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## Finnish re-exports to Russia



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## Contents

Abstract .....	3
1 Introduction .....	4
2 What are re-exports? .....	4
3 Finnish exports and transit traffic to Russia .....	7
4 Finnish re-exports to Russia.....	10
5 The effect of re-exports on the Finnish economy .....	16
6 Conclusions .....	23
Appendix .....	24
References .....	26

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Simon-Erik Ollus and Heli Simola <sup>1</sup>

## Finnish re-exports to Russia

### Abstract

We study re-exports from Finland to Russia. Re-exported goods are defined as goods that are imported by a purchaser in one country who then exports the product to a third country without processing. Re-exports are a major driver behind recent growth of Finnish exports to Russia, with re-exports constituting over a quarter of Finnish exports to Russia in 2005. Re-exporting typically involves high-value products such as electronics and vehicles. Finland's involvement in such trade reflects the technically advanced nature of Finnish logistics and traditionally large transit streams through Finland to Russia. Other reasons for re-exports include Russia's vast market potential for Finnish trading companies, Finnish companies' special knowledge about Russian demand (asymmetric information), transfer pricing and grey schemes. The domestic income and employment effects of re-exports are similar to those of transit trade. Re-exports are highly cyclical, making long-term developments hard to predict.

Keywords: Russia, Finland, foreign trade, re-exports.

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## 1 Introduction

Re-exports are a popular topic in Finland these days. Even as a considerable share of Finnish exports to Russia consists of re-exports, the concept of re-exports remains vague and subject to loose usage. This paper, therefore, examines re-exports from the perspective of the Finnish-Russian case. We attempt to estimate actual Finnish exports to Russia as well as the effects from re-exports.

Re-exports are hardly a new or rare phenomenon in world trade, but their scale has increased considerably in recent decades. This development closely reflects the strong growth of international trade in general and the robust increase in global transport volumes in transit traffic. Dozens of countries are now major re-exporters.

For Finland, re-exporting largely relates to trade with Russia.<sup>2</sup> As Russian import demand has soared in recent years, Finnish exports to Russia have boomed. Since this trade partly consists of re-exports, we ask if re-exports mask the actual trend in exports of Finnish domestic products. Exports are also traditionally an important driver of production growth and employment in small, open economies like Finland. As the nature of the exports has changed, we consider how this might affect other economic development.

The paper is structured as follows. Section 2 gives a definition of re-exports and presents re-exports in the global context. Section 3 examines the development and structure of good flows moving through Finland to Russia, making the distinction between exports and transit. In section 4, calculations of Finnish re-exports to Russia in 2002-2006 are presented and discussed. Section 5 considers the economic implications of re-exports and section 6 concludes.

## 2 What are re-exports?

The United Nations defines *re-exports* as foreign goods exported in the same state as they were previously imported. The goods are produced in one country and sold to a purchaser in another country. The purchaser, in turn, sells those goods onwards to a third country without further processing. In principle, such trade should be reported to customs officials as re-exporting.

Trade statistics can treat re-exports in two ways. Countries that use the General Trade System should record re-exports as both imports and exports in their trade statistics, but then, under UN recommendations, separate out re-exports in their export reporting. Countries that apply the Special Trade System (e.g. EU external trade<sup>3</sup>) should exclude re-exports from both import and export statistics. In practice, comprehensive exclusion is impossible since goods destined for re-export often go unreported to the customs authorities at the time of import. Consequently, re-exports are recorded in trade statistics as ordinary imports and exports and actual quantities cannot be identified directly (e.g. in the Netherlands and Finland). Thus, true re-export activity must be inferred.

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<sup>2</sup> While re-exports mainly concern Finnish exports to Russia, Finnish Customs suspects certain exports to Baltic and Scandinavian countries may in fact be re-exports.

<sup>3</sup> Intra-EU trade is recoded under a separate method, distinct from the General and Special Trade systems. From an EU customs official's perspective, re-exports do not exist in intra-EU trade since the EU is a single customs area.

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*Transit* trade is an activity fairly similar to re-exporting, with the crucial distinction that ownership of re-exported products does not shift to the purchaser in the intermediate country. For transited goods, the ownership shifts directly from the seller in the country of origin to the purchaser in the country of destination. Transit trade is never included in trade statistics. Although transit trade is conceptually different from re-exports, we mention it here as the motivation and effects of transit trade are similar to those of re-exports.

### *Re-exports in the global context*

Re-exporting is neither a new or rare phenomenon. It has expanded briskly, however, in recent years. In 2002, re-exports were estimated to constitute 5-15% of the world exports. Dozens of countries today are heavily involved in re-exporting, with the largest re-exporters including Hong Kong, the Netherlands and the US. In relative terms, re-exports also play a significant role in the export activities of small island nations such as Cyprus and the Bahamas. Hong Kong is perhaps the most extreme example – the share of re-exports has grown from about 20% in the 1960s to over 90% of all exports at present (Andriamananjara et al., 2004).

Some re-exporting countries act as intermediate hubs in multilateral trade, while others concentrate on servicing a single large market. There are also cases with multiple intermediate countries in the re-exporting chain. Re-exports are typically easily transportable, high-value goods. Electrical equipment and electronics constitute the largest product group in global re-exports. Other significant groups, depending on the country, include machinery, vehicles and textiles.

In re-exporting are primarily involved trading companies and multinational manufacturers. Trading companies are specialised in matching global supply to local demand. Multinationals often distribute production stages across countries based on lowest production cost and then ship the components or intermediate products to their units across the world for final assembly or localisation. It should be noted, however, that only a fraction of this intra-firm trade occurring within multinational companies can be regarded as re-exporting. Much of the intra-firm trade concerns semi-finished products and components that are further processed and thus beyond the scope of this paper.

### *Motivation for re-exports*

Logistical efficiency is a leading motivation for both re-exports and transit trade. Transit hubs can be sited in one country to optimise the shipping process and reduce costs. Most hubs are ports specialised in effective and competitive transport activities, which means they are in the best position to provide export companies with the low-cost goods delivery. In principle, this rationale should apply rather for transit transport than re-exports.

Asymmetric information is also commonly mentioned as a motivation for re-exporting (e.g. Hanson and Feenstra, 2001). The concept applies to an intermediate trader with better knowledge about the source or destination market for the products traded. Hence, it is easier and more efficient for the selling and buying parties to pay an intermediary trader specialised on this type of service to find them the appropriate suppliers, customers or products. This motivation largely applies to differentiated products,

where the characteristics are more difficult for an outsider to discern. As a result, re-exports are typically differentiated products like electrical devices.

Hong Kong traders are widely cited as masters of asymmetric information. Hanson and Feenstra (2001) argue that Hong Kong traders play a quality-sorting role in re-exporting Chinese products to world markets. These specialised traders have gathered specific knowledge on the quality of Chinese producers, as well as on the demand characteristics of the importing countries. They can buy large lots of goods from Chinese producers and then distribute them to different countries based on the quality requirements of the customers. Fisman et al. (2007) note a darker aspect of the asymmetric information motivation. In examining Hong Kong re-exports from other countries to China, they argue that traders are specialised in evading Chinese tariffs. Hence, the motivation for re-exports may also relate to the use of grey schemes.

Tariffs, quotas and taxation all provide additional motivations for re-exports. First, if a country has discriminative import tariff policies towards different countries, re-exports might be legally used to minimise the tariff payments. Second, where country-specific quotas exist, re-exports may provide a way to export more products via an intermediary country. Chinese textile-makers, for example, could circumvent European and American quotas by re-exporting through other markets. Finally, a multinational could be motivated by tax breaks or tax avoidance. They would use re-exports in combination with transfer pricing to globally optimise taxes, costs and income. Intra-firm re-exports can be used to transfer income to a unit located in a country with a lower tax rate.

### *The implications of re-exports*

Re-exports distort trade figures when they cannot be separated out properly. In such cases, indirect methods are needed to assess the situation. For example, re-exports can distort the picture of a country's market share and thus its competitiveness in export markets. Kusters and Verbruggen (2001) for the Dutch case raise this problem with their finding that the substantial and growing share of re-exports in Dutch exports masks the deteriorating market position of the Netherlands in its external markets. Moreover, re-exports considerably distort the official view of Dutch exports and thus the competitiveness of certain sectors.

Re-exports can also blur logical connections between exports and production or economic growth. Traditionally, exports have been an important factor in the economic growth of open economies. The German economist Hans-Werner Sinn (2006) highlights the apparent paradox of booming German exports in the face of sluggish domestic economic growth. Sinn argues Germany has been transformed into a "bazaar economy," specialised in trading activities. Many products exported by Germany are actually produced in Eastern Europe.<sup>4</sup>

In principle, re-exporting activity should not affect the trade balance as they would be cancelled out in the trade statistics. Ambiguity arises, however, when the import price is lower than the export price due to the added profit margins of traders or transfer pricing. This price difference reflects the value added created by the trading services and leads to overestimation of goods exports and underestimation of service exports. Hence, the IMF (2004) has suggested re-exports could be registered as service exports.

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<sup>4</sup> Sinn discusses the import content of exports in a wider context but re-exports can be considered the most extreme or limited example of bazaar trade.

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Moreover, re-exports also need to be separated from domestically produced exports because of their considerably smaller income and employment effects. Kusters and Verbruggen (2001) estimate the value added in domestically produced Dutch exports is 65%, whereas the corresponding figure for re-exports is 10%. The effect is still important for the Dutch economy, since the volumes of re-exports are so large. Re-exports might also change the structure of the re-exporting economy. As the re-exported products are not produced in the country, the income and employment effects of re-exports concern the service sector, primarily transport and commercial services. Re-exporting countries specialise to a large extent in trading activities. Hong Kong is an illuminating example; the share of manufacturing in the GDP in the special administrative region has fallen from 24% in 1980 to 7% in 1996 (Hanson and Feenstra, 2001).

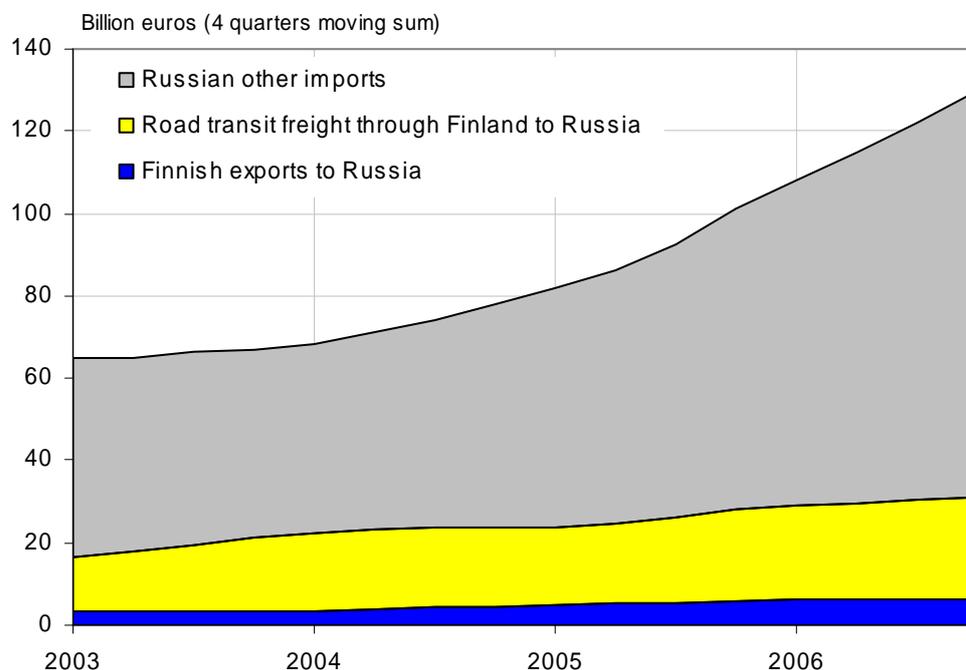
### 3 Finnish exports and transit traffic to Russia

Russian import demand has increased rapidly in recent years as Russia's booming economy has enhanced consumption possibilities. Growth in demand has concentrated on investment goods and consumer durables. Domestic production in many of these sectors is small and many consumers prefer foreign products. As a result, total imports climbed about 20% a year in euro terms during the period 2002-2006. Rapid import growth is also reflected as increased exports from Finland to Russia and transit freight traffic through Finland to Russia. Based on the Central Bank of Russia (CBR) import estimate a quarter of Russia's total imports of goods came through Finnish territory as exports or transit in 2006.<sup>5</sup> That share was even larger in 2003, when nearly a third of Russian total imports came through Finland.

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<sup>5</sup> Some observers claim the CBR figure underestimates actual imports to Russia. In our earlier paper (Ollus and Simola, 2007), we suggest an alternative estimation based on mirror calculation of Russia's total imports. The CBR estimate for total Russian imports averaged 9% less than our estimate of actual imports during this decade. Hence, the share of imports through Finland is slightly smaller than presented here. As our estimate is only available as annual data and the difference between our estimate of actual imports and the CBR figure is quite small, we here use CBR quarterly data for the sake of convenience.

Figure 3.1 Russian total goods imports and the share of goods passing through Finland, 2003-2006.

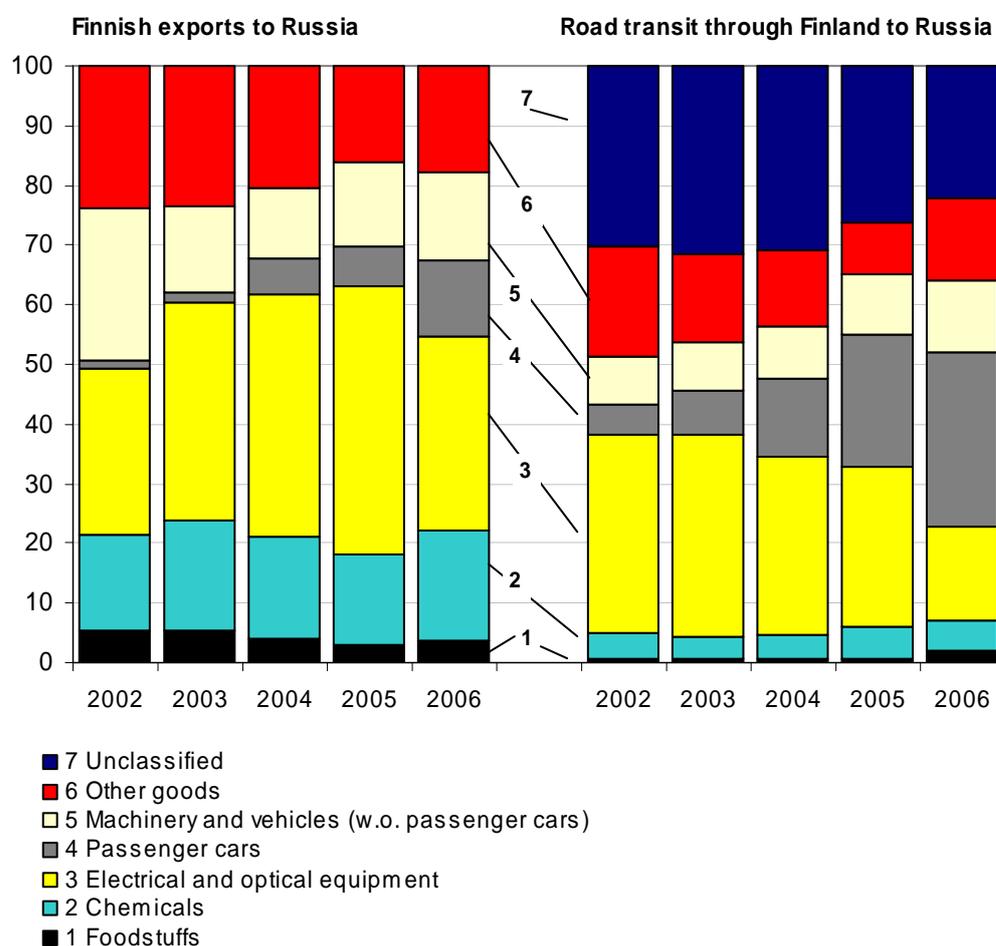


Source: Finnish Customs, Central Bank of Russia.

Finland seems to have successfully responded to Russian import growth, with the value of Finnish exports to Russia nearly tripling in the period 2000–2006. On average, growth in Finnish exports to Russia kept up with Russian import growth overall in the period (about 20% a year), whereas annual growth of total Finnish exports only averaged 5%. In 2006, however, Finnish export growth to Russia slowed to just 8%. The value of exports reached 6.2 billion euros in 2006 and Russia was the third largest export market for Finland, with a share of 10% of Finnish total exports of goods.

Electrical and optical equipment remain the top categories of Finnish exports to Russia, despite a marked diminution of share with the collapse of re-exports of mobile phones from Finland to Russia in 2006. Mobile phones accounted for a fifth of exports to Russia in 2005, but this share lowered to 9% in 2006, reducing the share of electrical equipment in exports overall. The second largest export category was machinery and vehicles, which increased in 2006 due in large part to booming exports of passenger cars. Car exports nearly doubled in value terms over just twelve months and accounted for 13% of Finnish exports to Russia in 2006. Other important categories in Finnish exports to Russia are chemicals, where exports of pharmaceuticals in particular have grown rapidly. Pharmaceuticals accounted for 5% of Finnish exports to Russia in 2006.

Figure 3.2 Structure of Finnish exports and road transit freight via Finland to Russia, 2002–2006, %.



Source: Finnish Customs.

Finland is an important transit hub to Russia. Most of the transit travels as road freight, the value of which is nearly five times greater than all of Finnish exports to Russia. Road freight transit was worth 25 billion euros in 2006. Transit traffic to Russia grew rapidly earlier in this decade, but has slowed somewhat up in recent years. Road freight transit through Finland grew in euro term on average 12% a year during 2004–2006. Finland is specialised in high-value goods transit to Russia. Finnish regions close to the Russian border have huge warehouse complexes specialised in servicing the transit business. Most of the goods arrive to Finland by sea and are shipped forward to Russia by road. Some goods arrive by train through the Trans-Siberian railway or by plane and are usually shipped forward by road. Hence, the road transit statistics provide a relatively accurate estimate of the value and structure of transit freight through Finland to Russia.

In Figure 3.2, Finnish exports and road transit freight through Finland are classified in the same way. As for Finnish exports, the top categories in transit are electrical and optical equipment and machinery and vehicles. The most significant single category recently has been passenger cars – about 530,000 cars were transited through Finland to Russia in 2006, and transited and exported cars through Finland to Russia corresponded to nearly 2/3 of Russia's total passenger car imports.

## 4 Finnish re-exports to Russia

### *Estimating the scale of re-exports*

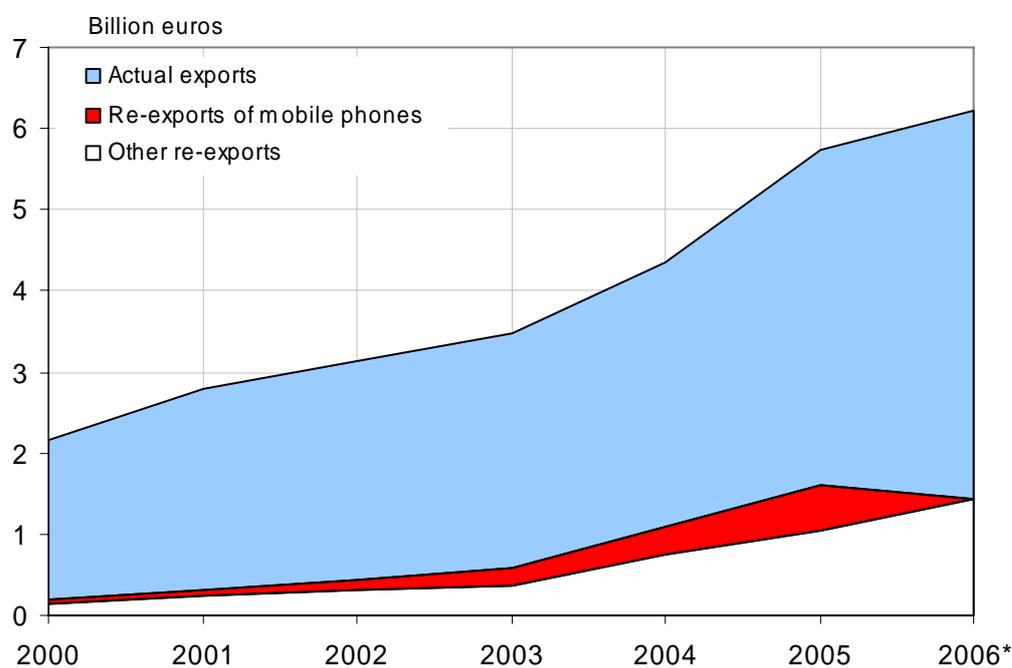
As stated above, re-exports are goods imported first to Finland, stored here and then exported forward with no more than minimal processing such as tossing in a Russian-language manual or re-packing the goods. Under this definition, re-exports can be calculated most accurately by comparing imports, exports, domestic production and domestic consumption data for a particular product. It is extremely difficult to get information on consumption of products at the detailed level, so here we concentrate instead on the most easily identifiable aspect of re-exports – the amount of exports that exceeds domestic production. Logically, if domestic production is less than exports to Russia, at least some of the exports must consist of imports. This method gives only a *minimum estimate* of re-exports as part of domestic production is typically consumed domestically, making the discrepancy between exports and production larger.

We examine the 30 largest export product groups in Finnish exports to Russia, which account together for nearly two-thirds of exports. Our calculations are based on industrial production figures for 2000-2005. Although industrial production figures for 2006 have yet to be released, we have compiled a preliminary estimate for 2006 based solely on export data. We simply examine the exports in products re-exported in previous years. Re-exports consist mainly of products that are either not produced in Finland or only produced in marginal amounts. Certain products may have been produced in Finland earlier, but production has been relocated abroad because of lower production costs or a shifting customer base. In such cases, it is unlikely production of these goods will be restarted in Finland any time soon. The estimate for re-exports in 2006 still should, of course, only be taken as preliminary.

In an earlier report (Ollus and Simola, 2006), we offer an estimate for re-exports in the period 2000-2004. For 2004, we find about a fourth of Finnish exports to Russia were re-exported. In this paper, we include a calculation for 2005 in the Appendix that the share of re-exports in Finnish exports to Russia was at least 28%. The Finnish Customs (2007) made their first estimate of re-exports only for 2005, which is 21-25% of Finnish exports to Russia. The difference between Finnish Customs calculations and ours largely reflects differences in estimating re-exports of mobile phones (the hardest category to estimate as much of the information is classified). Even so, the results generally support each other and show that a significant share of Finnish exports to Russia is re-exported.

As we calculated time series backwards, we can also study the development of re-exports. Our calculation shows that the value of re-exports increased on average 53% a year in the period 2000-2005, which is much faster than the expansion of Finnish exports to Russia in general. In the same period, domestically produced exports to Russia grew on average only 19% a year. Figure 4.1 shows the development of Finnish exports and re-exports in 2000-2006. Note the peak in growth of re-exports in 2004, when value doubled in one year. According to our preliminary estimate, re-exports other than mobile phones grew about 36% in 2006, mainly due to re-exports of passenger cars. The volume of exports of mobile phones fell in 2006, reflecting the collapse of re-exports of mobile phone to Russia. As it is very difficult to estimate the share of re-exports in mobile phones after the change, we exclude mobile phones from the preliminary estimate for 2006.

Figure 4.1 Finnish exports and estimated re-exports to Russia in 2000–2006.



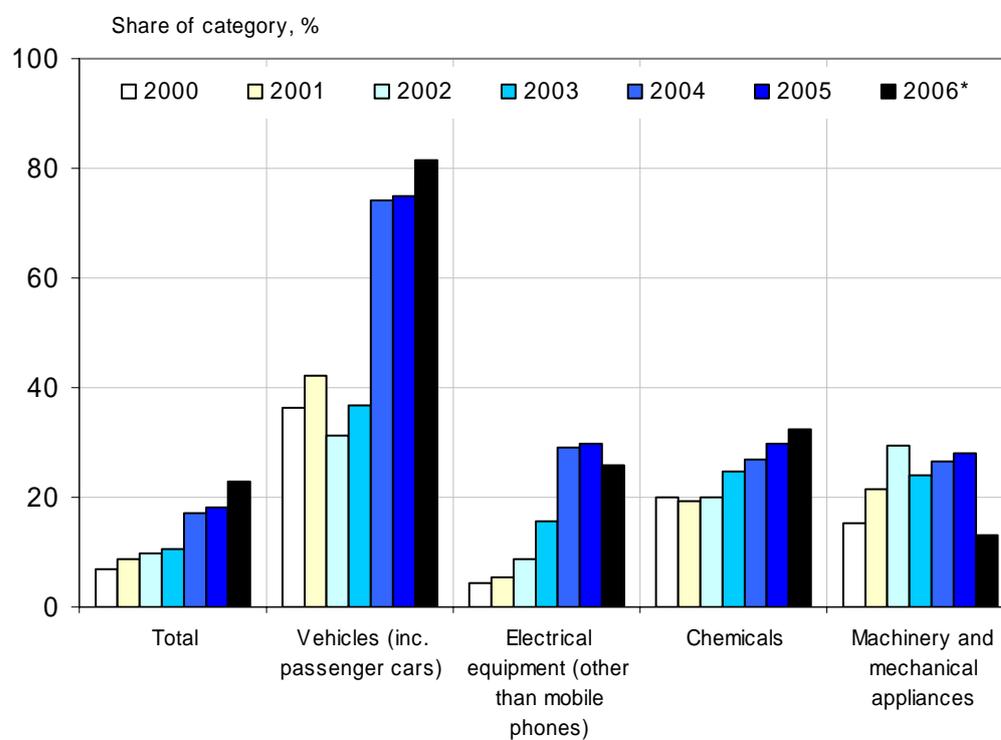
\* preliminary estimate without mobile phones

Source: Authors' own calculations based on data from Statistics Finland and Finnish Customs.

#### *What exactly gets re-exported?*

The most significant products in re-exports are mobile phones and passenger cars. Mobile phones were long the most significant product group, but they were surpassed in 2006 when passenger cars became the largest product group in Finnish exports to Russia. Passenger car re-exports have grown rapidly in recent years, due in part to changes in Finnish car taxation. Since 2004, the importer of a car does not need to pay the car tax at the time of the import to Finland, but only when the ownership of the car changes. Imports of cars to Russia have soared in response to the huge demand, and a significant share of them comes through Finland either as transit or re-exports. Russian Customs statistics show the value of Russian passenger car imports increased tenfold during 2000–2006.

Figure 4.2 Minimum share of re-exports for select product groups of Finnish exports to Russia in 2000–2006.



\* preliminary estimate

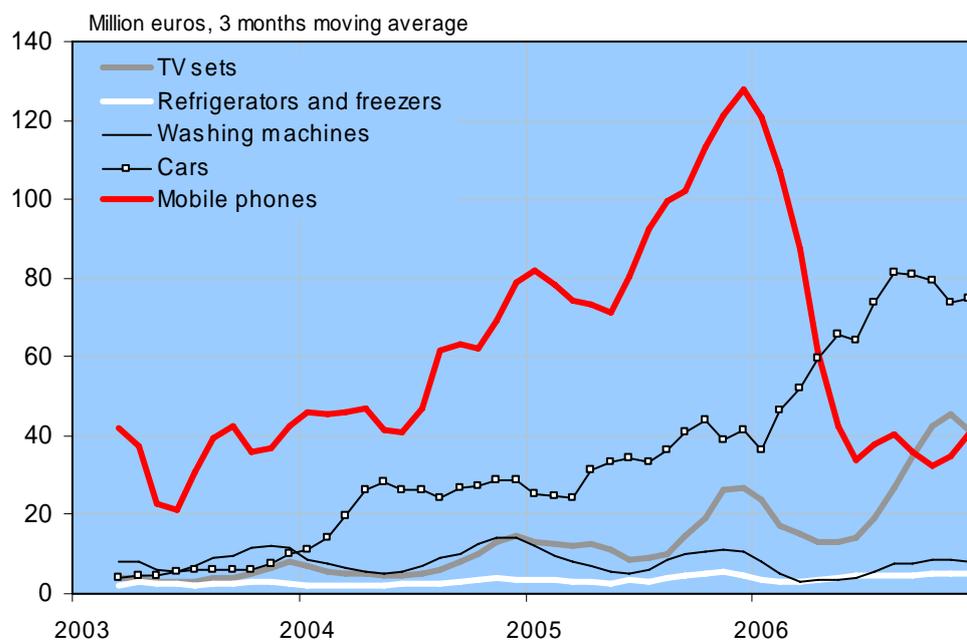
Source: Authors' own calculations based on data from Statistics Finland and Finnish Customs.

As mentioned, mobile phones were the top category of re-exports to Russia until a change in manufacturer policy. In 2006, their share of re-exports declined as alternative routes to Russia were identified. This was also observed in transit freight through Finland as the share of the category of radio, TV and computer equipment (including mobile phones) declined from 22% in 2005 to 16% in 2006. Mobile phone importers to Russia apparently switched to more direct routes to Russia in 2006. While Finnish Customs (2007) estimates re-exports were about a third of Finnish mobile phone exports to Russia in 2005, we estimate (see Appendix) roughly half was re-exports. The Finnish customs estimate assumes that the distribution of re-exported mobile phones is equal across all major export destinations; we assume Russia is the main destination of the re-exported phones.

In the group of chemicals, re-exports have also formed a rather large part of the exports during the decade. The largest group in this category comprises pharmaceuticals, where Finland also has own production. 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 grew nearly six fold in only one year. This growth was largely attributable to increased exports of domestically produced medicaments. However, since then the value of re-exported medicaments has grown faster than that of the domestically produced. In 2005 the share of re-exports was about a third of the exports of medicaments to Russia. In addition to medicaments, painter's fillings and lubricant products exported from Finland to Russia are largely re-exports.

In the machinery and electrical equipment category the most notable re-export products are washing machines, computers, refrigerators and freezers. Re-exports of electrical equipment have grown rapidly, even without taking into account mobile phones. For example, exports of TV sets not produced in Finland grew by over 70% in 2006.

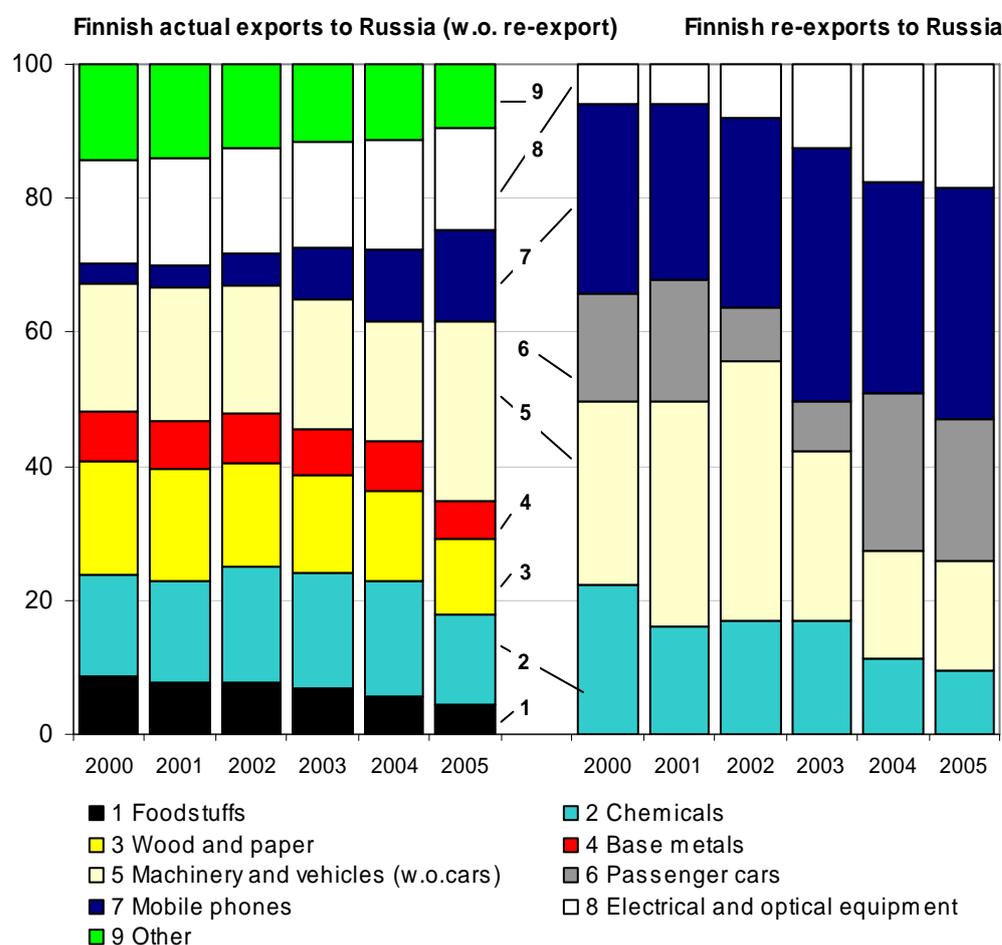
Figure: 4.3 Selected re-export-dominated groups in Finnish exports to Russia, 2003-2006.



Source: Eurostat.

Based on our calculation of the minimum share of re-exports in the 30 main categories, we also construct an estimate of the structure of Finnish domestic exports to Russia. In Figure 4.4, we present the estimated structures of Finnish actual exports and re-exports. Note that the share of Finnish exports of machinery and vehicles (excluding passenger cars) has increased in recent years, while electrical and optical equipment have stayed stable. Note further that the share of Finnish-made mobile phone exports has grown, indicating increased demand for the pricier models in Russia (Finnish manufacturing is focused on high-end devices).

Figure 4.4 Structure of Finnish actual exports and re-exports to Russia 2000-2005, %.



Sources: Authors' own calculations and Finnish Customs.

### *Why become a re-exporter?*

Finland's situation as a re-exporter is somewhat different from countries heavily involved with re-exports. Unlike the Netherlands and Hong Kong, Finland is not a global re-export hub. Finnish re-exports are concentrated on providing goods for the Russian consumer market.

The motivation for re-exporting to Russia to some extent follows the overarching reason huge transit freight volumes flow through Finland to Russia – Finland has a secure, effective system for transport and storage that is competitive for high-value goods transport to Russia. But why specifically should re-exports be favoured over transit? In some cases, re-exports offer greater flexibility than transit. As re-exports are declared to Finnish Customs as normal imports, it is unnecessary to ascribe a final destination as with transit. Transited goods are usually stored at customs warehouses and re-packed into smaller shipments before shipping to Russia. The ordinary warehouses can be cheaper than customs warehouses and may offer better re-packing opportunities. As there are no import duties for the goods when they come from another EU country or country with favourable

trade agreements with the EU, re-exports may serve as an attractive, flexible alternative to rigid transit. Even so, competitive logistics alone cannot account for all the re-exports through Finland to Russia.

Re-exports through Finland seem to be largely conducted by trading companies exporting to Russia. Companies operating in the sector of retail and wholesale trade handled over a quarter of Finnish exports to Russia in 2005. Trading companies seem to be attracted to re-exporting because of their access to asymmetric information. Companies specialised in trading between Russia and other countries possess specific knowledge in their field unavailable to outsiders. Hence, they can engage in trading activities more efficiently than their trade partners. Many trading companies involved in re-exporting are in fact Russian-owned or subsidiaries of Russian corporations. Using a Finnish intermediate provides some advantages for the Russian companies. A Russian trading company located in Finland gets a European identity which helps market entry in Europe, yet it knows the local Russian market. This confers an advantage over direct sellers in the Russian market. About half of the some 2,000 Russia-related firms in Finland are registered as retail and wholesale or transport companies, suggesting such activities are potentially quite common.

Finland's traditional market knowledge of Russia is built upon both asymmetric information and geographical advantage. Indeed, many international firms run still their Russia operations through Finnish subsidiaries (e.g. Nordic teleoperator TeliaSonera and electrical device manufacturer Canon). The Finns have historical experience of trade with Russia, and even today many major international firms consider Finns among the most knowledgeable in dealing with the Russian market. As a result, goods are often first imported to Finland by the Finnish subsidiary of a multinational and then a part of shipment is shipped forward to Russia. When Finnish demand cannot be ascertained ahead of shipping, it can be beneficial to report the whole shipment as an import to Finland. Then, if Finnish demand is inadequate to take the entire shipment, the remainder can be shipped on to Russia. For example, Finnish car importers usually empty their warehouses by selling forward to Russia cars not in demand in Finland. This explains partly the huge car re-exports to Russia and the importance of the Finland's new car taxation rules to re-exporters.

Both the transport hub and asymmetric information motivation have been long recognised. For example, a study of Finnish re-exports to Russia by Widgren, Kaitila and Arkonsuo (2000) estimates that 22% of the Finnish exports to Russia in 1996 were re-exports.<sup>6</sup> They state that re-exports concerned mainly product groups where Finland would be a net importer even without re-exporting to Russia. Based on this assessment, they conclude that re-exports probably consisted mainly of intra-firm trade of Finnish companies operating in Russia rather than pure intermediating trading activity. They also conducted a survey among Finnish companies re-exporting to Russia. The Finnish companies cite logistics and experience as their main advantages in the trading business. These results support the transport hub and asymmetric information motivations for re-exports at that time.

Transfer pricing may also motivate re-exports in certain cases. Through transfer pricing, the Finnish parent company is able to repatriate income from its subsidiary in a foreign country. Transfer pricing might be reflected in the differences between import and export prices of a product. This could well be the case for mobile phones. The average

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<sup>6</sup> Widgren, Kaitila and Arkonsuo (2000) use the term "transfer trade" (their translation of the Finnish *välityskauppa*) for re-export trade through Finland to Russia.

price of a mobile phone imported to Finland was 81 euros in 2006, whereas the average price of a phone exported from Finland to Russia was 189 euros. The price difference is partly explained by production of more expensive models of mobile phones in Finland, than imported.<sup>7</sup> Part of the price difference can also be explained by costs for warehousing and dispatching, but these reasons alone are probably insufficient to explain such a large discrepancy. Hence, the difference is likely also due to transfer pricing of the Finnish manufacturers or it reflects the intermediate trading company's profits.

Re-exports may also be related to grey schemes such as carousel trade and tax fraud. Carousel trade is where goods imported to Finland from another EU country are reported as exported outside EU (in this case to Russia) in order to claim a VAT refund. In reality, the products never cross the Russian border, but instead reappear on EU black market. The EU estimates that generally 20% of VAT refunds claimed by the member states are actually carousel trade fraud and that the goods never exited the EU (Junttila, 2006). Avoiding Russian customs duties is also a rather common phenomenon as many firms seek to avoid such duties by underreporting the value of the good to the Russian Customs. The most common scheme is double invoicing, whereby the false documents are only presented to the Russian Customs.<sup>8</sup> In cases where huge discrepancies in prices on the Finnish-Russian border are likely to raise suspicions among the authorities, schemers may transfer the ownership of the goods among intermediate companies and lower the documented price of the goods already in Finland before re-exporting to Russia. Such re-export cases, while still rare, nevertheless will probably become more common in order to avoid the tighter control induced by increasing cooperation between the Finnish and Russian Customs. In a way, such schemes are yet another way companies exploit asymmetric information. As mentioned in section 2, such schemes appear in re-exports of Hong Kong to China. There is anecdotal evidence that some trading companies operating in Finland may be involved in such grey schemes.

## 5 The effect of re-exports on the Finnish economy

### *Finland's market share in Russia*

As presented earlier, Finland's exports to Russia have experienced robust growth past years. In 2000-2006, the value of Finnish exports to Russia nearly tripled, with re-exports contributing almost half of this growth. For vehicles and electrical equipment, the growth contribution of re-exports has been even larger. If average growth rates prevailing in this decade were to continue in the coming years for both re-exports and domestically produced exports, the value of re-exports would surpass the value of actual exports before the end of

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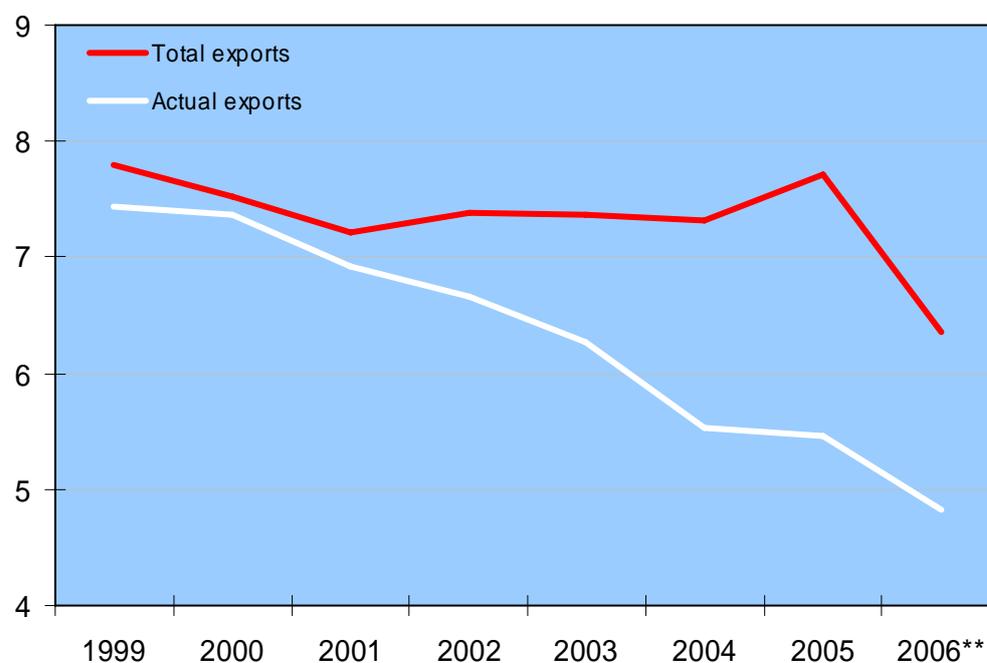
<sup>7</sup> Mobile phone prices are especially tricky as customs statistics record phone components from abroad as a complete mobile phone when the shipment includes all the components (circuit board, battery, screen, charger, cover, etc.) needed to assemble a mobile phone. Hence, some mobile phones assembled in Finland are registered as imports.

<sup>8</sup> Under a double-invoicing scheme, the exporter shows the real receipt to the exporting country's authorities and then switches documents after the goods leave the country. The second set of declaration documents show a much lower value for the goods or place the goods under a different customs classification to avoid high import duties in the country of destination.

the decade. Since the share of re-exports has been rather significant and increasing, it is likely that re-exports distort the picture as in the Dutch case.

To get a more accurate view on the development of Finland's market share in Russia, we exclude all re-exports and export of mobile phones (because the Finnish produced phones are hard to split from re-exported) from total exports and denote this actual exports. Then we compare the share of Finnish total exports and actual exports to the summed exports to Russia of the EU-25, the US, Japan, China and Korea. We use the exports as the point of comparison instead of Russian total imports because of the recording problems in Russian import statistics and more direct comparability of export statistics (compiled on FOB basis). The countries used for comparison provide a rather good proxy as they account for the majority of Russian imports in most products that Finland also exports to Russia (the structure of CIS countries exports to Russia is rather different, so they are excluded from this comparison).<sup>9</sup>

Figure 5.1 Finland's share in exports to Russia by main exporting partners\* in 2000-2006, %.



\* European Union (EU-25), the U.S., Japan, China and Korea

\*\* The export data for China in 2006 is available only at the aggregate level, so different components must be estimated based on their 2005 export shares.

Source: Authors' own calculations based on data from Eurostat, UN Comtrade and national customs.

The results of our comparison are presented in Figure 5.1. They suggest that mere examination of total export development can be somewhat misleading. Measured as total exports, it appears that Finnish market share compared to other major export countries has stayed rather stable past years, diminishing clearly only in 2006. However, the development path is different when re-exports and exports of mobile phones are excluded.

<sup>9</sup> Russian Customs reports that the EU-25, US, Japan, China and Korea accounted for about two-thirds of Russian total imports in 2006 and that this share has stayed fairly stable throughout the period 1999-2006.

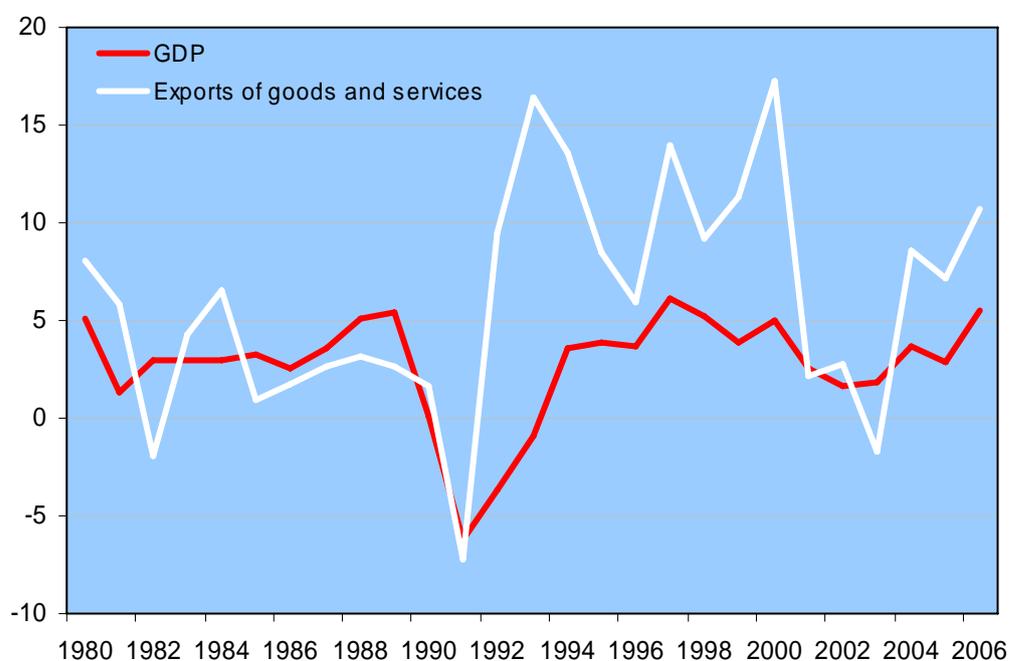
The change reveals a deteriorating trend in Finnish exports to Russia. The stability of market share is explained by the increase of the Finnish share in the markets of re-exported products; the share of domestically produced exports has diminished. Mobile phones show a dramatic decline in 2006, while the share of other domestically produced exports diminishes more moderately, but for a longer time.

### *Implications for the Finnish economy*

Exports are traditionally a significant factor in economic growth especially for small, open economies like Finland. Historically, exports have served as the motor of Finnish economic growth in several periods. Finnish exports currently account for about a third of the GDP and exporting industries employ tens of thousands of Finns. Nevertheless, a closer look at exports modifies this picture; all exported goods are not produced in Finland and thus have a less positive impact on Finnish industrial production and employment, or income.

In the Finnish case, re-exports are probably related mainly to exports to Russia. As presented earlier, Russia's share in Finnish exports has been roughly 10% in recent years and the share of re-exports in Finnish exports to Russia has been 20-25%. Hence, the share of re-exports in Finland's total exports would be only a few per cent. Figure 5.2 suggests that the rapid growth in re-exports has not obscured the link between exports and overall Finnish growth as we saw in the case of Germany.

Figure 5.2 Growth of Finnish exports and total production (volumes) in 1980-2006, %.



2005-2006 preliminary data

Source: Statistics Finland.

Manufacturing still employs about a fifth of Finland's labour force. Consequently, export demand is important for employment. The growth in exports to Russia is not necessarily reflected in major employment growth as in other markets. Indeed, exports to Russia had an employment effect in 2004 of 37,000 jobs, compared to nearly 50,000 for Germany and Sweden on similar-sized exports (Ollus and Simola, 2006). The amount of Finns employed by production exported to Russia was 26,000 in 2000. Hence, the employment has grown by 40% in four years even with the rise of re-exports.

Another implication from re-exports could be shifts in the structure of production and employment from manufacturing to services, especially in trading and logistics services, the sectors that benefit most from re-exports. While this shift has been notable in countries specialising in re-exporting services such as Hong Kong, there has been no such visible shift in Finland. The share of trading and logistics services in production and employment has stayed rather stable (about 20% of the total) in the last decades. So re-exports do not seem to have affected the structure of Finnish economy. This is hardly surprising given that the relative share of re-exports in the Finnish total exports is quite small.

Similar to transit transport, Finnish re-exports to Russia mainly contribute to the income and employment of companies engaging in transport, warehousing and dispatching services. Transit activities generate only minor income (e.g. fuel sales) in Finland. About 95% of road haulage from Finland to Russia is performed by foreign (mainly Russian) transport companies (Bank of Finland, 2006). The few Finnish transport companies that do take part in this business hire mainly Russian drivers and register their cars in Russia. In an earlier paper (Ollus and Simola, 2006), we estimate 4,000 people were employed in 2004 in business services related to traffic (mainly transit) through Finland to Russia. Of these, only a tiny share could be attributed to re-exports. The Finnish Ministry of Transport and Communications (MINTC, 2006) put the cost to Finnish society in 2005 from road transit trade to Russia at 20 million euros for maintaining roads, ports and railways and additional pollution. At the same time, transit transport brought in about 166 million euros to the private sector and public fees of 3 million euros. As private firms pay taxes and other costs, the transport business as a whole probably generated more income than costs for Finland. The employment effect from re-exports was small.

#### *Grey practices and the discrepancy in trade statistics*

Most grey activities, e.g. carousel trade or double invoicing, do not directly affect the Finnish economy. However, their indirect effect is notable. They introduce unethical business practices to Finland and encourage Finnish firms to participate in various ways of corruption in the Russian market. In the case of carousel trade, the goods are usually sold on the black market near where the fraud occurred, which means that when such goods are sold in northern Europe, it biases competition on Finland's domestic market. Moreover, some grey trade is organised by criminal groups such that companies involved also increase their risk of exposure to pressure from such groups.

Finnish law is still quite lax on grey-scheme practitioners. Reporting a low-ball value to the Finnish Customs for a good is a minor customs violation, punished only by fees. Finnish Customs want such underreporting to be punishable under the criminal code to decrease the incentive for underreporting (Finnish Customs 2005). The Finnish government is currently working on legislative changes.

Re-exports may also make the share of grey trade appear larger than it actually is. Comparing Russian import statistics and partner countries' export statistics, we find that Russian import statistics tend to report significantly lower values for most countries. The largest discrepancies (over 50%) are observed for the transport hubs to Russia, i.e. the Netherlands (specifically Rotterdam harbour), Finland and Lithuania. One reason for the large discrepancy with the neighbouring countries is the different country of consignment and country of origin of the products exported to Russia. Goods that are re-exported through these countries to Russia raise these countries' export figures, while Russians register these imports according to their country of origin. This might also be reflected in the fact that the import figures for countries like the US and Japan actually show a positive discrepancy. In their own statistics, these countries probably record this trade as exports to the intermediate countries that re-export them to Russia.

We calculate how much of the discrepancy in trade statistics of Finland and Russia could be explained by re-exports. The results are summarised in Table 5.1. In the upper part, we present the figures from Finnish and Russian trade statistics and the difference between them, both in euros and percentages. The next part of the table presents our estimate of the re-exports moving through Finland to Russia. When the estimated value of re-exports is deducted from the difference between trade statistics, we get a value for the difference that cannot be explained by the re-exports.

Table 5.1 Differences between Finnish and Russian trade statistics and re-exports, 2000-2006.

	2000	2001	2002	2003	2004	2005	2006*
Finnish exports to Russia, million euros	2157	2806	3128	3477	4362	5744	6215
Russian imports from Finland, million euros	1037	1435	1606	1631	1874	2492	3173
Difference, million euros	-1120	-1371	-1522	-1846	-2488	3252	3042
Difference, %	-52	-49	-49	-53	-57	-57	-49
Re-exports from Finland to Russia, million euros	203	327	436	586	1087	1672	1424
Difference excluding re-exports, million euros	-917	-1044	-1085	-1260	-1401	1580	-1618
Difference, %	-42	-37	-35	-36	-32	-28	-26

\* preliminary estimate for re-exports.

Source: Authors' own calculations based on data from Statistics Finland and Finnish Customs.

Table 5.1 shows that the discrepancy between Finnish and Russian trade statistics remains rather large even if the re-exports are excluded from the Finnish exports figures. The discrepancy, measured in percentages, appears to diminish significantly during this decade, suggesting that the share of grey imports to Russia might have declined. If all re-exports are registered by the Russian Customs by country of origin, the share of unregistered

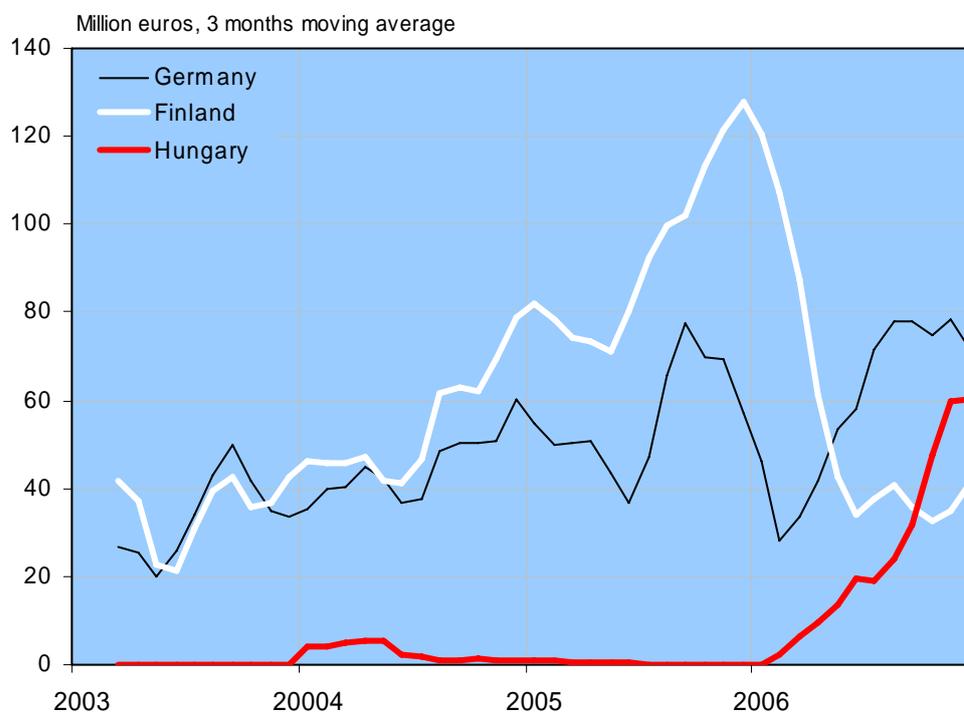
imports to Russia through Finland should be 28% for 2005. This share is only slightly larger than the 24% we presented for Russian overall imports in our earlier paper (Ollus and Simola, 2007). The discrepancy in the trade between Finland and Russia after excluding re-exports is only slightly larger than the average. Moreover, reasons other than grey schemes such as changes in exchange rates, differences in timing and confidential data explain part of the discrepancy. The preliminary estimate for 2006 is that the share of unregistered imports after excluding re-exports, to Russia through Finland continued to decline and was 26%.

#### *How stable are re-exports?*

As re-exports ebb and flow with transit traffic to Russia, we must ask about the long-term outlook. Finland currently acts as a transit hub for Russia. However, Russia has its own coastal ports on the Baltic Sea and the land routes to central Russia from Rotterdam harbour and most large European countries are clearly shorter through Eastern European countries than through Finland. Finland's advantage it appears is the shortage of logistical services and appropriate ports in northwestern Russia and the fact Finland has established a reliable major route for high-value goods imports to Russia. The question as to how long this situation might last is partly political. Russia has repeatedly stated it wants self-sufficiency in import infrastructure over the long term. Of course, Russia's ambitious plans to improve and increase the competitiveness of its own logistical services will naturally take time and require considerable investment. Eventually, Russia will likely succeed and transit traffic to Russia will decline along with re-exports based on logistical considerations.

It is also important to understand the cyclical nature of the re-export business. When car taxation is beneficial, car traders import through Finland. When legislation changes and authorities change their policies as with mobile phones, the goods easily find new routes. In 2006, re-exports and transit of mobile phones through Finland to Russia declined partly because transports moved to use other routes (e.g. the faster aviation route). The change reflected to some extent efforts by the Russian government to deal vigorously with grey imports of mobile phones following large seizures of illegally imported mobile phones by intermediate companies in autumn 2005 in Moscow. The government demanded that mobile phone manufacturers provide detailed price information and in some cases also start to handle the imports themselves instead of using intermediate companies. The customs also started to check mobile phone shipments thoroughly. Russian Customs estimates that in 2005 about 95% of the mobile phones were imported under grey schemes, i.e. excessively low import duties or none at all were paid. In 2006, the share of mobile phones imported under grey schemes was estimated to be only 5-10%. Also the average price of mobile phones in Russia rose nearly 50% in 2006 and mobile phone sales in Russia declined by 14%. The decline in using circuitous routes for mobile phones destined to Russia seems to be reflected in increased mobile phone exports to Russia from Hungary and Germany in 2006 as the final destination is declared already in the country of origin. Development of German, Hungarian and Finnish mobile phone exports to Russia are shown in Figure 5.3. Mobile phone exports from Finland to Russia in 2006 probably reflect more correctly the actual trade in mobile phones made in Finland exported to Russia.

Figure 5.3 Mobile phone exports to Russia from Germany, Hungary and Finland, 2003-2006.



Source: Eurostat.

Concerning mobile phones, it is also worth noticing that they are products with a high unit price and low weight, so transport costs do not account for much of their price. They can be transported through various intermediate countries to optimise logistical processes. Moreover, mobile phone demand follows technical and aesthetic trends that can change abruptly. Hence, the model destined for Russian market could conceivably lose its “must-have” status before reaching the market. Re-exports provide greater flexibility to traders as the final destination can be changed to meet the market.

Finally, re-exports are highly dependent on favourable logistics, trade agreements, customs regimes and policies in the countries involved in the transport. These can easily be disturbed if just one country modifies its policies. Hence, any business based solely on re-exports faces a highly uncertain future. Finland would thus be unwise to count on large re-export flows to Russia over the long term.

## 6 Conclusions

We defined re-exports as goods imported by a purchaser, who, without processing, exports the goods on to a third country. Re-exports seem to be common and partly the driver in the rapid export growth to Russia in recent years. Re-exports increased steadily in the early 2000s, reaching over a quarter of Finnish exports to Russia in 2005. In 2006, however, re-exports seem to have declined slightly with a fall in re-exports of mobile phones. Other re-exports, including passenger cars and home electronics, continued to grow.

Finland is now a major hub of imports to Russia, with a quarter of Russian total imports moving through Finnish territory either as exports or transit freight. Finland's secure and technically advanced logistics systems are competitive for high-value goods transports to Russia. Re-exports to some extent are justified by the same reasons as transit, but in certain re-exporting also adds flexibility – especially if the country of origin is within the EU or from a region the EU exempts import duties on the product. Russia also provides a vast market for Finnish trading companies. Other reasons for re-exports seem to be asymmetric information, transfer pricing and avoidance of the legal obligations (grey schemes).

The economic effects of re-exports are not dramatic, but they cause certain difficulties. Re-exports distort trade statistics, which gives a misleading picture and complicates economic analysis. In the Finnish case, re-exports have masked the downward trend in the share of Finnish domestic exports in Russian markets. Re-exports also blur the traditional links between exports and other economic indicators. This should be recognised because the income and employment effects of re-exports are smaller than those of domestic exports.

Re-exports could also lead to shifts in production and employment structure when the country specialises in trading and transporting activities. This has not happened in the Finnish case, given that the share of re-exports in Finland's total exports is still small. Grey schemes are not the driving force behind re-exports in trade with Russia, but they deserve further consideration as they can bias competition, promote unhealthy business practices and decrease the tax and custom revenues for the countries involved.

Finally, it is worth noting that re-exports tend to be highly cyclical and a risky business for middlemen. Today passenger cars are transported through Finland due to flexible car taxation and good infrastructure, but tomorrow that could end. We have already seen this in the case of mobile phones – exports of them moved from Finland to Germany and Hungary in a large extent in only one year.

## Appendix

### Estimating the value of Finnish re-exports to Russia in 2005

We calculate an estimate for the minimum value of re-exports in Finnish exports to Russia by comparing the statistics of Finnish production and Finnish exports to Russia. We examine the 30 largest product groups, which account together for nearly two-thirds of Finnish exports to Russia. The exercise is based on industrial production figures for 2005 (the latest data available).

In Table A.1, we report the estimates for re-exports calculated as the difference between Finnish production and Finnish exports to Russia. For passenger cars, however, we ignore domestic production, since virtually all passenger cars produced in Finland are exported to Western markets (Tuomi, 2006). As we can see in Table 3.1, we obtained for re-exports the minimum estimate of nearly 1.1 billion euros, which corresponds to 19% of total Finnish exports to Russia in 2005.

Table A.1 Estimates for re-exports in different product groups of Finnish exports to Russia in 2005.<sup>10</sup>

	Sold production of Finnish industry, million euros	Exports to Russia, million euros	Re-exports, million euros
Washing machines	1.8	100.3	98.5
Telephonic or telegraphic switching apparatus	0	53.7	53.7
Medicaments	0	81.3	81.3
Television receivers	1.8	184.7	182.9
Units of automatic data processing machines	8.8	138.4	129.6
Painter's fillings and similar materials	10	47.6	37.6
Monolithic integrated circuits	0	51.8	51.8
Lubricant preparations	2.2	42.4	40.2
Taps, cocks, valves and similar appliances	0.1	28.9	28.8
Electric heaters	1.2	23.2	22
Refrigerators and freezers	11.8	29.1	17.3
Passenger cars		353	353
<b>Total</b>		<b>5744</b>	<b>1096.7</b>

Sources: Statistics Finland, Finnish Customs.

<sup>10</sup> The largest product groups in Finnish exports to Russia were chosen at the 4-digit level of the CN-nomenclature in 2004 statistics, while the comparisons with the sold production have been conducted at the most detailed, 8-digit level.

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It is worth emphasizing that this method only gives a minimum proxy without mobile phones on re-exports based on some of the largest export product groups. Naturally, by using this method, not all re-exported products can be identified. In addition, we compare the Finnish production only with the exports to Russia – ignoring the total exports – hence the actual amount of re-exports might be underestimated.

We cannot calculate an estimate for the re-exports of mobile phones by the method used above as the production data is confidential. Finland is currently the main hub for mobile phone imports to Russia by the majority of the mobile phone companies and many of them are re-exported. Mobile phones are an important category in Finnish exports to Russia, and hence, we need some kind of evaluation of the extent of their re-exports. We use as a proxy the average share of re-exports in the product groups presented in Table A.1 (excluding passenger cars because of their share of 100%). We then average the estimate over the years and arrive at a very rough approximation of 50%.<sup>11</sup> As the Finnish mobile phone exports to Russia were worth 1.2 billion euros in 2005, the value of re-exports would have been 545 million euros. Thus, taking into account this rough assumption for re-exported mobile phones, the value of the minimum estimate for total re-exports from Finland to Russia climbs to roughly 1.6 billion euros, or 28% of total Finnish exports to Russia in 2005.

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<sup>11</sup> Although the estimation method is undoubtedly very rough, the estimate is supported by the estimates brought up in discussions and interviews we have had with different market actors, when we were putting together *Russia in the Finnish Economy* (Ollus & Simola, 2006).

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