengthened as Russia has become an increasingly important source of energy and raw materials for Finnish industries.

There are some worrying elements related to the growing trade: re-exports and grey schemes. Despite the fact that Finnish exports to Russia have grown rapidly, an increasing share of the growth has been attributable to re-exports. It must be taken into account that their impact on Finnish income and employment is significantly lower than the impact of "real" exports actually produced in Finland. However, Finnish production also exists in some of the growth sectors. Another worrying aspect in trade is the grey schemes implicated in the large discrepancies between the trade statistics of Russia and its trading partners. The most evident economic effect is lost tariff income for

Russia. The EU experiences significant losses in the form of VAT refund claims on false grounds, as the grey schemes in Russian trade often are a part of the Europe-wide carousel trade. In addition, grey trade exposes Finnish and other European business to international crime and biases competition. So far, the grey schemes have not been effectively rooted out. An efficient measure in reducing grey trade would be to diminish the rather high levels of Russian customs duties and other taxes. Efficient co-operation of all the EU countries, together with Russia, is also desired in getting rid of the grey schemes.

Despite the more negative elements related to trade, the overall development is rather positive. Even when the re-exports are excluded, Finnish exports to Russia have clearly experienced the fastest average growth in 2000–2004 compared to other major export markets of Finland. As exports have grown, their importance for Finland's industrial sector, as well as the economy as a whole, has gradually increased in past years. In 2004, the exports to Russia increased the Finnish output by more than 2% and the Finnish employment by 1.5%.

4 Russian transit traffic and Finland

Russian transit traffic through Finland

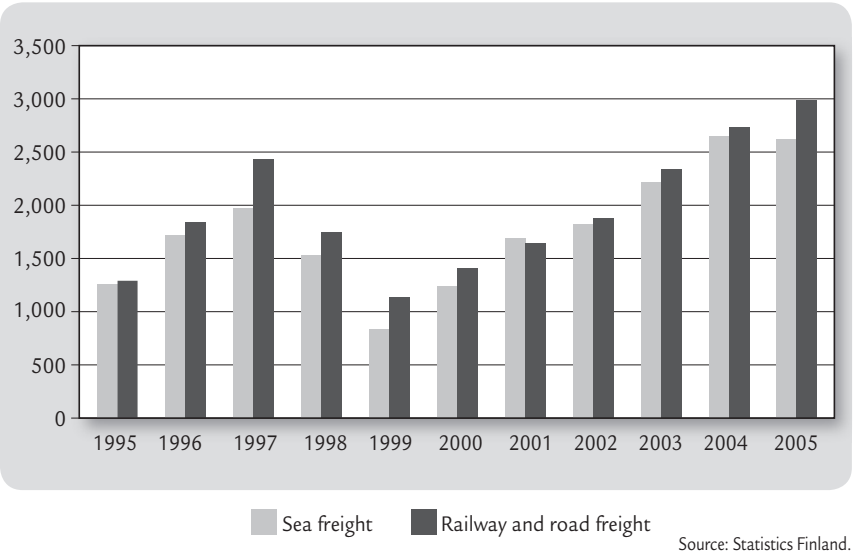
Together with the increase of the Russian total imports, transit traffic through Finland has also grown rapidly during the first decade of the 21st century. In fact, the Russian transit traffic through Finland increased already after the fall of the Soviet Union, but the 1998 crisis decreased it temporarily. However, the trend turned around rapidly, and currently transit traffic to Russia is much larger than Finnish exports to Russia. Despite its size, the effect of transit business for the Finnish economy has been studied very little, so far.

Transit freight through Finland does not pass through the Finnish customs border, although it heads through Finnish territory and the goods are often temporarily stored in Finland. Consequently, the transit freight is not included in the Finnish foreign trade figures and its impact on the added value for Finnish production is zero. Transit goods can be stored in Finland in a few customs warehouses (also called free-zone warehouses), but the customs declarations are done in the country of origin. The transit freight through Finland uses various combinations of transport means and the statistics presented here are gathered from various sources.

Finland significant value transit goods corridor to Russia

The transit freight through Finland to Russia was around 3 million tons in 2005. The volumes have grown a little more than threefold since 1999 and increased annually by nearly 20% in 2000–2005. In most cases, transit freight to Russia arrives in Finland by sea. The goods are loaded on trucks and trains for transfer onto Russia. In many cases, the cargo is also stored in Finland for longer times in customs warehouses in order to wait for the right moment to be transported to Russia. The sea freight or the combined railway and road freight volume can be used as a fairly accurate estimate of the volume of tran-

Figure 4.1 Transit freight through Finland to Russia 1995–2005, 1,000 tons.



Source: Statistics Finland.

sit freight through Finland to Russia. These volumes are given in Figure 4.1. However, in some cases the cargo is brought to Finland from the east by road or train and then shipped back to Russia with the same transport system, which explains some of the differences in the levels in the figure. This phenomenon especially concerns railway transit freight along the Trans-Siberian railway (TSR) from Far Eastern Asia to Finland. After storage in Finland the goods are shipped back to Russia by road.

Finland has specialised in value freight transit to Russia. Bulk freight heads to Russia mainly via the southern transit corridors. According to the Finnish Maritime Administration, roughly two thirds of all transit freight to Russia through Finnish harbours in volume consisted of itemised goods (mainly electronics and other value goods) in 2005. A fourth were metals and metal products, while a few per cent were chemicals, paper and cardboard. Most of these goods continued their journey by road. In volume terms, nearly all transit freight to Russia through Finland was shipped by road in 2000–2005. The railway's share was less than a tenth.

Since 2002, the National Board of Customs has made quarterly estimations of the value of road freight transit.[7] The largest category of road transit in

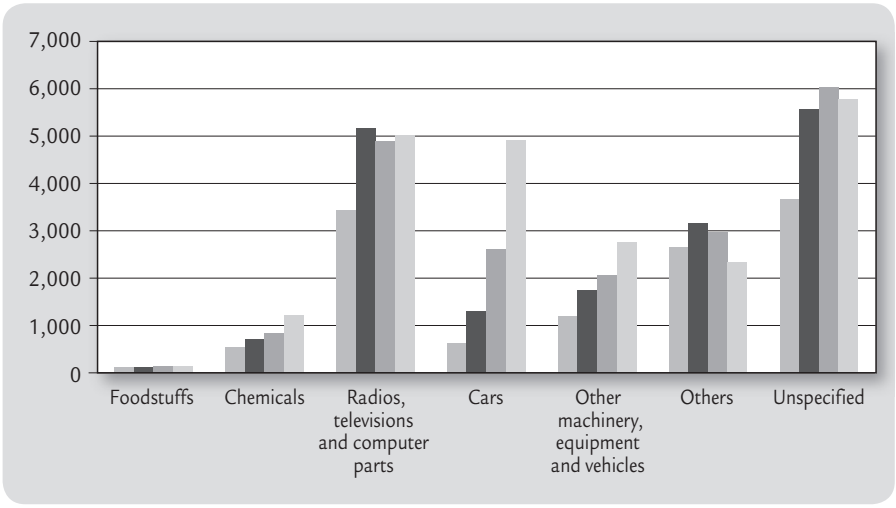
[7] The figures are based on estimation by the statistical department of the National Board of Customs. They estimate the value of transit based on the unit prices and weight of different categories using both Finnish and Russian customs statistics.

2005 was radios, television sets and computer equipment, which largely consisted of mobile phones and other electronics for Russian consumer markets. The share of this category was almost a fourth, although its share of volume was less than a tenth and it is the same category which has a large share of re-exports in Finnish export statistics. The second largest and fastest growing category was cars. Its share of the total transit was nearly as large as that of electronics, nearly a fourth of the transit in 2005.

The third largest transit category was other machinery, equipment and other vehicles (excl. passenger cars). This category's share was little more than a tenth of the transit through Finland in 2005. The share of chemicals was about 5% and that of foodstuffs around 1%. In the category others, the dominant share was held by the clothing sector, which represented nearly 7 percentage points of the transit freight to Russia. The unspecified category was a little bit over a quarter of the transit freight for Russia.

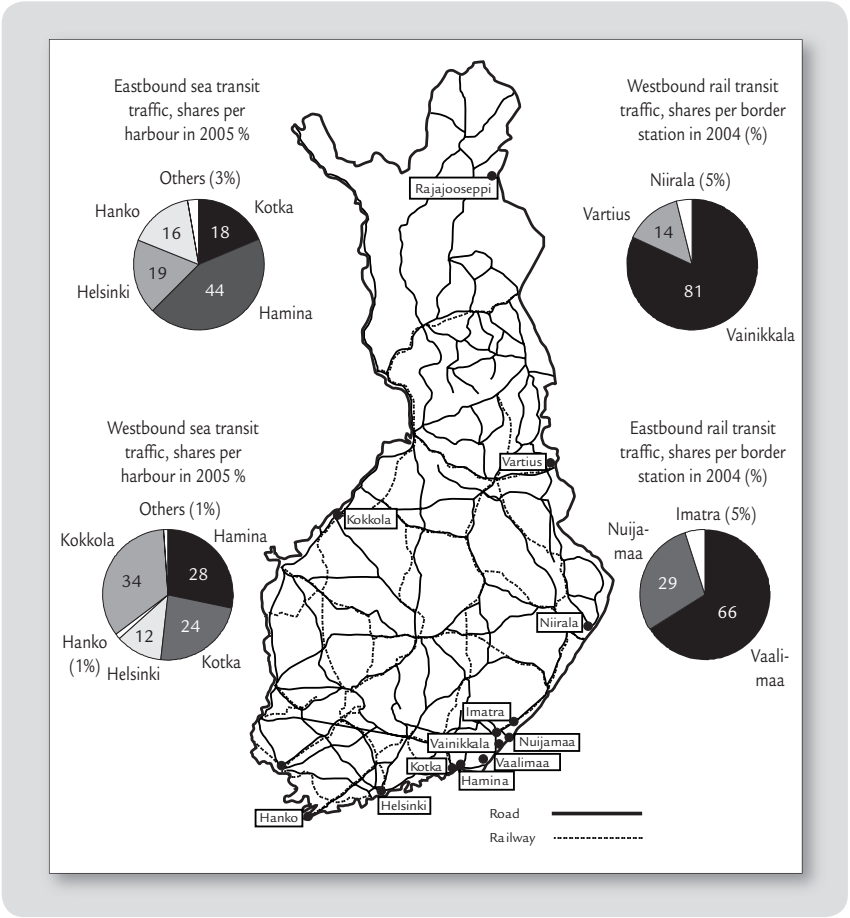
Measured by volume, most freight arrived by sea to the Ports of Kotka, Hamina and Hanko (see Figure 4.3). In many cases the goods were stored in warehouses in Southeastern Finland. From there the goods were loaded on trucks with destinations in Russia via the southern Vaalimaa border crossing point. In 2005, nearly half of the sea transit arrived in Kotka, a fifth in Hamina and a fifth in Helsinki. Hanko harbour's share was about 1/6, which mainly

Figure 4.2 Value of road transit freight through Finland to Russia 2002–2005, EUR 1,000.



Source: National Board of Customs.

Figure 4.3 Main transit freight entry and exit points in eastward and westward transit traffic through Finland.



Source: Harbour statistics by the Finnish Maritime Administration, Road freight eastbound by the National Board of Customs and Rail freight westbound by Pekkarinen (2005). Map edited at BoF and Edita. Base map © Genimap Oy, Licence L6701/06.

consisted of car transit traffic. During this decade, Helsinki has lost shares to the other harbours, especially to Kotka, whose transit freight volume has grown rapidly. Kotka has invested considerably in new capacity. In addition, the short distance to the Russian border from Kotka and Hamina makes these harbours attractive for transit to Russia.

Vaalimaa was the major border crossing for road transit freight eastward in 2005. Two thirds of all transit volumes to Russia went via this cross-

ing station. The second largest was the Nuijamaa border crossing near Lappeenranta with a little more than a fourth of road transit volumes, while 7% went through the Imatra border crossing. The fastest growing traffic volumes were at Vaalimaa with an increase of 15% in 2005 compared to the previous year. The shares of the other harbours and border crossings were marginal.

Some volumes of high value transit freight head to Russia also by air. According to the Finnish Civil Aviation Administration, Finavia the air freight from Finnish airports (mainly Helsinki-Vantaa airport) to Moscow was 4,600 tons, 390 tons to St. Petersburg and 2 tons to Murmansk, in 2005. Freight volumes grew by 30% from 2004. Of the air freight about 4/5 were transit freight, as according to the Finnish National Board of Customs, the Finnish exports by air to Russia were only about 1,000 tons in 2005. Finland is becoming an increasingly important hub for Asian traffic to Europe in particular, and also value goods transit from Asia. Especially, the Finnish national carrier Finnair has invested heavily in its traffic to Asia and developed connections between Asia and Northwestern Russia. Russian airports, however, lack adequate storage facilities, which create bottlenecks for air freight volumes to Russia. Hence, a part of the air transit freight through Finland to Russia arrives in Finland by plane, but is loaded on trucks at the Helsinki-Vantaa airport and delivered to Russia by road.

Half of Russian car imports through Finland

Finland has rapidly become a significant car transit hub for Russia and a huge part of Russian car imports goes through Finland. The number of cars shipped through Finland grew by nearly 50% each year in 2000–2005. In 2005, the number of passenger cars transited through Finland to Russia was 340,000. The car transit and the 19,000 cars accounted for in the Finnish export figures equalled about half of Russia's total car imports in 2005.

The Port of Hanko has specialised in car transit in particular and the port handled over two thirds of the car transit volume in 2005. The Port of Kotka represented 17% and the Port of Turku 8%. Other harbours do not have the capacity for car transit, as it requires huge storage space for the cars. The Port of Kotka has recently invested in enlarging its car terminal and plans to get a larger portion of the growing car transit through Finland.

The rapidly growing car transit traffic is also seen on the roads in southern Finland. In 2005 the Finnish border was crossed by 57,000 car transporters. These car transporters' impact on the road deterioration in Southern Finland has much been discussed in Finnish politics. The freight volumes are especially large on the Hanko-Helsinki-Kotka-Hamina-Vaalimaa route. There is also heavy traffic on the roads to Nuijamaa and Imatra border crossings.

Figure 4.4 Car transport to Russia through Finland 2002–2005, EUR million.

Source: National Board of Customs.

Two thirds of the cars exited Finland at the Vaalimaa border crossing and the rest were equally split between Nuijamaa and Imatra.

The huge volume of car transit through Finland has seemingly increased the Finnish car exports to Russia. Due to various reasons, a part of the flow of cars is recorded in the Finnish export statistics, consequently artificially increasing the Finnish foreign trade figures (see Section 3).

According to the transport business, the transit of passenger cars is estimated to grow to 600,000 cars in 2007,[8] as the demand for cars is assumed to continue to grow rapidly and Russia lacks harbour capacity for own car imports. Finland is favoured as a car transit country, due to the short distance to Russia, safe and effective car storing and dispatching facilities and sea route discounts by Finnish authorities for car transport ships.

The car transit through Finland is largely expected to decline after 2007–2008, when Russia will get own new harbour capacity into operation. There are plans for a large car terminal in Ust-Luga, south of St. Petersburg, but in mid-2006 the terminal was still under construction. Domestic car production is also expected to increase as foreign car manufacturers increase their car production plants in Russia.

[8] Already in the first half of 2006 the number of cars transited to Russia was 250,000 and is expected to grow to 500,000 for whole 2006.

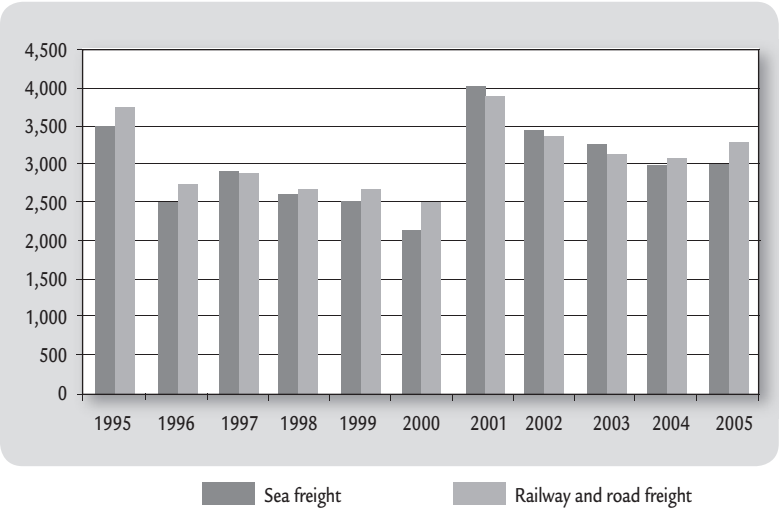
Transit traffic from Russia through Finland mainly natural resources

The transit freight from Russia has slightly declined from its peak in 2001. In 2005, the volume of the transit freight from Russia was about 3.3 million tons and grew slightly from previous years. However, it was still 20% less than in 2001.

While most of the transit traffic to Russia through Finland is value goods, with high unit prices, the situation is the opposite in westward transit from Russia. The transit traffic reflects the structure of Russia's foreign trade fairly accurately, where exports are dominated by natural resources and low value added goods, while the imports are dominated by consumption and high value added goods. In 2005, nearly half of all transit freight from Russia through the Finnish harbours was chemicals. The second largest group of products was ore and dressed ore, with little over a third of the transit volume. A little less than a tenth were individual goods and the remaining few per cent of freight were mainly mineral oil and paper and cardboard.

While roads dominate the haulage to Russia and railways are used much less, the situation is the opposite in transit from Russia. Only a few per cent of the transit freight from Russia comes to Finland by road. Most of it arrives by train from Russia directly to Finnish harbours. As the Finnish Rail Administra-

Figure 4.5 Transit freight from Russia through Finland 1995–2005, 1,000 tons.



Source: Statistics Finland.

tion does not keep value based transit statistics, we do not have value based statistics of the structure of the transit from Russia. Hence, we need to make own assumptions to calculate its value (see Appendix 5). We estimated that the value of the transit traffic from Russia through Finland was EUR 660 million in 2005. The value was marginal compared to the EUR 22 billion of the value of transit freight to Russia.

In terms of transit shipments from Russia via Finland, the most important harbour was Kokkola on the Gulf of Bothnia (see Figure 4.3). In 2005 its share was a little more than a third of transit freight volume from Russia. Second was the Port of Kotka with a share of little more than a quarter of transit freight volume and the third largest was the Port of Hamina with about a quarter. Both Kotka and Hamina, which are the largest in eastward transit, have lost ground in westward transit during this decade. Also Helsinki has lost ground in the transit traffic from Russia in recent years and the share of transit freight through the Helsinki harbour was only 12% in 2005. The Port of Hanko's transit traffic from Russia was marginal.

Instead the transit traffic through the Port of Kokkola has grown rapidly, as Russian customers have found the harbour. Kokkola has a railway connection to the Murmansk area, the Kola Peninsula and further to the Komi Area and in recent years the harbour administration has invested a lot in both enlarging the harbour and its capacity, but also in advertising the route to Russian customers. The Russian transit freight through Kokkola is mainly dry bulk: metals and metal products. The growth of transit freight through Kokkola is also seen in increased rail transit through the Vartius and Niirala border crossings in recent years. For instance the pellet transit traffic from Kostamuksa to Kokkola has increased rapidly in recent years.

A quarter of Russia's imports through Finnish territory

The volumes of transit traffic through Finland are significant. The transit traffic to Russia is slightly larger in volume terms than Finland's own exports to Russia. However, in value terms it is much larger as it is mainly value goods with high unit prices. According to our estimates (see more in Appendix 5) the transit freight in value terms is about 4–5 times larger than Finland's own exports to Russia. This means that nearly a fourth of Russia's total imports in value terms go through Finnish territory. Finland is currently a significant transport corridor to Russia, but not as significant as in 2003–2004 when a third of Russian imports went through Finland. Finnish exports and transit capacity does not manage to grow at the same pace as Russia's total imports.

It is much harder to estimate the value of Russia's total exports through Finland, as similar value based statistics of road transit freight are not available. We have based our estimation about the value of transit freight from Rus-

sia through Finland on the assumption that the unit price is largely the same for Finnish imports from Russia and for transit from Russia. According to our calculations the transit freight westward is only less than a tenth of all freight coming from Russia both in value and volume terms. The share of Russia's exports heading through Finland is only about 4% of Russia's total exports and much less compared to Russia's imports. The reason for these huge differences in shares is largely explained by the structure of Russia's total foreign trade. Expensive consumption and investment goods imported to Russia go through Finland, while the fuels and raw materials that dominate Russian exports mainly use the southern transport corridors, the gas pipeline infrastructure to Europe and Russia's two large oil harbours; Primorsk near Vyborg and Novorossiysk in the Black Sea.

Implications of the Russian transit traffic for Finland

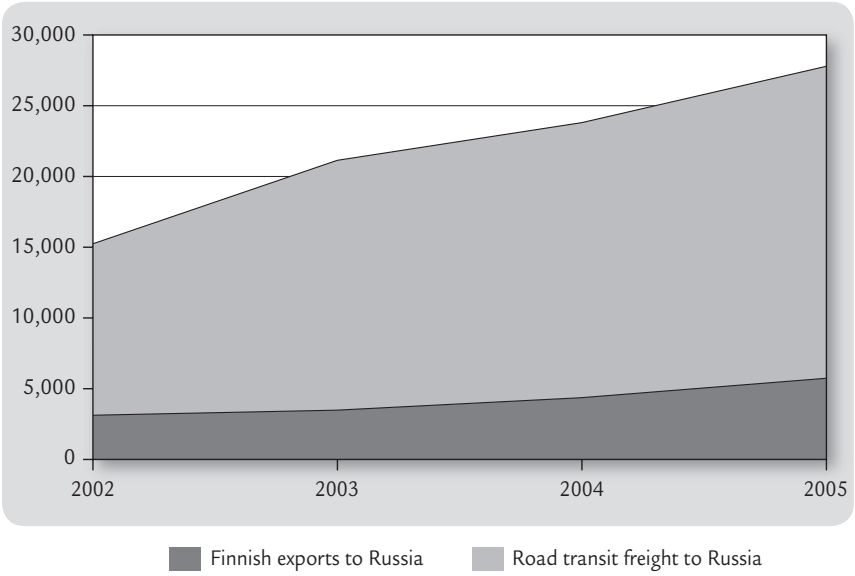
Why is Finland such an important transit hub for Russia?

Finland has become a significant transit hub for Russia, especially for value goods. The development has been very rapid, unexpected and happened due to a period of strong import growth to Russia. In terms of distance, the shortest corridor from Western Europe is railway or road through the European continental and Baltic countries or Poland-Belarus. However, these corridors are considered risky and insecure. Hence, Finland is favoured especially in value goods transport. Russia itself lacks harbour capacity in the Gulf of Finland and depends on imports through other countries. Also, Russian infrastructure policies so far have concentrated on achieving independence in export rather than in import capacity.

The main competing transit routes (drawn in Figure 4.8) with the Finnish one are:

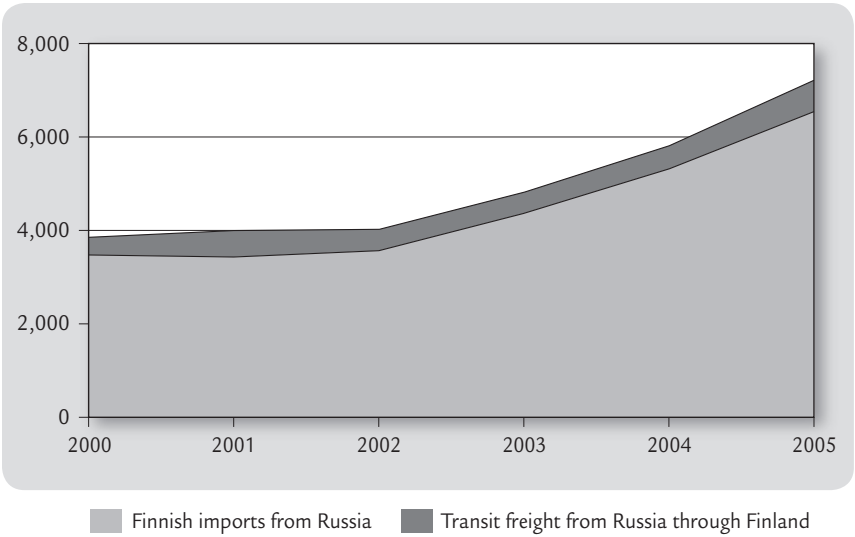
- **The Germany-Poland-Belarus route:** The route combines Central Europe with Russia and is used mainly for road transit. Also some volume of railway transit occurs on the route, but the change in railway track gauge at the Belarus and Polish border decreases the competitiveness of railway transit. The route is widely used by Germany for exports, especially to the Central Russian markets, Poland and Belarus. Low security and time consuming border crossings decrease the competitiveness of the route for value goods transit.

Figure 4.6 Transit freight to Russia and Finnish exports to Russia 2002–2005, EUR million.



Source: National Board of Customs.

Figure 4.7 Transit freight from Russia and Finnish imports from Russia 2002–2005, EUR million.



Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

- **Russian harbours:** Russia's only harbours in the west are the harbours in the Gulf of Finland, Murmansk and Kaliningrad. The route is the shortest sea connection to Russia. However, Russian harbours face serious capacity constraints, especially for the imports of goods. The Port of St. Petersburg is the only harbour concentrating on container traffic, but it is narrow and hard to expand and improve capacity due to its location in the city of St. Petersburg. The lack of ice breaker capacity in the winter aggravates the situation. The harbour of Kaliningrad depends on the land corridor to Russia through Lithuania and Belarus and faces the same difficulties as the Poland-Belarus route. So far transport firms have also been reluctant to invest in Kaliningrad. The harbours of Vysotsk and Primorsk near Vyborg concentrate on oil exports, not on imports. The Port of Murmansk is located on the shore of the Barents Sea and is mainly focused on the export of minerals. The sea route is long and freight needs to be forwarded from there by train inside Russia.

- **Harbours in Baltic countries:** The Baltic harbours have good logistical connections to Russia and are significant transit corridors, especially for bulk goods. The main harbours are the Ports of Klaipeda in Lithuania, Liepaja, Ventspils and Riga in Latvia and Tallinn in Estonia. They all have good geographical locations for transit transport to both Northwestern and Central Russia and the transit traffic heads by both rail and road to Russia. However, there are still problems with the slow border procedures and security. Also investment is needed in developing the railway infrastructure. Moreover, Russia's problematic relationship with the Baltic States increases the political risk on the route.

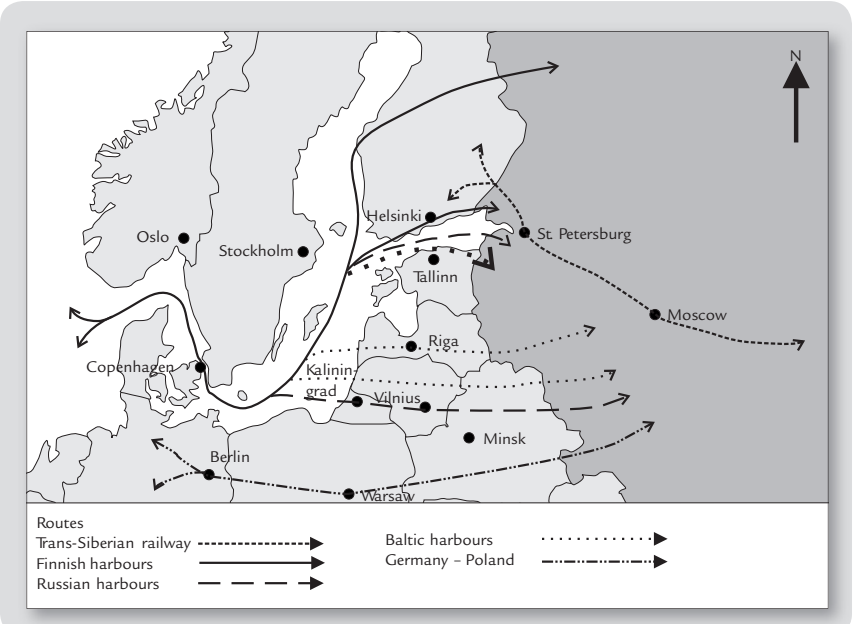
- **Trans-Siberian Railway:** The Trans-Siberian Railway (TSR) combines the Asian regions of Russia with the European ones, and is one of the most heavily loaded Russian transport systems. The railway is geographically and time-wise the shortest route for Asian manufacturers to get their products to Central and Northwestern Russian markets. The TSR starting point in the east is the harbours of Vladivostok and Nahodka on the shore of the Pacific Ocean. There are also rails to Shanghai and Beijing in China, but the different track gauge in China and Russia slows the traffic. The route is also an attractive transit route between Asia and continental Europe, but so far it has mainly served traffic between Asia and Russia. The lack of terminal and warehouse facilities in Russia, the low quality of the transport services in Russia, the lack of railway cargo wagons and unclear strategies and lack of investments from the Russian Railways have so far hindered

the wider development of the TSR for imports of value goods from Asia directed to Russia and continental Europe.

As the Russian imports have grown rapidly, freight volumes have grown rapidly on all major transit corridors to Russia. The Finnish transit corridor has so far managed to compete mainly in value goods to Northwestern and Central Russia. The Finnish corridor is in no way the shortest one from the Central European markets to the Moscow region, but one of the shortest to Northwestern Russia. The main strengths of the Finnish corridor can be summed up as the following:

- **Safe transit corridor and storage facilities:** The Finnish corridor is seen as a safe and reliable transport corridor, especially to the St. Petersburg area and the adequate customs warehouse capacity attracts the importers to store the goods on their way to Russia.

Figure 4.8. Map of the main transport corridors to St. Petersburg and Moscow from Central Europe.



Source: Map edited at BoF and Edita based on MINTC (2005b). Base map © Genimap Oy, Licence L6701/06.

- **Accurate timing and procedures:** The Finnish corridor is also reliable in timing. All from harbour stevedoring to custom procedures are reliable, fast and effective, which makes the agenda planning for the Finnish corridor easier than for the more unreliable southern corridors through the Baltic countries or Central Europe.

- **Good geographical location:** Finland's geographical location next to Russia, close to St. Petersburg is also a clear competitive advantage in the competition of transit traffic to Northwestern Russia.

- **Lack of retail warehouse capacity in Russia:** Russia lacks storage facilities for imported goods and the security in the existing ones is low. Many importers prefer to drive the trucks with imported goods directly to trade centres without storing them in Russia. Hence, much of the value goods are provisionally stored in Finnish customs warehouses, partitioned and shipped to Russia on demand.

- **Biased transport costs for the Russian railway:** Until the end of 2005, the Russian domestic railway transit tariffs were lower than for imports, which in some cases encouraged importing goods from Asia as transit freight by the Trans-Siberian Railway to Finland and then back to Russia. This transport stopped at the beginning of 2006 when the Russian railway raised the transit freight fees for the TSR.

Double transport infrastructure for transit freight

The transit to and from Russia through Finland in volume is largely the same. As previously stated Russian exports are usually based on rail transportation, while the imports rely mainly on road transportation. Consequently, Finland maintains a double infrastructure for the Russian transit traffic and foreign trade. For example in 2004, the Finnish-Russian border was crossed by about 320,000 railway wagons. Of these 5% were empty when arriving to Finland, but as much as 82% empty when leaving Finland. In road transit the figures are generally the opposite. For example, 57,000 car transporters drove from Finnish harbours to Russia in 2005. All of these transporters were empty when they arrived to Finland and full when left the country. The same phenomenon is valid for the trucks that transport electronics to Russia through Finland.

The double structure is explained by the huge differences in freight structures. Chemicals are transported in specially designed railway wagons and ore in dry bulk wagons. Again, most of the transit to Russia is individual itemised

goods that are transported in containers, mainly on trucks. Also a significant part of the transit is passenger cars, which are transported in specially designed car transporters. Hence, the possibilities of developing the use of same transit capacity two ways are challenging.

Due to the heavy transit traffic and its impact on the Finnish infrastructure, Finnish policy makers have proposed a more effective use of the transport infrastructure in transit traffic to and from Russia. For example in spring 2006, the Finnish Ministry of Transport and Communication examined the possibilities of shifting part of the car transporter traffic to railways, in order to decrease the growth of car transporters on Finnish roads.

These plans to shift a part of the freight volumes to Russia to railways have not got much positive response from the transit business. The lack of terminal and warehouse capacity in Moscow decreases the competitiveness of the railway shipments to Russia. Moreover, for short journeys, railway transport is much slower than road haulage and usually the railway is recommended for transportation first when the destination is further away than Moscow. Most of business prefers haulage by road as goods can be unloaded directly at the retail stores without the use of terminals. Unfortunately, road freight is also preferred due to the opportunities for taking advantage of grey schemes. Double invoicing is easier, more flexible and less risky when using road haulage compared to rail traffic. Hence, it is hard to see any switch from road to train transports in transit to Russia in the short term.

The impact of transit traffic on Finland is limited

The rapidly increased transit freight through Finland has raised considerable discussion about its impact on the Finnish economy. Does it only consume the Finnish road and railway infrastructure or does it also bring some income to the country? It is estimated that over 95% of the transit road haulage are managed by Russian transport companies and drivers. These trucks are registered in Russia. The fuelling and maintenance are also handled in Russia. Finns are involved in the transportation of some special goods that require specially designed trucks. Consequently, the direct income and employment effect of the road transit to Russia through Finland is very small.

In the transit from Russia, railway tariffs are paid on the cargo carried on Finnish railways and thus the direct income is little larger. In terms of sea haulage, about 2/5 of the ships were Finnish registered in inward transport and one fifth in outward in 2005. Hence, the employment effect is notable on ships, although not in itself large. The largest employment effect of the transit comes from the Finnish harbours and services related to the transit traffic.

We estimated the employment effect of transit transport by using a similar input-output model, as for the employment effect of goods exports. The

estimates are not, however, very accurate as there does not exist value-based, but only volume-based information on the transit activities. According to our calculations, the employment effect of transit was roughly 3,500 persons in 2003. ETLA has carried out similar calculations and they also sent questionnaires to the Ports of Kotka, Hamina, Hanko and Turku. From the answers they concluded that the number of people employed in logistics to Russia was 3,040 in 2003. To this figure we should at least add the employment effect on the Ports of Helsinki and Kokkola and the storage and transport companies active in the Lappeenranta and Kouvola regions. The real figure is probably about 4,000 persons.

The large transit traffic to Russia through Southeastern Finland has also attracted many Russian logistical entrepreneurs to start business in Finland. Of the 2,000 Russia-related entrepreneurs in Finland about 1/7 were logistical enterprises and a little more than a third retail and wholesale enterprises (see more Section 5). These firms have largely invested in Finland because of the possibilities of the transport sector to Russia and their effect on the Finnish economy is also notable.

Capacity constraints limit growth perspectives

The transit traffic to Russia is starting to meet capacity constraints in Finland. Finland has not managed to increase the transit traffic apace with the growth in Russia's total imports. At some harbours and border crossing points the freight volume has already reached its maximum. Also some of the main roads are heavily used for Russian transit traffic and the Finnish government's infrastructure budget lacks sufficient funds to enable a commitment to a rapid enlargement schedule for the main roads to the Russian border. The appearance of bottlenecks in the Finnish transit corridor delays transport times and decreases the competitiveness of the corridor. Hence, the question of adequate infrastructure is crucial for keeping the competitiveness of the Finnish transit corridor.

In 2005, the Finnish Ministry of Transport and Communication financed a study about the possibilities for logistical partnership between Finland and Russia, produced by ETLA. The report highlights some of the challenges in the transit business to Russia. The logistics capacity is close to its limits and investments are needed in the Finnish harbours, border points and roads between. Investments are also needed on the Russian side of the border. Also a better use of the transport capacity needs to be developed, by increasing the two-way use of trucks and trains and by increasing the size of trains and ships entering Finland. The report also underlines the possibility of developing Finland as a transport hub for the traffic along the TSR and the possibilities for Finnish logistical entrepreneurs to expand into the Russian market.

In the autumn of 2005, the Ministry of Transport and Communication published an action plan for strengthening the competitiveness of Finnish logistics. In the plan, one of the key goals for Finland is to maintain its active position in the logistics in the Baltic Sea area and the logistics between Asia and Europe. The action plan concludes that Finland has benefited from the opening up of the Russian markets and that Finland needs to put more focus on developing the transit traffic to and from Russia. The plan also stresses that Finland should have logistical matters on the agenda of its EU policies. For Finland, it is important that the EU's traffic and customs policies take Russia into account.

Future of transit traffic – Russia's own plans

Russia's foreign trade infrastructure networks are largely inherited from the Soviet time and were built for the Soviet foreign trade needs. Foreign trade was limited and concerned mainly Soviet satellite countries. Since the fall of the Soviet Union, little has been invested in improving and developing the transport systems, which puts constraints on the Russian transport infrastructure as a whole. For example, Russia lost much of its Soviet harbour capacity on the Baltic Sea, when the Soviet Union fell. The oil harbour of Ventspils and bulk harbours in other Baltic countries were lost. Russia's existing harbour capacity on the Baltic Sea is squeezed in small stretches of shore on the Gulf of Finland. The existing harbours there are the oil and fuel terminals of Primorsk and Vysotsk, the Ports of St. Petersburg and Kronstadt and the bulk and container terminal in Ust-Luga.

The harbours of Primorsk and Vysotsk near Vyborg were built, when Russia decided to limit the dependence of its energy exports on oil terminals located abroad. The terminals were constructed in record time and they concentrate on crude oil and oil product exports. The rapid construction of the terminals shows that if Russia prioritises an infrastructure project it can be realised swiftly.

The St. Petersburg harbour is old and mainly used for dry bulk. The harbour focuses both on exports and imports. The harbour is narrow and the possibilities for expanding it to any significant degree are limited. Also the harbour of Kronstadt on the dam in front of St. Petersburg has little chance of being extended. The most ambitious expansion plans are for the Ust-Luga harbour south of St. Petersburg. The harbour is still small with limited capacity. However, there is space and plans exist to build a large car import terminal and transfer significant parts of the bulk transit through Finland to Ust-Luga. The harbour does not yet form a significant threat for the Finnish transit corridor, but if the investment is realised and Russia's import growth slows, it probably shifts parts of transit traffic through Finland to Ust-Luga.

Russia lacks harbours and space for developing harbours on the Gulf of Finland. This fact limits the possibilities for self sufficiency in harbours. Although the Russian transport strategy aims at self sufficiency, Russia is doomed to partly depend on its neighbours due to geographical reasons. But Russia can still choose in which areas it aims for independency. So far, it has chosen the independency in the strategically important energy exports infrastructure, not in value goods imports.

The State owns nearly all transport infrastructures in Russia and actively uses price regulation in steering logistics, including railway, harbour, canal and other transport tariffs. In some cases the competing transport supplier can be owned by the Russian state and in the transport policies state-owned parties are favoured. Increased competition and decreased state monopoly in the Russian logistics is required to develop the Russian transport systems. This fact is also acknowledged in the Russian transport strategy published in 2004.

The transport strategy presents ambitious plans to improve Russia's transport infrastructure. The strategy presents different projects for increasing the Russian harbour capacity. Among others, it underlines the need to enlarge the Ust-Luga harbour and puts as a goal that 85% of Russia's foreign trade needs to go through domestic harbours instead of the present of 75%. The strategy also aims to decrease the exports of bulk goods and to develop the container and value added goods exports. The goal is also to increase the transit traffic through Russia by 150–200% until 2020. The strategy covers most of the different infrastructure systems in Russia. However, the Russian Ministry of Transport currently lacks the resources for implementing the strategy. It remains to be seen how much of it will eventually be implemented.

The lack of infrastructure capacity in Russia, together with safe and effective Finnish logistical systems forms the main competitive advantage for transit through Finland. Adding that Russia's imports grow rapidly and is not expected to significantly slow down in the medium term, the transit to Russia through Finland grows probably also in near future. However, when import volumes stop growing as fast as during recent years, a shift in favour of Russian infrastructure systems is likely to be seen.

Russia's plans do not necessarily mean that Finnish players in the field of transit logistics will loose ground. Instead, it creates challenges to transform a transit business fit for future needs. Both Russian and Finnish transport strategies raise opportunities related to the transport corridor between Asia and Europe through Russia along the TSR. One interesting project in this field is run by the developing company Innorail owned by the city of Kouvola. They plan to develop Kouvola to become an important crossing point for the transit traffic through Russia between southeastern Asia and continental Europe. The plan is ambitious, but if realised it could provide new business opportunities

for the Finnish logistic sector. The development plans also raise new possibilities for Finnish firms in Russia. If Finnish logistical companies now are significant players in the transit business to Russia, they should aim at a significant position in the future domestic logistics in Russia.

Conclusions: The effect of Russian transit traffic on Finland

Finland has become a significant value goods port for Russia, as a quarter of Russia's total imports already go through Finnish territory. The transit traffic certainly has an effect on the Finnish economy, especially in Southeastern Finland. It employs about 4,000 persons, which is much less than the employment in the industrial production for exports to Russia. The effect of transit business for Finland concerns mainly the harbours and facilities around them and is limited for the rest of the economy. One side effect of the transit business is that it brings entrepreneurs to Finland from Russia and a significant proportion of the SMEs in Southeastern Finland are Russian owned. These enterprises employ people, but also pay taxes to Finland which increases incomes for Finland.

Transit traffic also has some negative effects, such as increased re-exports recorded in Finnish foreign trade statistics and heavy deterioration of roads by Russian trucks in Southern and Southeastern Finland. However, the income and employment effect is probably still larger than the negative impacts of the traffic. Hence, the transit traffic is probably positive overall for the economy, but the positive effects are not very significant.

Transit traffic to Russia is expected to continue to increase steadily, as Russia's total imports are expected to continue to grow rapidly and Russia continues to lack its own import harbours in the Gulf of Finland. The rapid increase in Russian car and consumer electronics imports has been the main reason for the growth of the transit traffic to Russia, rather than planned policies by Finnish or Russian authorities. The growth of passenger car transit is expected to slow down after 2008, when Russia's own car import harbour capacity is constructed and as foreign car makers' car production in Russia increases. The consumer electronics transit to Russia is expected to remain high and continue to increase, as relevant warehouse and storage capacity is not available in Russia and will take time to construct. Also many large Asian electronics importers have invested in facilities in Finland and the development on the Russian field of logistics has to be quite advanced before these companies will withdraw. Hence, the current strong position also gives space for manoeuvre for the Finnish authorities to sharpen strategies and policies in order to remain a strong transit hub to Russia in the future too.

Strategically, Russia aims at logistical independence in its foreign trade transportation, which so far has been seen in Russia's exports. In the long term, once Russia has constructed and invested in enough export capacity, it will probably aim at independence in imports too.

In the westward transit from Russia, the volumes have declined as the Russian mineral exports have moved to Russia's own export harbours. Volumes would have declined even more, if the transit traffic from the Murmansk area and the Kola Peninsula had not increased. The transit from Russia seems to increasingly move to the Central and Northern Finland and to the harbours of the Gulf of Bothnia, while the transit to Russia heads along the harbours at the Gulf of Finland and the southern border crossings to Russia. Naturally, the transit logistics is double, as both transport systems are only in one way use due to the different structure of Russian exports and imports. The development of a two-way logistics solution remains a challenge.

5 Finnish-Russian investment relations

Finnish investments in Russia and their effect on the Finnish economy

During the 1990s, Finnish enterprises increasingly started to invest in Russia and during this decade investments have grown fast. Russia's rapidly growing markets offer an attractive expansion base for foreign enterprises. In the global economy of today, the analyses of investment flows are rather difficult, due to the lack of proper investment statistics and the difficulties in defining the country of origin of global capital flows. Many companies are global in nature, with several subsidiaries which borrow capital from each other and in various countries. This all complicates the traceability of investments. For example, if a telecom company registered in Finland and mainly owned by American pension funds invests in Russia using funds loaned by a Korean Bank, to which country's investment statistics should the investment be accounted? Moreover, different investment statistics are based on different methodologies, which also complicates combinations and comparisons. Also various investment statistics are used in this section.

Foreign direct investments in Russia

Foreign investments in Russia started to grow rapidly at the beginning of the 21st century. However, the general level of foreign direct investments (FDIs) remains modest. Since the fall of the Soviet Union, Russia has received only little more FDIs than Poland. The other fast growing emerging market – China, has received 2.5 times more foreign direct investments than Russia. The foreign investments' share of fixed capital formation is about 10–15% in Russia. Consequently, the impact of foreign investments on the economy is still limited.

The low level of foreign investments in Russia is largely due to protectionism, an uncertain investment climate and weak legal protection for foreign investments. Various surveys conclude that the Russian foreign investment levels are much lower than the potential for the economy. However, during the last years foreign direct investments in Russia have increased rapidly and a significant positive change in the investment climate has been observed.

According to the Russian Statistical Service (Rosstat), Finland did not belong to the 10 largest foreign investors at the end of 2005. The Netherlands were the largest FDI investor to Russia, measured by the investment stock at the end of 2005, which was 32% of all FDIs. The second largest was Cyprus with 27%. The United States were third with about 9% followed by Germany with 5%. The large FDI shares from Cyprus, as well as Virgin Islands and Bahamas are largely explained by the return of Russian capital that was transferred abroad during the turbulent years in the 1990s. Many oligarchs control their empires through holding companies in these tax havens.

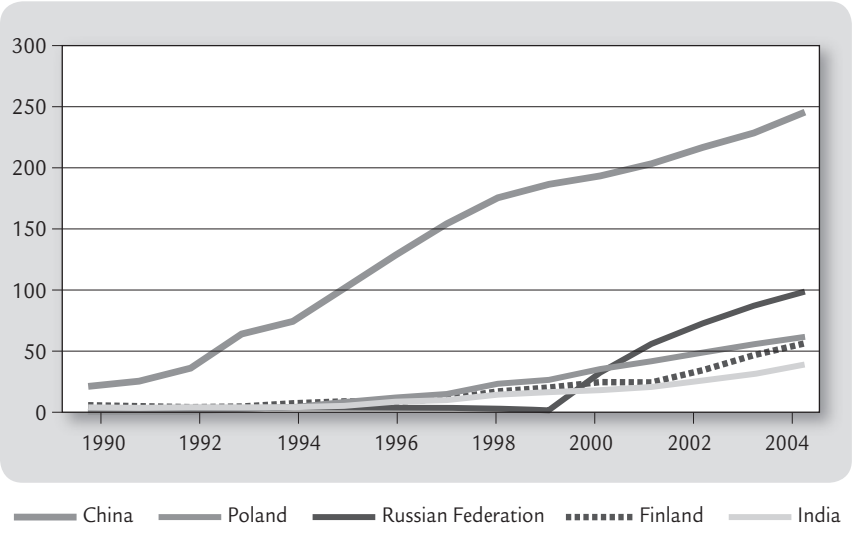
Half of all foreign investments in the Russian economy have gone to the industrial sector and especially to the mineral industry, which includes oil production.[9] It is also notable that a fourth of all foreign investments have been in the retail and wholesale trade sector, which has grown rapidly at the beginning of the 21st century. About 40% of all FDIs to Russia in 2000–2005 have been in the Central federal district and nearly a fourth alone in the city of Moscow. The Far Eastern federal district has received about a fourth of all FDIs in the period, largely because of the huge investments in the Sakhalin oil and gas projects. The Siberian federal district has got about a tenth, while the Ural, Volga and Southern federal districts, have been less interesting for foreign investors. The Northwestern district neighbouring Finland received about 7% of all foreign investments in Russia in 2000–2005. The city of St. Petersburg and Leningrad oblast gathered together about 4% of the FDIs to Russia in the period.

Finnish investments in Russia grew rapidly after 1998 economic crisis

Similar to global trends, Finnish companies are also increasingly investing in Russia. According to the Bank of Finland's (BoF) balance of payment figures, the stock of foreign direct investments in Russia by Finnish enterprises was EUR 448 million at the end of 2005. Russia is still a rather small investment market for Finnish firms. It accounts for less than 1% of the FDI stock from Finland, according to BoF. Most Finnish FDIs have gone to European Union

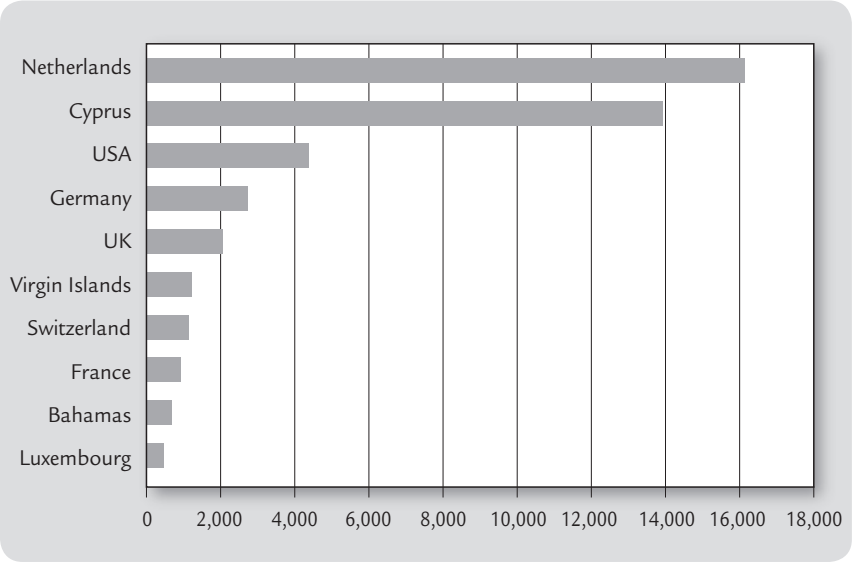
[9] Rosstat only publishes the sectoral distribution of the stock of all foreign investments (inc. portfolio investments and some credits) in Russia.

Figure 5.1 Stock of inward foreign direct investments in some selected countries 1990–2004, USD billion.



Source: World Investment report 2005, UNCTAD.

Figure 5.2 The 10 largest foreign direct investors in the Russian economy by stock at the end of 2005, USD million.



Source: Rosstat.

countries, where Sweden is the largest destination with a fourth of all direct investments from Finland.

The BoF figures, however, underestimate the stock of investments in Russia, as there are some limitations in the statistics for balance of payments. For instance, investments made by subsidiaries in third countries and investments of firms with an annual net sales less than EUR 5 million are not included in the figures. Investments that are less than 10% of the share stock are accounted as portfolio investments, not FDIs. The stock of Finnish portfolio investments in shares to Russia at the end of 2005 was EUR 1.1 billion and nearly 2.5 times larger than the stock of FDIs. Russia was the 9th largest destination of portfolio investments in shares from Finland. Moreover, many firms arrange their ownership through various intermediary companies and schemes, and hence not all Finnish owned companies can be seen from the FDI statistics alone. Due to this reporting method, the investment figure of Finnish FDIs to Russia by BoF is probably underestimated.

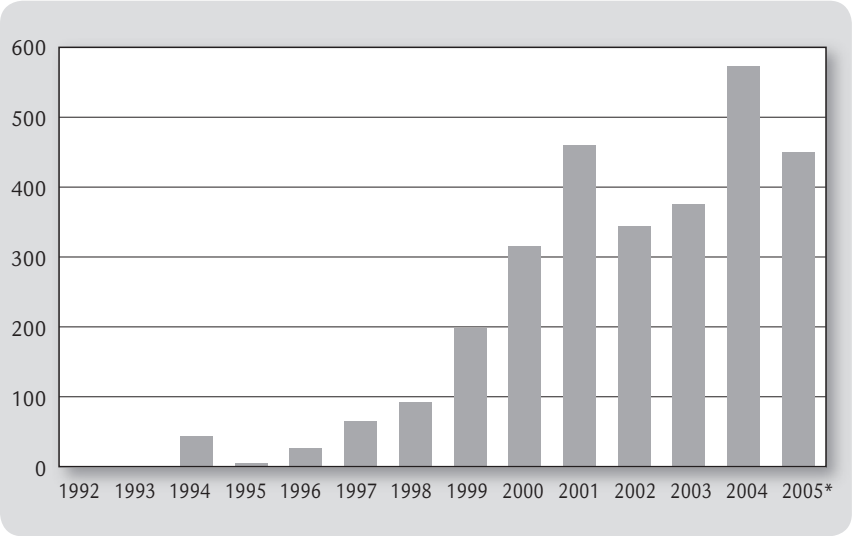
Hartwall's investment in Baltic Beverages Holding (BBH)[10] and Sanoma-WSOY's investment in Independent media[11] are examples of such investments, which are not included in the statistics of the Bank of Finland. These investments were made through entities in third countries. However, the BoF figures function as a fairly reliable indicator of the trend in the investment stock, which has steadily increased since the mid-1990s. The investment stock came down in 2005 due to changes in the exchange rates and because ownership of some Finnish enterprises that have invested in Russia moved from Finland.

A broader definition of Finnish investments in Russia is used in a study by the Research Institute of the Finnish Economy (ETLA) published in 2005. Their study analyses annual reports from 75 large Finnish companies and the study concludes that the stock of investments from Finland to Russia was around EUR 1.8 billion at the end of 2005. The study assumes a continuing 10–15% annual investment growth and the study forecasts that the stock of investments will be EUR 2.5 billion in 2007. ETLA also takes into account investments made by Finnish enterprise entities in third countries and smaller than 10% ownership. Hence, the figures are not fully comparable with the figures from the Bank of Finland.

[10] The Finnish brewery Hartwall established Baltic Beverages Holding (BBH), jointly with the Swedish brewery Prips in 1992. Since then BBH has grown to become Russia's largest brewery. However, BBH is based in Sweden and considered as an investment in Sweden in the ordinary balance of payments statistics. Hartwall was bought by Scottish&Newcastle in 2002, largely because of it's ownership in BBH. Following the deal, the investments in BBH were excluded from the Finnish investment figures.

[11] The Finnish media house Sanoma-WSOY bought the Dutch owned Russian media house Independent Media in spring 2005. However, as the purchase was a transaction between a Finnish and a Dutch company the investment is not reported as made to Russia, but rather to the Netherlands in ordinary balance of payments statistics.

Figure 5.3 Stock of foreign direct investments from Finland to Russia 1992–2005, EUR million.



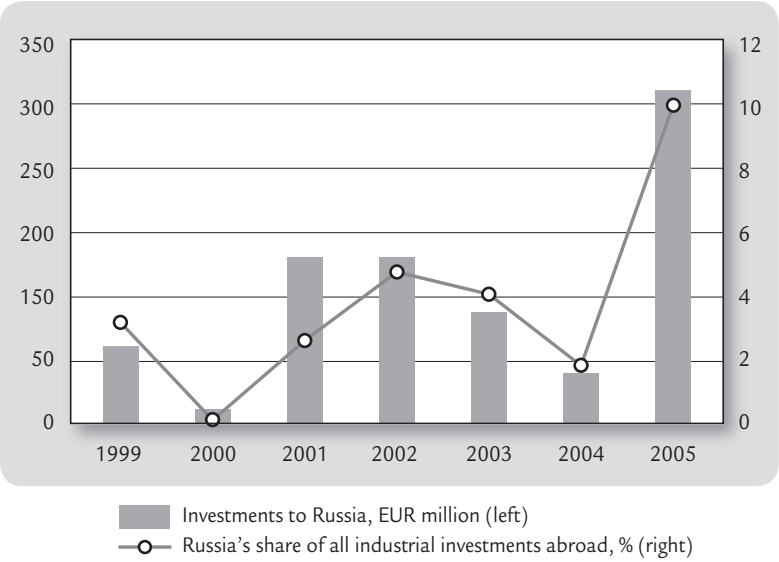
* Preliminary figure

Source: Bank of Finland.

ETLA also estimates the impact of Hartwall's investment in BBH, Sonera's investment in MegaFon, Neste Oil's former investment in the joint venture with Lukoil, Chips' production transferred to Orkla and Nordea Bank's investment in International Moscow Bank. By including these figures, today's value of the investments would exceed EUR 3 billion. However, these investments cannot any more be reported as being Finnish, as their ownership has been transferred abroad. Thus, one conclusion to be drawn is that recently sold Finnish parent companies have been quite successful in their Russian operations and their sales abroad were partly advanced by their success in Russia.

The ETLA survey concludes that investment activity has increased during the last years and interest in investing in Russia is on the rise. Their findings are supported by a survey, which the Confederation of Finnish Industries (EK) made among its members at the end of 2005. The survey shows that the Finnish industrial investment flow to Russia grew sixfold from 2004 to 2005 and that a tenth of all foreign investments made by Finnish industries went to Russia. Russia's share of Finnish enterprises' investments flows abroad was about 3% in 1999–2004. According to the survey, a change occurred at the end of 2004. Since then investments in Russia have significantly increased. However, the EK survey only considers industrial enterprises' investments, not service sector's investments, so the real figure of Finnish investments abroad is higher.

Figure 5.4 Investments by Finnish industrial enterprises to Russia and share of Russia of all industrial investments abroad in 1999–2005.



Source: Confederation of Finnish Industries.

Investment decisions are seldom done on the spot and the period from the decision to the investment itself takes in many cases years. Hence a possible conclusion to be drawn is that many of the decisions were already taken before 2005 and that the current trend will probably continue for a while. This assumption can be supported by the positive attitude towards the Russian opportunities that have recently been reflected in different surveys (e.g. the Finnish-Russian chamber of commerce bi-annual member survey from spring 2006).

Finns invested in mainly non-strategic sectors

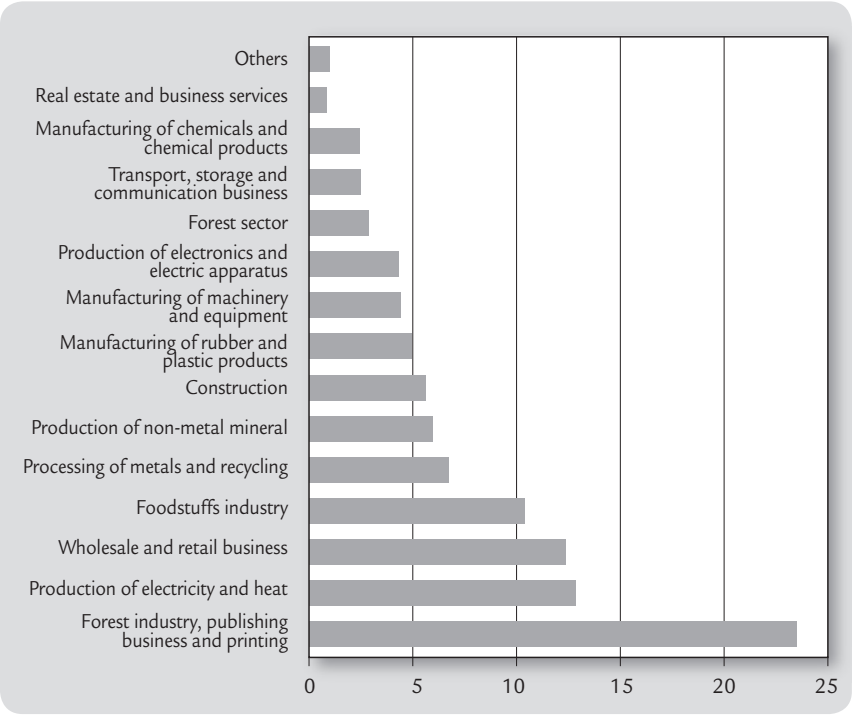
The ETLA survey also reports Finnish investments in Russia by sectors. Nearly a fourth of all Finnish investments until the end of 2005 have gone to the forest industry and its extension in publishing and printing business. This fact is largely explained by Sanoma-WSOY's large investment in Independent Media, and Finnish forest industries' ownerships of various production facilities in Russia. Although the share is large, the Finnish forest industry has yet not invested largely in Russia. It mainly imports raw wood from Russia for production in Finland. Its facilities in Russia are mostly sawmills and small pioneering projects. The Finnish forest industry has so far restrained from larger long-term investments in Russia, due to the still-uncertain investment climate and undeveloped

forest legislation. However, as the printing and paper business grows rapidly, the demand for paper grows. As Russia has some of the world's largest reserves of raw wood, the investments in this field are expected to grow in the future.

Other large branches, which have invested in Russia are wholesale and retail business and production of electricity and heat. In the wholesale and retail business investments, especially Stockmann's investments are significant. So too are Fortum's investments in Northwestern Russian power facilities for the production of electricity and heat. During 2005 and spring 2006 Fortum has bought significant minority shares in the St. Petersburg regional energy company Lenenergo and the Kola Peninsula regional energy company Kolenergo. Through the investments Fortum acquired 26% of the new Northwestern Russian energy company TGC-1 and in 2006 became the largest foreign participant on the Russian electricity business.

The foodstuffs industry is also a significant Finnish investor in Russia. It accounted for about a tenth of all investments from Finland. Here, Fazer, with its bakeries in St. Petersburg and Moscow, was a major player.

Figure 5.5 Structure of Finnish enterprises' investments in Russia at end of 2005, %.



Source: Research Institute of the Finnish Economy.

It is notable that the Finnish investments do not follow the general pattern of foreign investments in Russia. Most of the foreign investments in Russia have gone to the mineral sector and manufacturing industry, but in the Finnish case the path is different. Finnish enterprises appear to invest considerably in consumption-driven sectors, electricity, publishing and the forestry business. Most of these sectors are not considered strategic from the Russian perspective. Hence, the political risk is smaller than for example in foreign investments in the Russian oil and gas business.

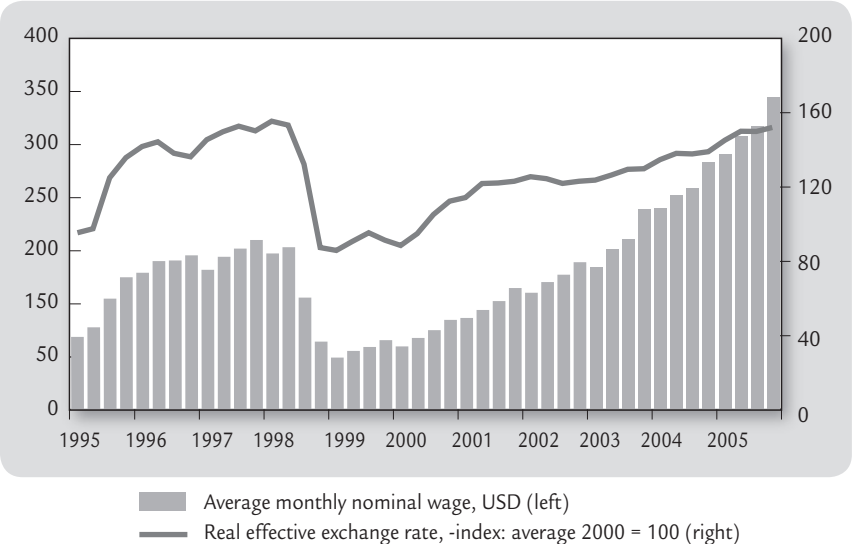
The latest proper study on the regional spread of Finnish investments in Russia is the member survey by EK in 2003. The stock of investments from industrial firms to Russia was estimated as being around EUR 1.4 billion at the end of 2002. About 80% of these investments went to the Northwestern federal district. The rest was mainly in Moscow and its surroundings. According to Rosstat regional statistics, Finnish firms were the second largest direct investors after the Swiss ones in the Leningrad oblast and fourth largest in St. Petersburg city in 2005. For the Republic of Karelia, Finns were the most important investors measured by the stock of investments at end of 2005. However, various recent surveys on the potential of the Russian markets state that Finnish firms are increasingly considering investments further away than Northwestern Russia, as the firms aim for production and representation closer to the other million cities in Russia. This would indicate that the proportional share of Northwestern Russia will decline in Finnish investments in the coming years.

Fast growing export market forces Finnish companies to invest in Russia

There are many reasons why investments from Finland to Russia have increased during the first decade of the 21st century. Interestingly, Finnish investments in Russia mainly focus on production for the Russian market, while investments in e.g. China and Central and Eastern Europe also aim at production for global markets. Production for global markets has not been the driving force for Finnish investments in Russia, as protectionism, high customs duties, high levels of corruption and rapidly increasing labour costs reduce Russia's competitiveness compared to many other areas. Also the strengthening real exchange rate of the rouble reflects the increase of costs (see Figure 5.6). Hence, Russia is fast loosing its relatively cheap labour force advantage. Notable too is the rise in salaries for Russian specialists in some fields (e.g. in the ICT sector) and especially directors to already exceed those in Finland, for example.

The nature of the market also differs. When the market was still underdeveloped and the volumes were relatively small, a foreigner could easily do successful export business to Russia. After the 1998 rouble devaluation, the domestic competitors got a significant competitive advantage, but since then,

Figure 5.6 The average wage and real exchange rate (REER) of rouble 1995–2005.



Source: Rosstat.

the market has grown rapidly and more enterprises have started to become interested in it. Now, a foreign enterprise is almost always in a disadvantageous situation in relation to domestic price competitiveness, due to longer distances, import tariffs, varying border procedures, difficult certification processes and in many cases more expensive production. Hence, as competition increases, many foreign firms are forced to establish production in Russia in order to keep their current market shares in Russia. And the location matters: facilities have to be close to the main market in the million cities. This clearly decreases the competitiveness of the regions close to Finland, as they are small population centres with small markets and usually accessed only by bad logistical solutions.

Consequently, Finns primarily invest in Russia for the market potential, rather than for cheap labour and production. Moreover, the location next to Finland is not a necessary criterion for the investment. These issues were also acknowledged in a survey by the Northern Dimension Research Institute at the University of Technology in Lappeenranta from 2005. The major reason for investing in Russia for all firms in the survey, independent of size and branch, was the Russian market potential. Although, so far most of the Finnish investments have been in Northwestern Russia and the Moscow region, the firms increasingly look farther afield. When asked about potential areas in Russia, Finns favoured areas where the million cities are located; the cities of Moscow

and St. Petersburg and the oblasts around them came first, but considerable potential was also seen in Krasnodar, Tatarstan, Sverdlovsk, Rostov, Samara, Bashkortostan and Nizhnyi Novgorod.

There are, however, some exceptions from the general trend. PKC Group and Elcoteq are two large Finnish subcontracting companies for electronics business with production facilities in the regions close to Finland. Their business idea is based on using Russian labour for their labour intensive production and to import the products to Finland and other European countries. PKC Group is located in the city of Kostamuksa near the Finnish border and Elqotec is located in outside the suburbs of St. Petersburg. However, PKC Group's and Elcoteq's business concept in Russia is rare for foreign companies in Russia.

Also, a new trend in investments is seen: Subcontracting has forced many Finnish SMEs to invest in Russia. This has been the case especially in the construction business, when large Finnish construction companies have invested in Russia, many smaller subcontractor firms have had to follow them. Some Russian subcontracting firms have also found lucrative business possibilities in the co-operation with Finnish firms and Finns are also used in subcontracting for Russian firms. For example some Finnish energy and construction companies are also taking part in the development of the oil and gas projects in Sakhalin Island.

Although investment flows have grown rapidly, the Russian market is by no means reported as an easy investment market. According to a report on investment barriers by the Finnish Ministry of Foreign Affairs published in 2005, Finnish companies complain about problems in the process of certification and trade mark registration of products in Russia. Moreover, Finnish firms in Russia have experienced a lack of transparency when dealing with Russian authorities. Instead sound knowledge of local business environment and good contacts are needed when investing to Russia. Finnish firms have also experienced juridical problems; especially as the implementation of certain laws varies greatly by regions. Some regions such as St. Petersburg and its surroundings have proven to be more investment friendly than for example the city of Moscow. Finnish firms in Russia have also experienced problems with adapting their international accounting standard to the Russian one. This will probably change in future, as Russia slowly shifts its accounting standard towards international standards.

Finnish firms in Russia have also experienced problems with widespread corruption. According to the Ministry of Foreign Affairs, firms that have not participated in corrupt practices have found it harder to enter the market. Firms also consider the quality of the Russian infrastructure low, and have experienced problems in getting basic facilities such as internet, phone and fax connections to their offices. Finnish firms have also complained much about the slow processes of getting visa and work permits for the foreigners posted

to Russia. Hence the list of problems experienced by Finnish firms in Russia is a good reminder that although investments have recently grown at a rapid pace, Russia is still a rather difficult environment to work in.

Positive income effect of Finnish investments in Russia

Have Finnish investments in Russia a positive or negative impact on the Finnish economy? In principle, investments abroad replace domestic capital formation and personnel abroad substitute domestic personnel. However, in practice the equation is not so simple. In many branches, Russia offers a new growth market and growth opportunities for enterprises that would have been impossible in Finland or elsewhere in Europe. As the world economy opens, competition is getting tougher and growth is necessary, otherwise the business is bought up. Hence, the domestic market gains if an enterprise is globally competitive. In the Russian case the Russian market has offered a sizable income for Finnish companies and many Finnish companies get a large portion of their net sales from Russia, especially on the retail and wholesale sector. Russia is for many Finnish companies the necessary and welcomed expansion market for the company to stay competitive in a global economy.

In order to analyse the income effect, we again need to base our analysis on various indicators. In its FDI statistics, the Bank of Finland also compiles statistics of the income of the direct investments abroad. According to the figures, Finnish companies have gained EUR 325 million on the period 2000–2005 from their investments in Russia, of which EUR 71 million in 2005 alone. During the period 2000–2005 Finnish enterprises have gained even quite significant returns on their investments in Russia. In 2002 and 2005 the income from the investment was even larger than the investment flow in the same year.

It is too early to conclude, whether the overall direct investments have been profitable, as most of the investment decisions are made as long term investments and most of the investments are done during the first decade of the 21st century. However, the trend and the fact that the return on the investments in 2000–2005 was larger than the investment flows to Russia in these years, indicates profitable investments. As repatriation of profits from Russia has been partly regulated, many companies have developed own schemes of transfer pricing for importing profits from their Russian subsidiaries. Such incomes are not registered in the BoF income statistics. Also returns to subsidiaries in third countries are not reported in the BoF figures. Hence, the real rates of return of the Finnish enterprises' investments in Russia are almost impossible to estimate.

Another effect of investments is their effect on the net sales and employment in Russia. According to the BoF figures, Finnish firms' subsidiaries (were

the Finnish firm holds more than 50% of the Russian firm) had 8,400 employees in Russia at the end of 2004. According to BoF, Finnish enterprise entities' net sales in Russia were EUR 960 million during 2004. Various other surveys, however, indicate these numbers to be too pessimistic. ETLA presents in its survey that the Russian personnel in Finnish owned companies in Russia was 29,600 employees and the annual net sales as much as EUR 1.9 billion at the end of 2005. A majority of the employees are of course Russian citizens and few Finns are employed by the subsidiaries.

Finnish retail business also active outside Moscow and St. Petersburg

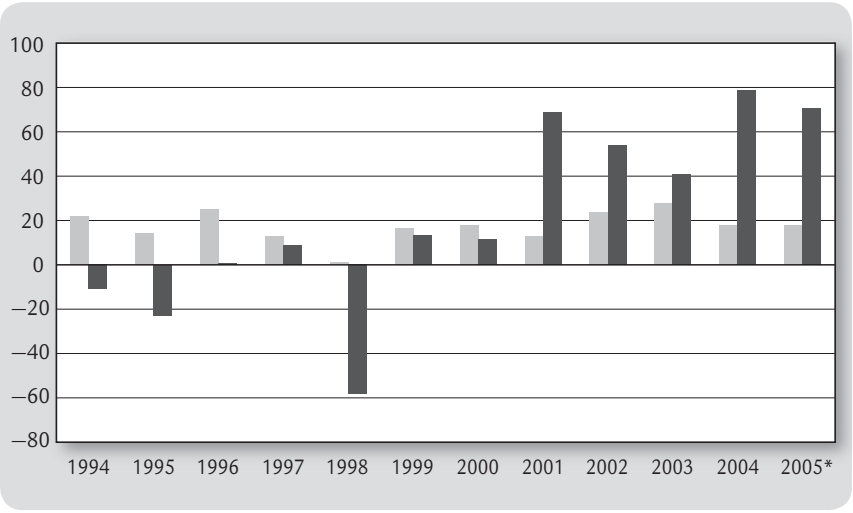
Bank of Finland figures indicate that after the 1998 crisis the Finnish enterprises' net sales in Russia increased rapidly. The trend seems to continue, as Finnish enterprises increase their investments in Russia. Although it is difficult to get detailed information about different companies' geographical distribution of net sales figures, some figures are available for the rapidly expanding retail sector.

The Association of Finnish Technical Traders (TKL) members, to which most of the companies in the Finnish retail and wholesale sector belong, estimate that their branch's net sales in Russia were EUR 800 million alone in 2005 and grew by 29% y-o-y.[12] Their forecast is that TKL member companies' net sales in Russia will exceed EUR 1 billion in 2006. TKL members employed over 3,300 Russians at the end of 2005. The Finnish retail and wholesale sector also looks quite optimistically on the future. High expectations are especially on the growing markets in the regions outside Moscow and St. Petersburg. TKL member enterprises already have trade centres or representative offices in places like Krasnoyarsk, Yekaterinburg, Magnitogorsk, Samara, Nizhnyi Novgorod, Novorossiisk, Novosibirsk and Riazan.

Maybe the most rapidly expanding Finnish retail store in Russia is the Stockmann department store chain, which in 2005 already earned over a tenth of its net sales from Russia. In comparison, the average share of net sales from Russia of those TKL members that have invested to Russia was about 6–8% in 2005. For Stockmann, the share has grown rapidly and recently the chain has expanded with many new department stores and clothes retail stores in Moscow, St. Petersburg and Kazan. Stockmann also plans to open a department store in St. Petersburg at the end of 2008, which will be of similar size to

[12] The TKL net sales figure alone was equal to the whole BoF net sale figure for all sectors at the end of 2005. We know, however, that retail and wholesale business does not dominate the investment or net sales figures. Hence, this indicates that the BoF balance of payments method clearly underestimates the real amount of investments, net sales and employment.

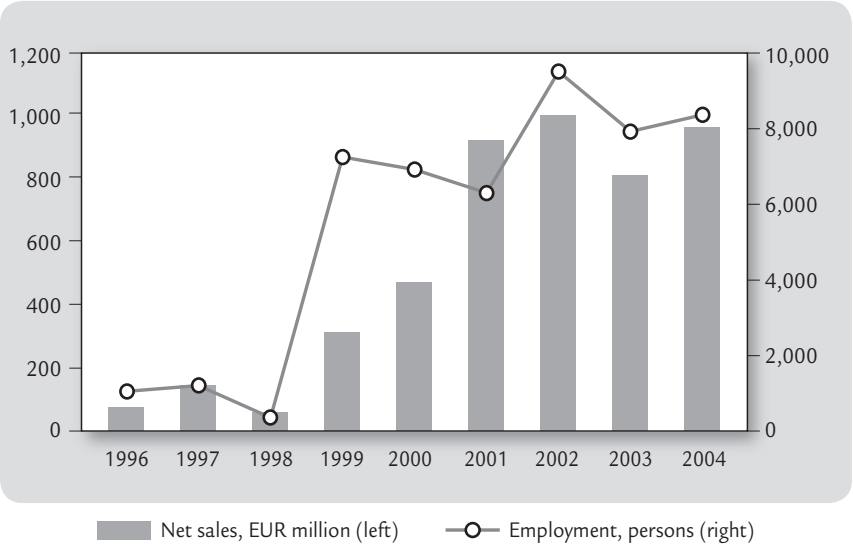
Figure 5.7 Income by country of direct investments abroad, EUR million.



*Preliminary figure

Source: Bank of Finland.

Figure 5.8 Turnover and number of employees of Finnish enterprises in Russia in 1996–2004.



Source: Bank of Finland.

its flagship in Helsinki. Once realised, this investment will enlarge the Russian share in Stockmann's net sales significantly.

Future of Finnish investments in Russia

The future of Finnish investments in Russia looks quite optimistic. The fast growing exports force many more Finnish companies to consider investing in Russia in order to keep their market positions. Moreover, Russia is the fastest growing large market area close to Finland, which offers Finnish enterprises that want to expand a natural market for it. However, the Russian market is still difficult, and problems occur, which cannot be neglected. But as in economy generally; when risks are high, so are also the profits and Russia offers many possibilities for Finnish firms to expand.

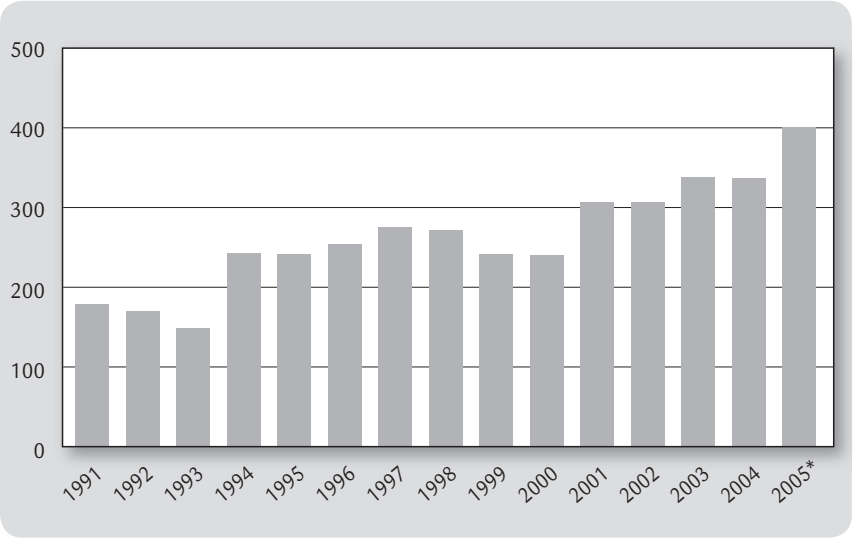
In the official discussion between Russia and Finland, the Finnish authorities have in several occasions raised the issue of an investment protection agreement for Finnish enterprises' investments in Russia. Russia has so far been reluctant to sign such an agreement with Finland, although even the Russian president promised to promote the issue on his visit to Finland in autumn 2005. The agreement is mainly desired by the Finnish forestry industry that considers the Russian forestry sector as an immature investment market for huge and expensive paper mill projects. The existence of such an agreement would for sure encourage more large Finnish investments, especially in the field of forestry, as many of the larger firms desire strict guaranties before investing in large projects. However, the lack of such an agreement has not stopped the growth of other Finnish investments in Russia.

A new interesting trend is also noted – namely the establishment of Finnish owned and managed industrial parks in Russia. As for many smaller firms the risk and problems to enter the market in Russia alone can be overwhelming. Two serious projects had been launched by mid-2006, one by Technopolis and one by Sitra. Both parks aim for St. Petersburg area and the interest to participate among Finnish companies has been large. Especially for many SMEs the participation in a Finnish run industrial park in Russia, offers attractive possibilities to enter the Russian market and decreases risks related to the acquirement of estates in Russia, which are often complicated. Hence the incentives by Technopolis and Sitra are welcomed for supporting SMEs to enter the Russian market and it will be interesting to see how the projects eventually will work.

Russian investments in Finland

According to the statistics by the Bank of Finland, the stock of foreign direct investments from Russia to Finland was about 89% of the stock of FDIs from

Figure 5.9 Stock of Russian direct investments in Finland 1991–2005, EUR million.



*Preliminary figure

Source: Bank of Finland.

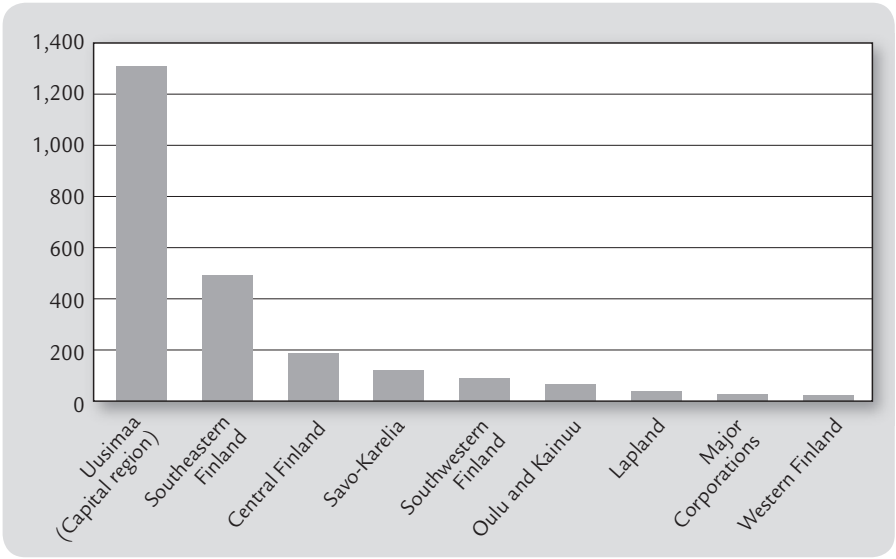
Finland to Russia. The stock of Russian investments in Finland was EUR 400 million at the end of 2005. However, many of these investments were done already during the Soviet time by some large companies, mainly in the energy sector. Quite little investments have flown after the collapse of the Soviet Union and much of the increase of the stock of investments has come from exchange rate and valuation changes. The most significant Russian owned firms in Finland are Teboil, Gasum, Suomen Petrooli, RAO Nordic and Delta Auto.

Another striking difference between Finnish and Russian direct investments is that the Finnish ones have started to bring significant income from the beginning of the 21st century, while the Russian ones have had a small and positive rate of return constantly during the decade as seen in Figure 5.7. Most of these investments and income are, however, achieved by the few large companies established in Finland for already some time ago. Although much of the investments are dominated by a few large Russian companies, Russians are also significant small and medium size entrepreneurs in Finland. So far, they have not brought significant amounts of capital to Finland, but they still have a certain effect on income and employment.

Russia-related firms most active in trading business

According to the National Board of Taxation (NBT), there existed 2,364 Finnish registered enterprises that were related to Russian citizens in June 2006.

Figure 5.10 Russia-related firms in different Finnish regions, number of firms.



Figures based on situation in June 2006

Source: National Board of Taxation.

The Russian involvement means having a Russian national either among the board members (chairperson, member or deputy member), higher management (chief executive officer, executive vice president) or a Russian national as a holder of procurator. This figure is equal to about one percentage of the firms in Finland. Nearly all of these enterprises were defined as SMEs and nearly all were established after the fall of the Soviet Union

If we leave out the firms that have not reported their tax information on a longer time and assume that they are non-active, the number of Russia-related firms in Finland was about 2,000 in June 2006.[13] Nearly all of them were limited companies. Only a small share was limited partnership companies and private tradesmen. Of the enterprises, 77 were housing corporations, which were either Russian owned houses or just a Russian citizen in a normal housing corporation's board.

[13] It is rather difficult to get a number of the real figure of active companies. The final accounts of the year 2005 were reported to the National Board of Taxation by 2,024 enterprises, which can be considered as a quite close figure of the number of Russia-related enterprises active in 2005. However, the figure does not include all the new enterprises established during the year or later in January-June 2006 and those who have ceased their activities during the period.

The geographical distribution of the Russia-related firms' location is based on the regional tax offices jurisdiction they belong to. Most of the firms were registered in the Uusimaa tax office (Capital region), where 55% of the firms were located. Second most Russia-related enterprises were found in the Southeastern Finland, with 21% of all Russia-related firms. The high number of Russian firms in the Southeastern Finland is also acknowledged in a survey by the Kotka–Hamina Region development company, Cursor Ltd, which estimates the amount of Russia-related enterprises to be about 400 at the end of 2005 and that the Russia-related firms already accounted for about a tenth of all new enterprises registered in 2005. The Central Finland accounted for about 8%, while the rest of the regions for less than 5% each. Notable is that 26 of the firms were corporations, registered under tax office for major corporations.

According to the NBT figures, a little more than a third of the Russia-related Finnish firms were registered as retail and wholesale businesses. Business services accounted for a little more than a fifth, while transport and logistics for about 13% of the Russia-related firms, then came construction with 8%, finance with 5% and manufacturing with 5%. The shares of the other sectors were small.

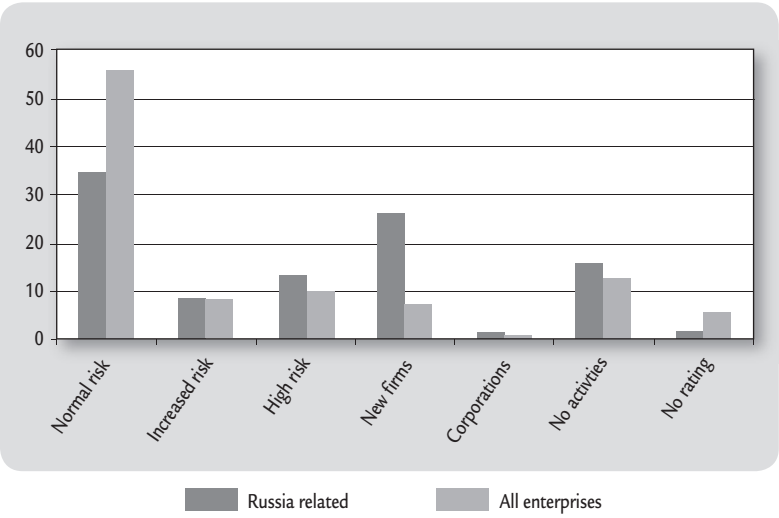
In terms of net sales, the NBT lacked information on half of the Russia-related firms' annual net sales figures, as they were new firms or for some other reason had not reported their sales figures. However, for those whose figures were available, a third were firms with net sales less than EUR 40,000 a year, about 1/6 with net sales EUR 40,000 – 100,000 , little more than 1/5 with net sales of EUR 100,000 – 400,000 and about 1/6 with net sales of EUR 400, 000 – EUR 2 million. Only a little over 10% of firms reported net sales larger than EUR 2 million and 1% net sales larger than EUR 40 million, which were mainly the major corporations.

Russian firms slightly riskier than Finnish firms

The NBT categorises all Finnish firms based on their taxation reports and the reports issued by two rating agencies.[14] The NBT estimates that Russia-related

[14] The risk definition is taken from the Finnish National Board of Taxation's database in May-June 2006. The database is administrated by the development project for cooperation between public authorities relating to fighting black economy and financial crime, appointed by the Ministry of Finance (VIRKE). The NBT database defines companies in different categories by combining information about the companies from their annual reports to NBT, the Finnish patent and registration government's database and the databases of rating agencies Suomen Asiakastieto and Dun & Bradstreet. The risk itself is categorised as normal, increased and high. Increased risk means some minor negligence of obligations by the enterprise or its agent, while high risk means negligence of obligations.

Figure 5.11 Risk categorisation of Russia-related firms and all firms in Finland*, %.



*Based on data from May–June 2006

Source: National Board of Taxation.

firms were generally slightly riskier than the average of all firms in its register. Of the Russia-related firms according to the NBT definition 22% were categorised as enterprises of increased or high risk.[15] The equivalent figure for all enterprises in NBT's register was 18%. As many as 13% of Russia-related firms were categorised as being of high risk, while 10% of all firms fell into this category. A little more than a third of Russia-related firms were enterprises of normal risk, while of all firms normal risk had little more than half of the enterprises. Of Russia-related firms, a fourth were new enterprises, which had not yet submitted the whole first year's accounts so they could not be classified yet. The same figure for all enterprises was 7%. The high number of new Russia-related enterprises in June 2006 indicates a significant current rush of Russia-related enterprises to Finland.

The reasons for entrepreneurship among Russians in Finland differ. A large and growing group is Russian corporations that aim for expansion to Finland. These are enterprises mainly in the retail, wholesale, logistics and transport businesses and are located in the capital, harbour and border ar-

[15] The figures are based on authors' calculations of the NBT database, and here we have cleaned the firms that have been closed down out of the figures. We have included limited companies, limited partnership companies and private tradesmen, but left the 77 housing corporations out of the calculations as their risks are not defined in the NBT database. The 26 corporations are included, but their risk is not categorised.

eas. Most of these firms work with export or transit business to Russia. Some reasons for Russian firms to establish subsidiaries in Finland could be the following:

- **Access to Finnish public services:** Finnish legal entity gives better access to Finnish public service systems, when having activities in Finland.

- **Access to Finnish finances:** A Finnish legal entity is often required in order to get finances from Finnish banks for operations in Finland. In some cases, the finances may be transferred to Russia through various schemes.

- **European firm entity:** Being a European firm can, in some cases, make it easier to buy products on European market for exportation to Russia.

- **The Russian value added tax scheme:** By buying products in the Finnish firm's name, storing them in Finland and only exporting when needed to Russia, the firm does not need to pay all high Russian VAT at once.

- **Risk control:** For some firms the reason for establishment in Finland can also be to minimize the Russian country risk and to compensate for the lack of legal protection there, e.g. in the field of intellectual property rights. It can be advantageous to register a Russian innovation in Finland rather than in Russia, due to poor patent protection rights in Russia. In transit business many Russian companies store their value goods on their way to Russia in warehouses managed by their subsidiaries in Finland. In some cases Finland can also be a safe haven for murky Russian capital and Russian entrepreneur wants to save his/her earnings in a Finnish legal entity.

- **Use of grey schemes:** In some cases the Finnish legal entity is used to hide the true sellers and the costs of the goods. Then the double invoicing at the border is harder to perceive (see also Section 3).

Another reason for the large number of Russia-related enterprises in Finland is immigration, as immigrants establish firms to gain employment for themselves. This phenomenon is called immigrant entrepreneurship and for an im-

migrant it is often the easiest way to get employment if foreign origin, poor language skills or cultural differences are obstacles to the labour markets. Usually, the entrepreneur is the only worker in the firm, so the employment effect of immigrant entrepreneurship is not huge. Nearly all of the Russia-related firms outside the capital, border and harbour regions are immigrant entrepreneurs. However, to distinguish between Russian immigrant entrepreneurship and subsidiaries of Russian firms in the Finnish capital, harbour and border region is much more difficult. The fact that the number of new enterprises is growing so rapidly, while the Russian minority only grows slowly, indicates that the Russian subsidiaries dominate among the newly established Russia-related enterprises in Finland.

According to a study from 2005 by the Northern Dimension Research Centre at the Lappeenranta University of Technology, Russian firms' main barriers to business in Finland are: getting suitable business contacts in Finland, lack of language skills and a lack of available information. Especially for SMEs it has been difficult to find information on how to function in Finland and get access to public support. There are not many centres that provide information for Russian companies in Finland, while there are many that provide information for Finnish companies on how to get to Russia and other markets. Some firms also complained about the unequal attitudes towards Russian companies in Finland.

One of the centres that provide information for Russian entrepreneurs in Finland is the development company of Kotka-Hamina region, Cursor Ltd. Cursor has also experience of many Russian owned firms having unrealistic business plans and erroneous expectations of the size of the Finnish market. There have also been cases were Finnish firms have cheated their Russian partners. It has also been a problem to acquire finance for operations in Finland, as Finnish banks are often reluctant to finance Russian clients.

Effect of Russia-related firms on Finnish economy

According to the database of the National Board of Taxation the net total sales of the Russia-related firms in 2005 were EUR 7.5 billion, which is equal to about 3% of Finnish enterprises' total net sales. According to the firms' own declarations they employed 8,063 persons in Finland in 2005. This was equal to about 0.5% of the private sector employment and 0.3% of total employment. On average, Russia-related firms seem to be employing fewer employees per firm than firms in Finland overall. The average for Russia-related firms was 3.9 employees per firm while the whole country's average was 5.6 persons per firm. If the Russia-related firms were to be as active as the rest, they should employ about 10,500 people in all. The smaller share of employment can largely

be explained by the distribution of Russia-related firms: they are mainly SMEs with a small employment effect and only a few large corporations.

Although the Russia-related firms only accounted for roughly 1% of all firms in Finland, their share of total net sales was still higher, while their employment effect was less. This can partly be explained by the fact that most enterprises are involved in trading to Russia, where value of trade is usually relatively large, but generated by a small number of employees. Moreover, the definition "Russia-related" does not necessarily tell if the firm is owned by Russians or only has some senior manager who is a Russian citizen. When enlarging activities into Russia some Finnish corporations in particular have hired Russians as managers or board members to deepen the knowledge of the market. Hence, some of the corporations are probably Finnish, which causes an overestimation of the net sales figure and the employment effect.

The rapid growth of Russia-related enterprises in Finland seems to be largely correlated with the fast growth in trade and transit traffic to Russia. The distribution of firms is similar to the one of SMEs in exports to Russia and clearly trading companies dominate the distribution, followed by transport businesses. In regions like Kotka-Hamina a tenth of the new companies are already Russian owned. The effect of their ownership is mainly positive, as seen above, but in some cases grey economical activities are also involved. Not all Russia-related firms are by any means active in grey schemes, but some firms are established for complicating the officials' attempts at tracking goods shipments to and from Russia and for falsifying documents. Also re-exports are often dubious and generally handled by the Russia-related trading companies in Finland (see more about re-exports in Section 3). On average, Russia-related firms also had more often neglected their obligations, and were generally seen as slightly riskier than the average stock of firms in Finland. Thus, it is worth monitoring the development of Russia-related firms, preventing grey business practises to blossom and supporting good Russian business propositions in Finland.

Those regions where the number of Russia-related firms grows rapidly are the same regions where transit traffic is blossoming. Russian trading and transport firms are increasingly interested in acquiring Finnish transport infrastructure, which is understandable as nearly a quarter of Russian imports head through Southeastern Finland to Russia and Finland has become a significant transport corridor to Russia. However, if Finns want to maximise the income effect of the increased trade and transit, it could be clever also to keep some of the infrastructure in Finnish hands. If all trucks, warehouses and ports go over to Russian ownership, the income effect on the Finnish economy will decrease and mainly the negative effects will remain. Hence, some strategies and discussion on how to maximise the posi-

tive effects in Finland from the trade and transit traffic to Russia would be good to have.

Conclusions: The effect of investments mainly positive

Finnish firms increasingly invest in Russia. Finns, however, invest mainly for establishing production for the Russian market rather than to respond to global demand. So far, most of the Finnish investments have gone to the Northwestern and Central federal districts, but potential is starting to be seen in many regions farther away. Finns also mainly invest in sectors that are not considered strategic from the Russian perspective. Consequently, the political risks become smaller.

Although there has been much discussion on whether Finnish firms repatriate profits from Russia or not, the figures clearly show that most of the investment streams have already returned as profits, although the period of positive returns has so far been quite short. Investments are generally made on a long term basis, so the effect will probably be much larger in the future. It is also worth noting that some Finnish firms have been sold abroad due to successful operations in Russia. Hence, the investments in Russia have been important for Finnish firms in enlarging both their market and net sales, and in consequence have increased the value of the firms. In general, the Russian market has mainly been and remains a worthy investment for Finnish enterprises.

There are currently no direct clouds visible on the horizon for Finnish investments in Russia. Various surveys indicate a strong optimism about the Russian market among Finnish firms and as much of the investments are long term, and the investment flows started to grow in 2005, the trend will probably not decline directly, but stay and maybe even grow in the coming years. Finnish business seems to view the possibilities on the Russian market in quite an optimistic light.

Russian investments' and firms' affect on business in Finland has been studied quite little, so far. Based on the foreign direct investment figures issued by the Bank of Finland, Russians have invested in Finland nearly as much as Finns have in Russia, but most of the investment already came during the Soviet time and at the beginning of 1990s and concerns only a few large firms. The investment stock has recently increased, largely due to the changes of valuations and exchange rates. Hence, investment flows on a larger scale to Finland from Russia have not yet been witnessed. Also the income effect for Finland from these investments is not as significant as for Finnish investments in Russia.

Russians have established a lot of SMEs in Finland and the number of Russia-related firms in Finland is about 2,000. These firms are mainly located at the border, harbour and capital region and are related to trade and transit to Russia. The Russia-related firms' employment and income effect on the Finnish economy is currently still quite modest. In employment terms it was 8,100 persons or 0.3% of the employed in 2005, which is slightly less than the Russia-related firms' share of firms. The continued growth of exports and transit traffic to Russia also indicates a continued rapid increase in the amount of Russia-related enterprises in Finland.

6 Trade in services

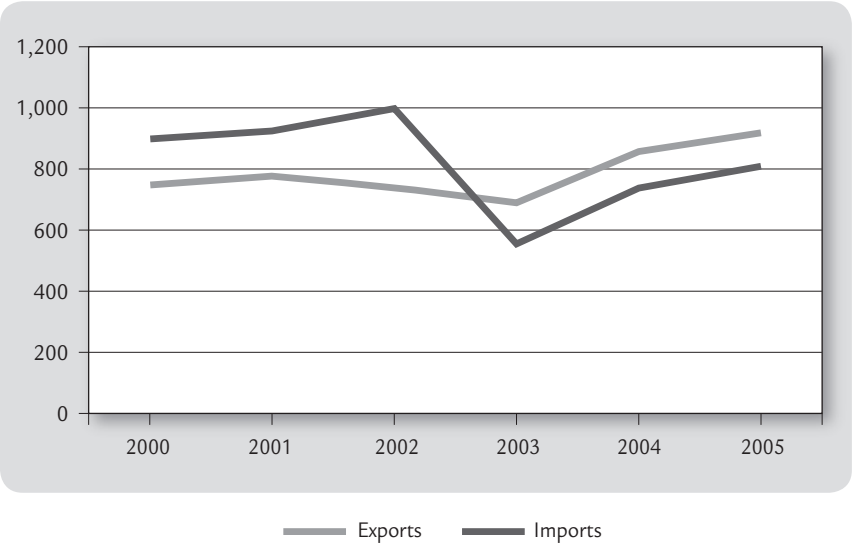
Finland exports travel and construction services, imports transport services

Often studies on foreign trade focus only on the trade in goods, as they traditionally form a clearly larger part of the foreign trade than services. However, the significance of trade in services is increasing, and Finland's export of services has also been growing steadily past years. According to the preliminary balance of payments statistics for 2005, the share of services in Finnish total exports reached 14%. The share of services in Finnish exports to Russia was at the same level.

As in goods exports, Russia has become one of the most important export markets for Finland in terms of services exports. The value of service exports to Russia was rather stable until a peak in 2004, when it grew by a quarter. The upward trend continued also in 2005, and Russia was the second largest export market of Finnish services, although clearly behind Sweden. Russia's share in Finnish services exports was 11% to a value of EUR 920 million. According to Eurostat's balance of payments statistics, Finland accounted for nearly 10% of total services exports of the EU25 to Russia in 2004 (the latest figure available). In terms of Russian services imports, Finland was in 2005 in the fourth place with a share of 5%.

In terms of Finland's total services exports have dominated other services, transport and travel, each accounting for about a fifth share. The sectoral distribution of Finnish services exports to Russia is, however, somewhat different. This is largely due to the fact that the category of other services includes many services between affiliated enterprises, which in the Finnish case mainly concerns Western markets and not Russia (see Section 5). In 2004, Finnish services exports to Russia consisted mainly of travel services and construction services. Travel services were also the most important sector in the total import

Figure 6.1 Finland's trade in services with Russia in 2000-2005, EUR million.



Source: Bank of Finland, Eurostat.

of Russia accounting for nearly half of the value of Russian services imports. Other larger sectors were unspecified business services and transport services.

As we can see in Figure 6.1, travel services have dominated Finnish services exports to Russia in recent years, while the significance of construction services has increased and that of transport services decreased. The travel sector will be discussed in more detail below. In the construction sector Finnish companies have rich experience of the Russian markets, as Finnish companies carried out several construction projects already in the Soviet Union. In 2004, there was a considerable leap in the exports of Finnish construction services exports to Russia and nearly half of construction services exported from Finland was destined for Russia. Although it should be noted that as the projects in the construction sector are often large and last fairly long, the annual variation can partly be explained by the rarer entering of income. But the positive trend has prevailed also in the total imports of construction services to Russia, as the Russian construction sector has been growing over 10% annually past few years.

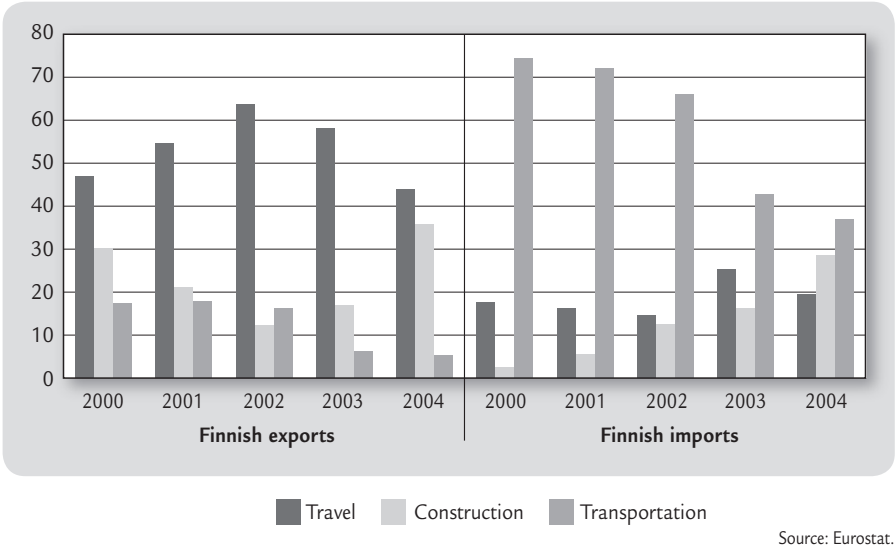
In the transport sector the development has been quite the opposite. The value of Finnish exports of transport services to Russia diminished notably in 2003 and has stayed at a lower level. Especially the value of sea transport services has declined. Russian companies have gradually gained market shares at the expense of Finnish ones in transportation between Finland and Russia (see Section 4 for more on transit and transportation). Russian total imports of

transport services have, however, been growing throughout the decade, but the growth has obviously come from other sources than Finland.

In terms of total Finnish imports, services have accounted for roughly 20% during the whole decade. However, looking at Finnish imports from Russia, the share of services has been somewhat smaller, reaching 12% in 2005. Russia has become a rather important trading partner for Finland in imports of services. Finnish services imports from Russia grew steadily until a sharp drop in 2003, when their value diminished to nearly half. The drop was caused by a considerable reduction in imports of transport services. After the drop, imports have turned upwards again, and in 2005 their value climbed to EUR 800 million. The share of Russia in Finnish services imports was about 8%, but before it were Sweden, the US, Germany and the UK. For Russia, Finland was the 9th largest export market in services trade. In the services imports of the 25 EU countries from Russia, Finland accounted for more than a tenth in 2004.

The largest groups in Finnish total imports of services in 2005 were transport services, other services and travel services. In services imported from Russia to Finland the most important sectors have been the same as in Finnish exports to Russia. Transportation services have prevailed as the most important services imported from Russia during this decade, but their share has decreased notably in past years. Finland has imported mainly sea transport services from Russia, but in 2003 their value plummeted to only about a third of the preceding year. On the contrary, imports of construction services in-

Figure 6.2 Share of travel, construction and transport services in Finnish services trade with Russia in 2000–2004, %.



Source: Eurostat.

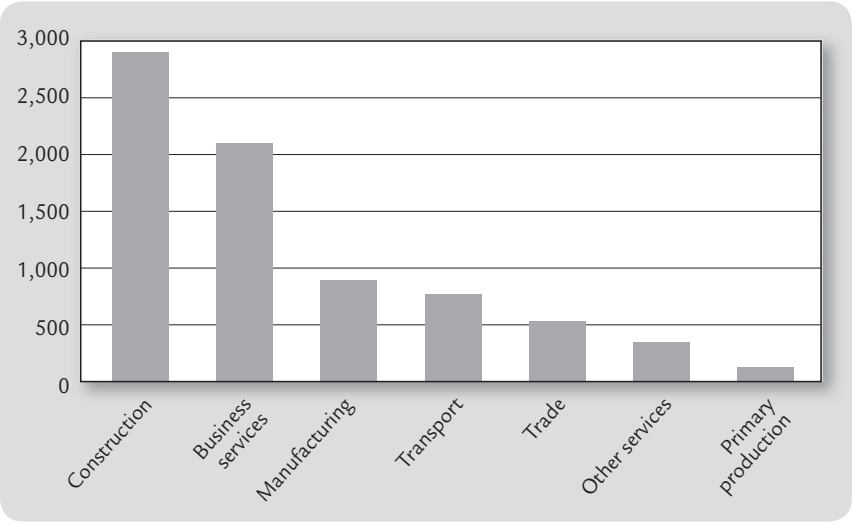
creased considerably in 2004. The share of travel services has stayed fairly stable throughout the decade. Transportation and travel services have been the main branches also in the total services exports of Russia during this decade.

Economic effects of trade in services

Services exports to Russia have also a rather sizeable impact on the Finnish economy and employment. First we concentrate on the economic effects of trade in services excluding travel services, and then we discuss the travel sector. The effect on output and employment is calculated in the same way as with the goods exports, i.e. using input-output tables. When taking both the direct and indirect effects on Finnish production into account, services exports contributed about EUR 800 million, or the equivalent of 0.3% of Finnish output, in 2004. The effects were naturally the most significant in sectors providing the most exported services, such as construction, business services and transport. But services exports had also some indirect effects on industrial and agricultural sectors, thereby also increasing the production of those sectors by a total of more than EUR 100 million.

The impact of services exports to Russia is relatively even more significant when measured by the people they employ. This is due to the fact that the service sector is, by far, the main employment sector in Finland, employing about two thirds of all the work force. The total employment effect of the

Figure 6.3 The employment effect of Finnish services exports (excl. travel services) to Russia in 2004 by sectors, persons.



Source: Authors' calculations based on the statistics by Statistics Finland and Eurostat.

Finnish services exports (excluding travel services) to Russia reached to over 7,000 people in 2004. The effects were focused on the construction sector and business services, where the employment effect was nearly 3,000 and 2,000 people, respectively. The employment effect was large also in the transport sector as well as in the wholesale and retail trade. However, the indirect employment effect of services exports to other sectors of the Finnish economy was also almost 1,000 people in 2004.

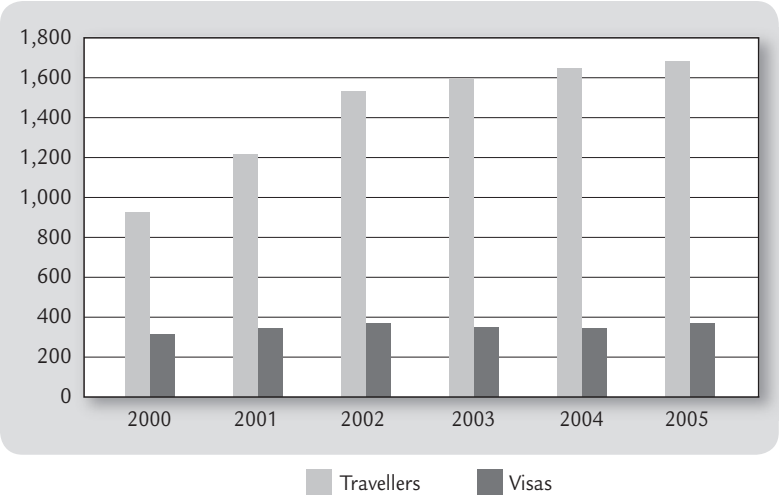
Russians' travel and tourism to Finland

As presented above, travel services have been the most important sector in Finnish services exports to Russia. Russian travellers are indeed a significant group for the Finnish travel industry. The number of Russian travellers to Finland has grown slightly but steadily throughout the decade. According to the preliminary figures for 2005, the Russians were still by far the largest group of travellers coming to Finland. Of the 5 million travellers who arrived in Finland in 2005, a third came from Russia. Besides Russia, most travellers come to Finland from Sweden, Estonia and Germany. It has to be noted, however, that this figure reflects only the number of times that foreigners have crossed the Finnish border, so if the same person comes to Finland several times, it is always counted as a new visitor entering Finland.

Although Russian tourists are the largest national group entering the country, they are only third largest group of travellers when measured by the number of overnights in Finnish accommodation facilities. Less than third of Russian travellers use the services of Finnish accommodation facilities at all, whereas, for example, every German visitor spent, on average, 1.6 nights in Finnish accommodation facilities. Due to its proximity, Russians often do day trips to Finland. Moreover, Russians often use Finland as a gateway to other countries within the Schengen area, as in many cases Finnish visas are more convenient to apply than a visa for the final destination country. In addition, some Russian travellers have friends or relatives in Finland, at whom they can spend their nights. According to Finnish statistics, the share of travellers coming to visit their friends or relatives in Finland was about 7% in 2005.

As we can see in Figure 6.4, the number of Russians coming to Finland has been considerably larger and grown clearly faster than the number of visas issued by the Finnish representatives in Russia. In 2000, a Russian traveller came to Finland on average three times, but in 2005 already 4.6 times. In 2005, nearly 1.7 million Russian travellers came to Finland, but less than 0.4 million visas were issued by the Finnish representatives in Russia. Thus, it seems that the Russians' visits to Finland have concentrated on fewer people in recent years.

Figure 6.4 Russian travellers coming to Finland and number of visas issued by Finnish representatives in Russia in 2000–2005, 1,000 persons.



Source: The Ministry of Foreign Affairs, Finnish Tourist Board.

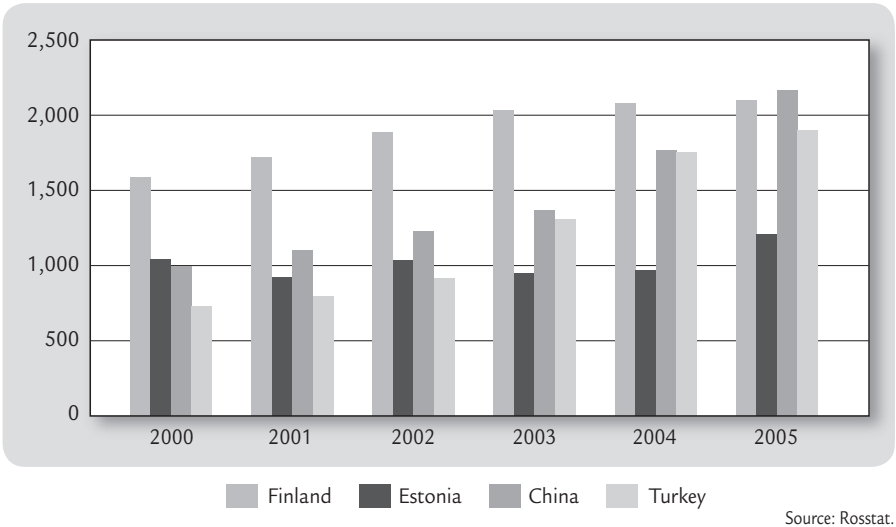
According to the Finnish Tourist Board the most popular time to come to Finland for Russians is the winter, especially December and January, during their New Year holidays. In contrast, the other largest passenger groups, such as Swedes and Germans, mainly come to Finland in the summer. Russians also like to come to Finland during their most common summer holiday months of July and August. More than half of the Russian travellers come to Finland to spend their leisure time or visit friends and relatives, whereas business trips accounted for a fifth of visits.

Most Russian travellers coming to Finland are from St. Petersburg and Moscow and they come to Finland using land routes. For Russians, the most popular destinations in Finland are the so-called Lake-Finland area in Central and Eastern Finland as well as Southern Finland including the capital area. According to an interview survey carried out in 2003–2004 by the Helsinki School of Economics, what Russians appreciated the most about their visit to Finland was the cleanness and safety of the environment, the friendliness of the people and Finnish nature. The most disappointing things for the Russians had been the price level and the weather.

Finland's significance for Russia as a travel destination

Whereas Russian tourists are important for Finnish tourism business, Finland is also one of the most popular travel destinations for Russians. Rus-

Figure 6.5 Travels of Russians by main non-CIS destination in 2000–2005, number of journeys.



Source: Rosstat.

sians' travel has increased, especially in the past few years, as their income has grown. According to Rosstat, which reports only the number of journeys, in 2005 Russians travelled (crossed the Russian border) altogether about 28.5 million times, of which about half were destined for countries other than CIS countries. This implies that on average, every fifth Russian travelled outside the country in 2005, but only every tenth of them travelled to other than CIS countries. It must be noted, however, that according to Rosstat, the journeys Russians make to the CIS countries are mainly regarded as "personal", e.g. visits to relatives or acquaintances, and not tourism. Of journeys made to other than CIS countries, over 40% were regarded as tourism in 2005. The share of personal journeys was also high.

Finland was the most important destination for Russian travellers among non CIS-countries until 2004 but in 2005 China rose as the top destination. So far, Finland has been able to maintain its attractiveness as a resort, but Russians' journeys to China, Turkey and Egypt have increased at a faster pace. The popularity of Turkey and Egypt can be partly explained by the fact that Russians do not need a visitor's visa to enter those countries.

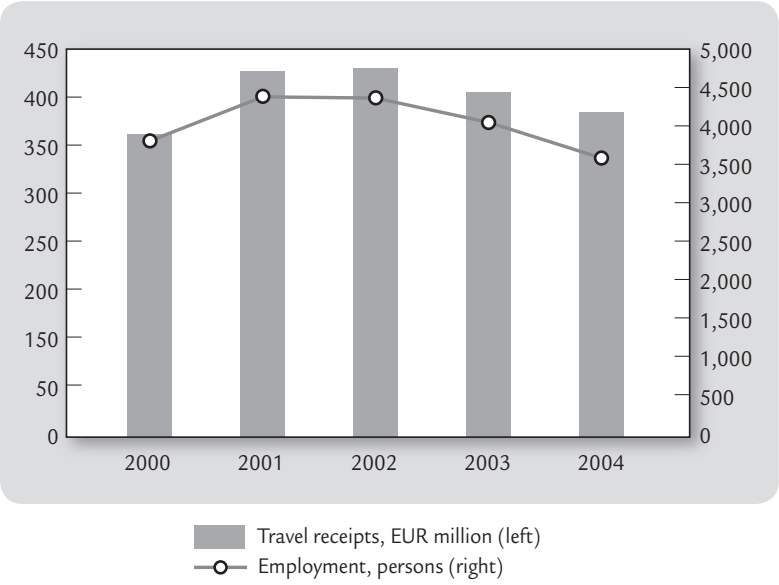
Economic effects of the Russian travel to Finland

Of the foreign travellers visiting Finland, the Russians have brought the highest travel receipts to Finnish travel business during this decade. Although the total

value of travel receipts received from the Russian travellers diminished slightly until 2005, it rose again to over EUR 400 million according the preliminary figures. In 2005, travel receipts from Russian travellers accounted for nearly a quarter of total travel receipts collected from foreign visitors. One reason for this is naturally the high number of Russian travellers, but the other one is that their daily spending in Finland has been among the highest.

In 2005, Russian travellers spent on average EUR 88 per day, which was the second highest average spending after the Chinese. Russian travellers spend by far the largest share on shopping. This is partly explained by the large number of same-day visitors, who often come to Finland primarily to shop. The spending of Russian tourists on shopping in Finland may diminish or at least the purchased goods are likely to change as the amendments to the customs legislation came into force at the beginning of 2006. According to them the maximum weight of tax free shopping was diminished to 35 kilograms per passenger in order to abolish grey imports by private citizens. It is likely that the purchases made by Russian travellers who used to buy construction materials or spare parts for cars in the Finnish border towns will reduce as a consequence of the new restrictions.

Figure 6.6 Travel receipts received from Russian travellers and the employment effect of Russian travellers in 2000–2004.



Source: Statistics Finland, Finnish Tourist Board, authors' calculations.

We have to evaluate the employment effect of Russians' travelling in a different way than the effects of other services, because the travel services include several types of services and it is rather difficult to divide the value of them correctly by sector. Thus, we have used the share contributed by Russian travellers to Finnish consumption of travel services as an approximation of the employment effect. In 2004, the Russian travellers accounted for about 6% of the total consumption of the travel services in Finland. As the sector employed about 60,000 people, the employment effect would correspond to over 3,500 Finnish people employed in the travel sector. In addition, there are some indirect effects, e.g. Russian travellers' consumption in Finnish restaurant sector is also reflected in the agricultural sector and foodstuffs industries providing inputs to restaurants, etc.

Conclusions: Construction and travel – the key services sectors

Although trade in services is conducted on a clearly smaller scale than the goods trade between Finland and Russia, as well as with other countries, it still has a significant effect on the Finnish economy. Russia is among the most important trading partners for Finland, also in services trade. Both Finnish exports to Russia and imports from there are concentrated on the same sectors: construction, travel and transport. The impact of Finnish services exports on Finnish output is notable, but even more significant is the employment effect of them, as the service sector is by far the largest employer in the Finnish economy.

The total effect of Finnish services exports to Russia on Finnish output was over EUR 1 billion (0.4%) in 2004. The effect was naturally largest on the most important export sectors, but the indirect effects were reflected in the whole Finnish economy. Although the impact of services exports on output was only about a fifth when compared to the impact of goods exports, services exports have a clearly more significant impact on Finnish employment. Services exports to Russia in 2004 had an employment effect of more than 10,000 persons on the Finnish economy, which corresponds already to a third of the effect of the goods exports. The employment effect is concentrated especially on sectors related to travel, but it is also significant in constructing, trade and business services sector.

What about the future perspectives of Finnish services exports to Russia? First, the construction sector has good prerequisites for continuing its exporting success to Russia. The construction market in Russia is growing fast and the trend will probably continue, since there is still a vast unsatisfied demand for new apartments, offices, warehouses and production plants, as well as

for renovating services. The future may not seem that bright for the transport sector. Russian enterprises have gradually gained market shares and are at present clearly dominating over Finnish ones in the transport sector. The costs are considerably higher for the Finnish transport companies than for Russian ones, which naturally makes it harder to compete against them. Russian transport infrastructure and facilities are constantly developing, which will tighten the competition in Russian markets. For the travel sector, there is a vast yet unrealised client potential in Russia, as at present merely a small fraction of Russians can afford to travel abroad at all. Finland's trump cards as far as attracting Russian tourists are concerned are the country's nature and tranquillity, as well as shopping possibilities. Although in the longer term it is likely that the significance of shopping trips to Finland will decrease, as the same items will become available in Russia, at the same or even cheaper prices.

7 Conclusions: The effect of Russia on the Finnish Economy

Economic effects on Finland

It is quite obvious that Finland has benefited from the strong economic growth of Russia during the present decade. Finnish exports to Russia have increased considerably during the past years and Russia has risen back to being among the most important trading partners of Finland. In 2005 already 12% of Finnish foreign trade was with Russia. According to our calculations, exports to Russia increased the Finnish output by more than EUR 5.5 billion, accounting for slightly over 2% of the total output in 2004. In some industrial sectors the effect was even larger. Among the EU25, Finland has become the most dependent on Russia in its exports. The significance of Russia as a trading partner for Finland has also been fortified as Russia has become increasingly more important source of energy and raw materials for Finnish industries.

Also transit traffic through Finland has grown rapidly since the fall of the Soviet Union. If we calculate together the value of transit traffic and exports to Russia, a quarter of Russia's total imports already go through Finnish territory. Transit traffic certainly has an effect on the Finnish economy, especially in Southern and Southeastern Finland. The effect of transit business for Finland mainly concerns the harbours and facilities around them and seems to be limited for the rest of the economy. The transit business, however, brings entrepreneurs to Finland from Russia and a significant share of the SMEs in Southeastern Finland is Russian owned and involved in trading and transportation business to Russia. These enterprises employ people and pay taxes to Finland.

Finnish firms have also increased their investments in Russia. So far most of the Finnish investments have gone to the Northwestern and Central federal districts, but today Finnish firms are increasingly looking for investment objects further away from Finland close to the million cities, where market poten-

tial is large. It is notable that Finns invest mainly for establishing production for the Russian market, rather than because of cheap labour. Finns also mainly invest in sectors that are not considered strategic from the Russian perspective, where the political risk is smaller.

Finnish firms have already profited from their investments in Russia. In 2000–2005 the income from the investments has been larger than the investment flows. Russia is also currently the fastest growing destination for Finnish industrial firms' investments abroad. Hence, Russia offers Finnish enterprises a prosperous growth market, which supports the firms' global competitiveness.

Russia has also become one of the most important markets for Finland in services exports and a moderately important trading partner for Finland in imports of services. Russians were the largest tourist group visiting Finland in 2005 and the one that consumed the most. Also trade of construction and transport services to Russia are significant income sources and employers in Finland.

Russian employment effect in Finland

The interesting question is how many people these economic activities with Russia employ in Finland. We have only focused on the trade of goods and services, transit and investments. Of course there are more fields of co-operation, but these are the main ones. We calculated that in 2004 the total employment effect of the goods exports to Russia reached to over 34,000 persons, whereas that of transit business reached to roughly 4,000 persons in 2003. Moreover the NBT register told us that the Russia-related firms in Finland employed 8,100 persons in 2005. Finally, we estimated that the trade in services (inc. tourism) employed 10,500 persons in 2004.

The figures are from various years and trade figures include also the indirect effect, while the others are the direct effect. The situation has probably changed over time in some fields, so of course the comparability of the numbers can justifiably be criticised, but they still serve our goal; to give a rough picture of the situation. The figures concerning Russia-related firms are especially difficult, as those Russia-related firms participating in trade with Russia are also included in trade and transit statistics and hence need to be excluded from the total employment figures. Therefore in Table 5.1 we present a rough estimation of 46,600–52,600 persons in Finland who are employed by economic activities conducted with Russia. Russia-related firms participating in trade of goods and services and transit form about little more than half of the firms, so the average of the range is probably quite exact. Consequently, about 50,000 persons earn their income from Russia's current prosperity. This is equal to about 2.1% of total employment in Finland.

Table 5.1 The Russian employment effect in Finland, number of employees.

	Year of data	Employment
Trade of goods	2004	34,000
Tourism	2004	3,500
Other trade of services	2004	7,000
Transit traffic	2003	4,000
Russia-related firms in Finland	*2005*	*8,100*
Employment related to Russia		46,600 – *52,600*
Total employment in Finland	2005	2,401,000
Russian employment effect, share of total employment, %		1.9 – 2.2

Italic = Russia-related firms' employment effect included in figure Source: Authors' own calculations.

While comparing the share of Russia-related workplaces in Finland to other fields, the employment effect is slightly less than for the consumer durables industry (57,000) and slightly higher than the banking and insurance sector (47,000) and mail and telecommunication services (47,000). Hence, the Russia-related business in Finland is notable and as co-operation is increasing on all fields, the effect will probably be much higher in the future.

The effect is, however, still much smaller than during the bilateral trade regime with the Soviet Union and its best days in the early 1980s. In 1985 the employment effect was nearly 150,000 persons, which was equal to 6% of the total workforce. The effect at that time was concentrated only on trade of goods and services. Now it is much broader and includes transit traffic and many Russian firms in Finland.

The negative effects are mainly related to the grey economy

The increased trade and transit traffic through Finland also have some effects on the economy that can be considered worrying. An increasing share of the growth of exports has been attributable to re-exports. We estimated that in 2004 at least a quarter of Finnish exports to Russia were de facto re-exports. Their impact on Finnish income and employment is significantly lower than the impact of "real" exports actually produced in Finland. For example the volume of Finnish exports to Russia was nearly as much as to Germany and Sweden in 2004, but the employment effect only 2/3 due to re-exports. Currently, a majority of the largest product groups in Finnish exports to Russia are partially or totally re-exported goods. Mostly the same product groups have also been growing fastest during the past years. There are various reasons why

goods head through Finland as re-exports. Partly, it is a side effect of transit traffic, partly an option for Finnish exporters to fill the Russian import demand in products that Finnish industry does not produce and partly – unfortunately – also related to the grey economy. By trading the goods a number of times before importing them to Russia, it becomes harder for authorities to follow the shipment and easier to implement various grey schemes in imports.

Russian trade has already been afflicted by grey schemes since the demise of the Soviet Union. Despite various authorities' efforts, it has not yet been possible to root out grey trade. In 2005 the discrepancy between Finnish and Russian customs statistics was 57% and after we excluded our estimate of re-exports the discrepancy was still 32%. The discrepancy is of course also large on other Russian borders, but that is not a reason to ignore it. The evident economic effects of grey trade are realised as lost tariff and tax income of the Russian Federation, but it also has indirect effects on Finland, such as increasing biased competition and introducing unhealthy business practices in Finnish business. Grey trade should not be regarded as solely a problem of Russia. The problem of grey trade should also be tackled at the European level in order to assure effective results.

The fast growth of Russia-related trading and transport firms can also be partly seen as worrying. The Russia-related firms' number increases rapidly and e.g. in the Kotka-Hamina region their share of new enterprises was already about a tenth. And we know that these business fields are those dominated by grey schemes. The whole transport business to Russia is mainly dominated by Russian firms, and the use of double invoicing is more a rule than an exception. Hence, we have a strong suspicion, which was also supported in our discussions with customs authorities, that there is a lot that is dubious in some of the Russia-related trading firms' records. Of course most of the Russia-related firms in Finland are by no mean dirty, but some still are and on those firms' activities the Finnish authorities need to put more focus on.

The situation is difficult, as most of the grey schemes are used for avoiding high Russian import tariffs. If the Russian Federation lowered significantly its custom duties and other tariffs on imported goods, the grey activities around the trade would decrease. However, it is quite unlikely to happen as the Russian Federation is currently earning a third of its budget incomes from custom duties. Even when Russia becomes a member of the WTO, it is unlike to change the current situation significantly.

What about the future?

What are the future perspectives for economic co-operation with Russia? On average, the Russian economy has grown over 6% annually since the 1998 economic crisis. Economic growth is driven greatly by the unprecedentedly high

price of crude oil as well as consumption-led growth in the production sector. Most forecasters do not expect any sudden falls in overall Russian growth in the short and medium terms, as oil prices are largely assumed to remain high. Of course there are structural problems and certain uncertainty in the economic policy, but over all the economic policies seem to be stabilising. We assume the economy will continue to grow at a brisk pace for the rest of the decade. Optimism in the economy also predicts continued fruitful development of Finnish-Russian economic relations.

Trade will probably continue to grow at a rapid pace, but as Finnish direct investments also increase, there are doubts how long the growth of exports can continue at its current pace. Russia will probably stabilise its position as Finland's largest trading partner, but the trade will probably never again account for a quarter of Finnish foreign trade as it did with the Soviet Union in the early 1980s. There are also some worrying elements in trade that need to be focused on; especially part of re-exports and grey schemes. If re-exports continue to grow at their current brisk pace, re-exports will already be larger than Finnish produced exports to Russia in 2009.

Also transit traffic to Russia is expected to continue to grow rapidly, as Russia's total imports are expected to continue to grow at a fast pace and Russia lacks own import harbours in the Gulf of Finland. The growth of passenger car transit is expected to slow down after 2008, while the transit of consumer electronics is expected to remain high and probably still increase. Strategically, Russia aims for independence in its foreign trade logistics, which has been seen so far in Russia's exports. In the long term we will probably also see it in imports. However, the current strong position gives space for manoeuvre for the Finnish authorities and enterprises to sharpen strategies to keep their current positions.

The prospects for investment growth look positive. There are no direct clouds visible and optimism among firms regarding the Russian market, as reported by various surveys, indicates that investment growth will continue for a while. Although Russia is seen as risky and insecure market, Finnish firms increasingly invest and succeed there. Finnish firms have also repatriated nearly all investments as income from Russia. When the Russian economy and politics have become more stabilised, investments growth will probably even accelerate.

Russian investment to Finland will probably also continue to grow. Currently the stock of investments is only slightly smaller than the stock from Finland to Russia, but Russians' are increasingly using Finland as a hub for the European markets. The number of Russian firms will probably continue to grow, especially in Southeastern Finland.

In terms of trade in services, Russia will probably keep its position among the most important markets, as tourism and construction are expected to

continue growing. The demand for construction services is likely to stay on a high level, as there still exists an extensive need for both new buildings and the renovation of the existing ones. As for tourism, there is a vast yet unrealised client potential in Russia, as at present merely a fraction of Russians can afford to travel abroad at all. Finland is close and has a great natural environment, efficient logistics and service and good shopping possibilities. However, the future looks more pessimistic for the transport services sector. In transport services Russian firms have gradually gained market shares and at present clearly dominate the market.

With right actions the perspectives are fruitful

Relations with Russia have always been complicated and a double-edged sword for Finland. Finland could not fully integrate into Europe before the fall of the Soviet Union. Since then integration has been rapid and Finland has changed considerably. Today the country is one of the most competitive in the world and has benefited fully from internationalisation and integration in the world economy. Now, it is time to see the new opportunities Russia offers for Finland.

In the previous decade there was very little Russian influence on the Finnish economy, and the engine behind the growth was largely internationalisation and integration in the world economy. During the present decade the Russian effect has again increased. The effect is mainly positive, and partly an engine behind the current economic growth in Finland. However, worrying tendencies also exist, which need to be tackled. With right policies of authorities and enterprises the negative effects can be limited and Finland can fully benefit from the positive effects of Russia on the economy.

What about the future? It could be even better than today. If the employment effect in trade for example grew by half during the present decade, it could also do so in the future. Moreover, the Russian market offers Finnish firms a fast growing emerging market close by, which supports Finnish enterprises' growth and continuing competitiveness in the world economy. Finland is a significant transit corridor to Russia, which helps development of especially the southeastern region of Finland and Russian firms increasingly invest in Finland. These are opportunities for Finland to gain more from the emerging Russian market and with right actions by firms and coherent policies by authorities the perspectives will be fruitful. The opportunities offered by the fast growing Russian market cannot be defaulted. Russia is a chance Finland cannot miss.

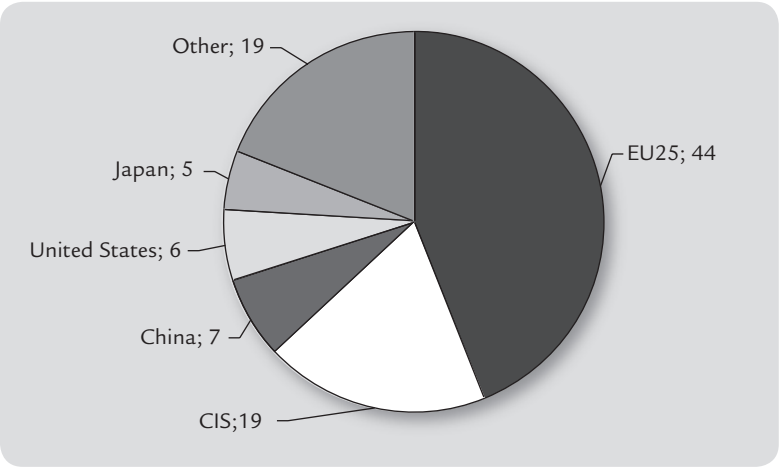
APPENDIX 1

Estimation of actual imports into Russia

It is not clear what the actual value of Russian imports is, as parts of imported goods are not recorded in the official import statistics compiled by the Russian Customs, due to grey schemes. The Central Bank of Russia (CBR) has estimated the amount of grey import in its import figures. This estimate is based on information concerning the volume of traded goods in Russia and the share of imports, as well as several other factors. However, there are suspicions regarding the adequacy of the estimates of the CBR. We have compiled our own estimate for the actual value of Russian imports by using the export statistics of its main trading partners as the basis. However, this method is not fully accurate, either, as the differences between Russian import figures and partner countries' export figures are in many cases quite large.

In 2005, the EU was still major source of Russian imports, although its share has diminished a little in recent years. Germany was by far the main source of European imports for Russia. The share of the CIS countries fell to less than one-fifth in 2005, especially due to the reduction in imports from Belarus. Ukraine was the major import country for Russia from the CIS accounting for about 8% of Russian imports. The share of Asian countries, especially of China and Japan, in Russian imports has increased into the 21st century.

Figure A1.1 Geographical distribution of Russian imports in 2005, %.



Source: Russian Customs.

The difference between Russian import figures and partner countries' export figures grew in 2000–2004 for most of the countries, but in 2005 the development was just the opposite, suggesting that the amount of grey imports would have declined. As a result, the average (negative) difference has diminished slightly from 23% in 2000 to 21% in 2005. However, the average difference in trade with the 25 EU countries has been some percentage points higher and was 25% in 2005. Besides the EU25, Chinese export figures also exceeded the reported Russian import figures quite largely (45%). For the other major sources of imports for Russia, namely the U.S., Japan and Ukraine, the difference has, however, been positive in recent years. This implies that the problem of grey imports mostly concerns European countries and China.

In the following we calculate an estimate for the actual value of Russian imports on the basis of its main trading partners' export statistics. First we have collected the data on exports to Russia for the main import countries of Russia and summed them up. The countries included in the calculation of the estimate were the EU countries (aggregate), the U.S., Japan, China and Ukraine. Ukraine was used as a proxy for Russian trade with the CIS countries. Then we have calculated the countries' combined share in Russian imports on the basis of Russian import statistics compiled by Russian Customs. Dividing the value of combined exports of the main import countries by their combined share in Russian imports, we get an estimate for the total imports of Russia.

Figure A1.2 depicts the import figures of Russian Customs and Central Bank and our estimate for the total imports of Russia. As we can see, our estimate exceeds both official import statistics figures throughout the period 2000–2005. However, at the beginning of the period, the differences between the official figures and our estimates were clearly lower than in the past three years. The difference was largest in 2004, when our estimate for the grey imports reached its high, whereas the Central Bank estimated that the share of grey imports actually diminished some percentage points. In 2005, the Rus-

Table A1.1 Calculation of the estimate for actual Russian imports.

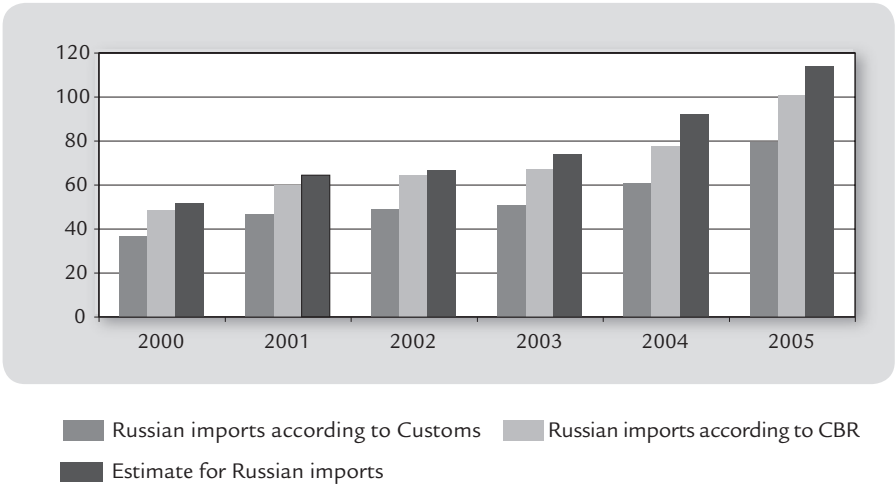
	2000	2001	2002	2003	2004	2005
Value of combined exports of countries*, EUR million	29,427	37,924	42,468	56,486	78,075	99,302
Combined share of countries in Russia's imports, %	61.9	65.7	67.2	67.7	68.3	70.0
Estimated value of total imports (exports / share in imports)	51,473	64,462	66,842	73,792	91,965	113,994

* EU25, the U.S., Japan, China and Ukraine. Source: Eurostat, Russian Customs, national statistics.

sian Customs reported the total imports to Russia to have been EUR 79 billion and the Central Bank EUR 101 billion, whereas our estimate indicates that it would have actually been EUR 114 billion. Thus, the Central Bank estimated the share of grey imports to be 22% in 2005, but according to our estimate, the share would have been 31%.

The larger-than-officially-reported imports would implicate too high a surplus in the balance of trade, and thus also in the current accounts of Russia. The trade balance of Russia has been well on surplus side during this decade and it would not change into deficit even if our estimate were correct, instead of that of the Central Bank of Russia. However, the surplus in the balance of trade would decrease by 14% or by over EUR 13 billion. Thus, it would skew calculations on the income of Russia, as actually more payments than accounted for would have been destined for abroad. In terms of Russian GDP, it would account for 2%. In addition, the underestimated amount of imports gives somewhat wrong picture of the distribution of consumption between domestic production and imports. Thus, the importance of domestic production would be overestimated.

Figure A1.2 Value of Russia's imports according to Russian Customs, Russian Central Bank and authors' estimate, EUR billion.



Source: Eurostat, OECD, Russian Customs, Central Bank of Russia.

APPENDIX 2

Estimation of re-exports from Finland to Russia

To get an estimate for the value of re-exports from Finland to Russia, we compared the value of the sold production of Finnish industries with the Finnish exports to Russia. Since the comparisons are very data-intensive, we decided to limit our calculations only to the 30 largest product groups, which together account for nearly two thirds of Finnish exports to Russia. The largest product groups in Finnish exports to Russia are chosen at the 4-digit level of the CN nomenclature. Then, the sold production is compared with the exports to Russia (at the 8-digit level), and the amount by which the exports exceed the production is considered re-exports.

This way, we can get *a minimum estimate* for the value of re-exports from Finland to Russia. Naturally, using this method all the re-exported products cannot be identified. For example, although Finnish production exceeds the exports to Russia, it might still be lower than total Finnish exports of that product, referring that some of the exports must actually be re-exports. However, it is rather difficult to separate the amount of re-exports going exactly to Russia, although Russia is the main market of products re-exported through Finland.

Table A2.1 shows the results of our calculations. It must be noted, however, that for passenger cars we did not take domestic production into account at all, since it is exported completely to Western markets, and not to Russia. We obtained the minimum estimate for re-exports of nearly EUR 750 million, which corresponded to 17% of the total Finnish exports to Russia in 2004.

In addition to the above mentioned products groups, it is known that re-exports are related to mobile phones in particular. However, as mobile phones are also produced in significant quantities in Finland, we cannot get an estimate for the re-exports of mobile phones by the method used above. Because of the considerable share of mobile phones in Finnish exports to Russia, it is anyhow important to get some kind of estimate of the extent of their re-exports. As a proxy, we used the average share of re-exports in the product groups presented in Table A2.1 (excluding passenger cars because of their share of 100%). Then we averaged the estimate also over the years and arrived at a very rough approximation of 50%. The approximation is by no means accurate, but the use of the average can be reasoned. Finland is currently the main hub for mobile phones imports to Russia by the majority of the mobile phone companies and many of the mobile phones are re-exported, not transited. The scale of our approximation is also supported by the estimates

Table A2.1 Estimates for re-exports from Finland to Russia in 2004.

	Sold production of Finnish industry, EUR million	Finnish exports to Russia, EUR million	Re-exports, EUR million
Washing machines	2.3	109.2	106.9
Telephonic or telegraphic switching apparatus	0.0	95.3	95.3
Pharmaceuticals	0.0	50.8	50.8
Television receivers	45.2	94.3	49.1
Units and parts of automatic Data processing machines	2.1	43.5	41.3
Painter's fillings and similar materials	10.5	51.5	41.0
Monolithic integrated circuits	0.0	36.2	36.2
Lubricant preparations	2.3	32.5	30.2
Taps, cocks, valves and similar appliances	0.1	17.7	17.6
Electric heaters	0.8	16.4	15.6
Refrigerators and freezers	10.3	20.9	10.6
New passenger cars	36.0	254.4	254.4
Total:		4,362.0	749.0

Source: Statistics Finland, National Board of Customs.

brought up in discussions and interviews we have had with different market participants.

As Finnish mobile phone exports to Russia were worth EUR 686 million in 2004, the value of re-exports would have been EUR 343 million. Thus, when taking into account also this rough assumption on re-exported mobile phones, the value of the minimum estimate for re-exports from Finland to Russia in total reached roughly EUR 1.1 billion, accounting for a quarter of total Finnish exports to Russia in 2004.

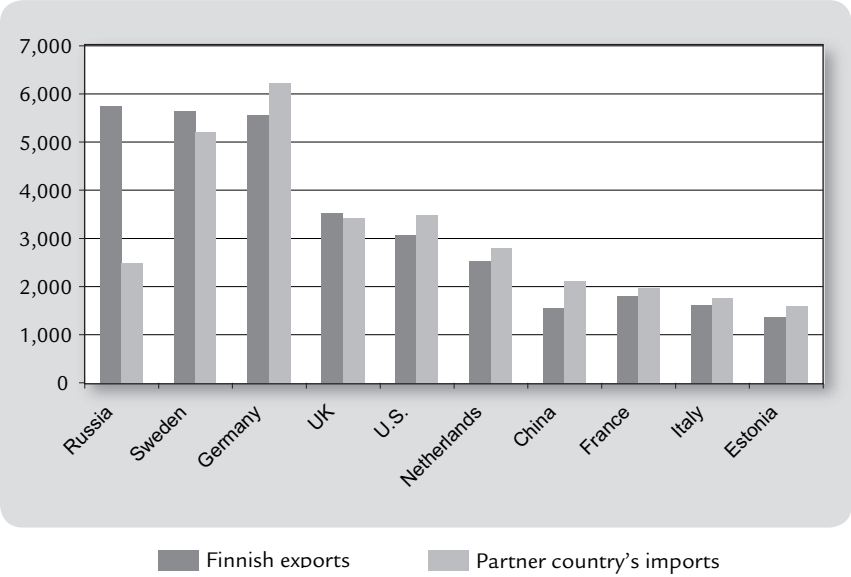
APPENDIX 3

Discrepancies in trade statistics illustrating the amount of grey trade

Differences in trade statistics of Finland and its major trading partners

To measure the amount of grey trade we have compared the import statistics of Russia and the export statistics of some of its major trade partners in this decade. There were significant discrepancies between the statistics for majority of the countries examined. Finland was among the countries showing the largest negative discrepancies, both in monetary and percentage terms. However, these discrepancies cannot be automatically regarded as measures of grey trade, since they can arise for a variety of reasons, e.g. differences in country of origin and country of consignation, exchange rate fluctuations, confidential data etc. It is rather difficult to divide the discrepancies caused in part by these

Figure A3.1 Mirror trade statistics of Finland and its ten largest export markets in 2005, EUR million.



Source: Eurostat, national statistical offices.

other factors and by grey schemes. Therefore we just present some comparison with other major trading partners of Finland to illustrate the extraordinary scale of the discrepancies in Finnish exports to Russia.

As we can see from Figure A3.1, there were some discrepancies between Finnish export figures and other countries' import figures as well, but the discrepancies were considerably smaller both in monetary and in percentage terms than in trade with Russia. In addition, the discrepancies were mainly positive, as is natural when taken into account the different methods of compiling export and import statistics, i.e. on the basis of FOB and CIF values. Despite Russia, Finnish export figures exceeded the import figures of Sweden and the UK. But as the negative discrepancy in Finnish exports to Russia was about 57%, it was merely 8% and 3% in the exports to Sweden and the UK, respectively. On the basis of the figure A3.1, it seems that the different currencies of Finland's trading partners do not significantly affect the discrepancies in bilateral trade statistics.

Effect of re-exports on the discrepancies in trade statistics

A possible explanation for the large discrepancies between Finnish and Russian trade statistics form the rather large amount of re-exports. The Russian Customs have also referred to re-exports as the reason for the discrepancies. According to the Russian Customs, the products re-exported through Finland are recorded in Russian statistics by their country of origin instead of their country of consignation, i.e. Finland. This explanation could be applicable also in the cases of some other countries experiencing large losses of value in their exports to Russia, like the Netherlands, Lithuania and Estonia. Lithuania and Estonia are acting as gateways to Russia as well as Finland due to their similar location as neighbours of Russia's. On the other hand, the Netherlands act as one of the main gateways to European markets for products coming from third countries, so it can also be regarded as a hub of re-exports.

Since we have estimated the value of re-exports from Finland to Russia, we can also evaluate the significance of them in explaining the statistical discrepancies. In Table A3.2 are presented first the figures from Finnish and Russian trade statistics and then calculated the difference between them, both in euro and in percentage terms. The next part of the table presents our estimate of the re-exports going to Russia through Finland. When the estimated value of re-exports is deducted from the difference between trade statistics, we get a value for the difference, which cannot be explained by the re-exports.

As we can see from the Table A3.2, the discrepancy between Finnish and Russian trade statistics would remain rather large even when re-exports are taken into account. The discrepancy measured in terms of percentages would,

Table A3.1 Differences between Finnish and Russian trade statistics and re-exports.

	2000	2001	2002	2003	2004
Finland's exports to Russia, EUR million	2,157	2,806	3,128	3,477	4,362
Russia's imports from Finland, EUR million	1,037	1,435	1,606	1,631	1,874
Difference, EUR million	-1,120	-1,371	-1,522	-1,846	-2,488
Difference, %	-52	-49	-49	-53	-57
Re-exports from Finland to Russia, EUR million	203	327	436	586	1,087
Difference excl. re-exports, EUR million	-917	-1,044	-1,085	-1,260	-1,401
Difference, %	-42	-37	-35	-36	-32

Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

however, have diminished significantly during this decade, implying that the share of grey imports in Russia would also have reduced.

When taking into account also the discrepancies between Russia's and other countries' trade statistics, it seems plausible that the difference can be partly explained by re-exports. For example passenger cars come to Finland from Japan and microcircuits from the United States which were also the only countries with which Russia had positive difference in trade statistics. This would support the assumption that those products have been recorded in Russian statistics according to their country of origin, i.e. Japan and the U.S. respectively instead of Finland. However, many products re-exported to Russia through Finland have been coming from EU countries. And as we presented before, the discrepancies between Russia's and EU countries' trade statistics have prevailingly been negative. So this would suggest that the re-exported products would not have been recorded by their country of origin, and thus, actually passed the customs without being registered at all, reinforcing the presumption that grey schemes in Russian trade seem to be still a significant problem.

APPENDIX 4

Impact of goods exports to Russia on Finnish output and employment

Exports of goods to Russia have a direct impact on Finnish output, as they increase the demand for Finnish products. But there are also indirect impacts on other sectors, whose products or services are used in the production of the final product. In order to be able to also take these indirect impacts into account we need to use the input-output data on Finnish economy. In this estimation we follow the method used by ETLA.

The input-output data includes information on the amount the different sectors' products are used as inputs in the production of a specific sector. By reducing the export demand of Russia from the total demand of Finnish production we can find out the impact of the exports for the different sectors measured in euro. As the input-output data is available only until 2003, we used the coefficients of 2003 to calculate the impact of exports in 2004. When we calculated the impact of exports we used the value of "real" exports, i.e. the value of re-exports is excluded. This may diminish the impact somewhat, but if the re-exports were included, the impact would be overestimated.

Statistics Finland also publishes information on the usage of the labour force in different sectors. After calculating the total (direct and indirect) monetary effects of exports to Russia by sectors, we multiplied the values by the labour input coefficient to get an estimate for the employment effect. The labour input coefficients are also from 2003. This may overestimate the employment effect a little, as the labour input coefficients have been diminishing past years in the majority of the sectors. However, the scale will roughly be correct. The total employment effect of exports to Russia on Finnish employment is calculated as the sum of the effects on different sectors.

Table A4.1 The impact of goods exports to Russia on Finnish production in 2000 and 2004.

	2000		2004	
	EUR million	% of output	EUR million	% of output
Agriculture, forestry and fishing	187.4	2.5	193.0	2.5
Mining and quarrying	32.1	3.7	34.7	3.2
Food industry	279.0	3.6	294.0	3.4
Textile and clothing industry	94.8	6.5	108.0	8.2
Forest industry, publishing and printing	526.1	2.1	711.3	2.9
Chemical industry	457.3	3.9	953.0	7.7
Metal industry	315.6	2.8	512.0	4.0
Manufacture of machines and equipment	394.1	3.8	681.9	6.0
Electrical industry	453.1	1.9	919.1	4.4
Manufacture of transport equipment	68.7	2.3	115.7	4.5
Other manufacture	129.7	3.2	170.1	3.9
Electricity, gas and water supply	51.0	1.2	93.6	1.7
Construction	11.3	0.1	19.2	0.1
Wholesale and retail trade	234.6	1.1	178.3	0.7
Hotels and restaurants	8.2	0.2	10.6	0.2
Transport, storage and telecommunications	170.4	0.9	262.5	1.1
Finance and insurance	43.2	0.6	64.4	1.1
Real estate, renting, R&D and other business services	172.5	0.5	346.8	0.9
Other services	37.4	0.1	72.6	0.2
Total	**3,666.9**	**1.5**	**5,740.3**	**2.1**

Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

Table A4.2 The employment effect of exports to Russia in 2000 and 2004, persons.

	2000	2004
Agriculture, forestry and fishing	4,041	3,403
Mining and quarrying	206	177
Food industry	1,478	1,429
Textile and clothing industry	1,297	1,451
Forest industry	1,163	1,706
Publishing and printing	1,205	1,324
Chemical industry	1,912	3,201
Metal industry	1,696	2,479
Manufacture of machines and equipment	2,325	3,796
Electrical industry	1,621	3,503
Manufacture of transport equipment	573	888
Other manufacture	1,178	1,400
Electricity, gas and water supply	205	235
Construction	101	162
Wholesale and retail trade	2,130	1,596
Hotels and restaurants	144	170
Transport, storage and telecommunications	1,693	2,334
Finance and insurance	235	423
Real estate, renting, R&D and other business services	1,976	3,694
Other services	571	1,007
Total	**25,750**	**34,377**

Source: Authors' own calculations based on the statistics of National Board of Customs and Statistics Finland.

APPENDIX 5

Value of transit freight through Finland

The value of transit freight to Russia is quite easy to calculate. Since 2002, the Finnish National Board of Customs has collected value based statistics on the road transit to Russia. In terms of volume, less than 10% of transit to Russia goes by railway, while the rest goes by road. Rail transit is mainly used for bulk goods, with a low unit price, while road transit is value goods with a high unit price. Hence we can use the road freight value statistics as a quite accurate approximation for the value of transit freight through Finland to Russia.

The value of road transit freight was 4–5 times larger than Finnish exports to Russia in 2002–2005. The total value of freight to Russia through Finnish territory was about EUR 28 billion in 2005 and based on Russian customs figures represented a third of Russia's total goods imports in 2005. However, this figure is too high as personal imports and double invoicing is not taken into account in the Russian Customs figure. The Russian Central Bank presents its own estimation on Russia's total import, based on an assumption of the amount of personal imports and grey schemes. In 2005 the CBR's figure was about 28% larger than the Russian customs figure. The calculations behind our own estimation of Russian imports are presented in Appendix 1. It is slightly more pessimistic. We came up to the figure of about 24% of Russia's total imports went through Finnish territory in 2005.

Table A5.1 Finnish exports and transit to Russia.

EUR million	2002	2003	2004	2005
Road freight transit to Russia	12,100	17,653	19,435	22,032
Finnish exports to Russia	3 ,128	3,477	4,362	5,743
Total:	15,228	21,130	23,797	27,775
Russian imports (Russian Customs)	49,111	50,856	60,833	79,198
Share of Finnish transit and exports, %	31.0	41.5	39.1	35.1
Russian imports (CBR)	64,807	67,398	78,393	100,744
Share of Finnish transit and exports, %	23.5	31.4	30.4	27.6
Our estimate of Russian imports*	66,842	73,792	91,965	113,994
Share of Finnish transit and exports, %	22.8	28.6	25.9	24.4

*see Appendix 1

Source: Russian Customs, Central Bank of Russia, Finnish National Board of Customs and authors' own calculations.

The share of Russia's exports that heads through Finnish territory is harder to estimate as we are missing similar value based statistics as in road transit to Russia. Nearly all transit traffic from Russia goes by train. Here we assume that the transit freight's structure is largely the same as Finnish imports from Russia. The assumption is quite reasonable and is supported by harbour statistics. We use the same unit price as for imports to get an estimate for the value of transit from Russia. The transit freight's value is about a tenth of the imports from Russia. Calculating the sum of transit traffic and imports together, we reckon that the share of Russia's exports heading through Finnish territory was about 3–5% in 2000–2005. Here we use the Russian Central Bank's figure for exports. The differences between Russian Customs' and Central Bank's figures are minimal, and assuming that grey schemes are not largely used in Russian exports, a similar own estimate as in imports is not needed in calculating shares of exports.

Table A5.2 Finnish imports and transit from Russia.

		2000	2001	2002	2003	2004	2005
Finnish imports	Value (EUR million)	3,461	3,427	3,566	4,367	5,320	6,547
from Russia	Volume (1 000 tons)	22,033	23,503	26,389	30,125	33,217	32,380
	Unit price (EUR/ton)	157	146	135	145	160	202
Transit freight	Value (EUR million)	394	569	456	451	491	663
from Russia	Volume (1 000 tons)	2,507	3,901	3,377	3,108	3,068	3,277
through Finland	Unit price (EUR/ton)	157	146	135	145	160	202
Value of freight from Russia (EUR million)		3,855	3,996	4,022	4,818	5,811	7,210
Russian total exports of goods (EUR million)		113,961	113,906	114,061	120,433	147,482	195,829
Finnish transit and imports as share of exports,%		3.4	3.5	3.9	4.5	4.3	3.5

Grey=authors' calculations

Sources: Finnish National Board of Customs, Central Bank of Russia, Statistics Finland.

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What is the effect of Russia on the Finnish economy? Russia's strong economic growth has led to flourishing development in the economic activities between Finland and Russia. Russia is one of Finland's largest trading partners with both Finnish and Russian companies increasingly investing over the border and Russian tourists flow into Finland. But the picture is not perfectly rosy: the strong growth in exports is partly based on re-exports, grey schemes are still used in trade and heavy transit traffic burdens Finnish roads. The report also provides new information on Russia-related firms in Finland.

This thorough report presents the essential features in current Finnish-Russian economic relations, evaluates both positive and negative aspects related to them and provides conclusions on the present significance of Russia on the Finnish economy. The purpose of the report is to provide a versatile view of Russian influence on the Finnish economy and to serve as an impetus for further discussion in the issue.

The report is written by Simon-Erik Ollus and Heli Simola, who both work as economists at the Bank of Finland Institute for Economies in Transition (BOFIT).

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