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## Finnish trade with the USSR: Why was it different?



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Pekka Sutela\*

## Finnish trade with the USSR: Why was it different?

### Abstract

Trade with the USSR accounted for about 15 per cent of Finland's total exports in 1952-1990, peaking at more than a quarter in the early-to-mid 1980s. Such trade is routinely seen to have had a major beneficial impact on the Finnish economy, whether in terms of profitability, diversification or stability. At the same time, trade with the USSR is seen to have had a major negative impact on the economies of the Central European member countries of the CMEA. This paper discusses this paradox, looking at both the institutional arrangements of Finnish – Soviet trade and the available analytical evidence. Much research, however, still remains to be done.

**Key words:** Finland – economic development; East – West trade; bilateralism; clearing.

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# 1 Introduction

Trading with – and in particular exporting to – the Soviet Union was traditionally seen by many in Central and Eastern Europe as a burden to be minimised. It created an undesirable dependency relationship; strengthened the role of state bureaucracies in the economy, via its reliance on government-level negotiations; and tied up scarce resources in the production of goods that, more often than not, failed to meet world market standards for productivity and quality. On the other hand, one explanation often put forward for the relative success of the Finnish economy in the postwar period is the apparent benefits derived from trade with the Soviet Union. Thus the standard monograph on the Finnish growth experience argues that Finland in fact benefited from Eastern trade because of the more varied export structure and higher value added content than was the case for Western trade and because of the stability and predictability that was created by the five-year trade agreements.<sup>1</sup> Assuming that both attitudes are based on facts, an obvious question arises: how can trade with the USSR have been both a bad thing (for Eastern Europe) and a good thing (for Finland)? In searching for an answer, this paper discusses some of the peculiarities of Finnish exports to the USSR.

Another question emerged after the collapse of the Soviet market in 1991. In retrospect, were both Eastern Europe and Finland actually too dependent on trade with the USSR? In particular, how did the decline in Finnish exports to the USSR contribute to the 14 per cent decline in Finnish aggregate production in the early 1990s, which was unprecedented for a post-WWII developed market economy?

To provide some background for the discussion to follow, it might be appropriate to include a few remarks on the trade arrangements between Finland and the USSR. Trade between the countries started after the war in 1945. The first five-year trade agreement between the countries was signed in 1950. This was intended to provide both a continuation of the shipments that Finland had made up to 1951, as war reparations, and a trade environment that was consistent with the Soviet principles of central management. Trade flows were organised around five-year agreements, further detailed in annual trade plans. Trade was financed as clearing that was originally supposed to be kept quite strictly in balance.

Trade was organised in several formats. Starting in 1967 there was a permanent inter-governmental economic commission, but companies and their organisations also had direct contacts with Soviet foreign trade organisations and often with plants as well. Concerning major deals, in particular, government-level trade agreements often simply codified agreements already reached on the company level. Prices, in particular, were agreed at company level. On the other hand, major projects were discussed and even agreed at the level of heads of state.

By 1960 clearing trade became a rarity in Europe. Because of balance of payments considerations, it was important to have high domestic-content requirements for Finnish exports to the USSR. This, along with the need to observe COCOM restrictions, amounted to a further limitation for the trade procedure.

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<sup>1</sup> Hjerpe Riitta: *The Finnish Economy 1860-1985*. Helsinki 1989, p. 162-163.

## 2 Finnish Exports to the USSR

Finland's trade with the USSR was unique among developed market economies in two respects.<sup>2</sup> Finland is the only country of its kind for whom the USSR has been, at least temporarily, the most important trading partner. While the Soviet share of Finnish exports was some 15 per cent in 1952-1980, it expanded along with the rise in energy prices and peaked at over 26 per cent in the early-to-mid 1980s. After that, the share declined, to about 14 per cent in 1989, as the grinding collapse of the USSR began (see Figure 1).

This trend, though at the time deplored by many in Finland, provides evidence that Finnish export trade had already adapted to some extent to the decline of Soviet demand by the time it became conspicuous in 1990 and finally collapsed in 1991. It is in retrospect fortunate that – contrary to many suggestions – Finnish trade authorities did not in 1988-1990 undertake further financing or other related measures to maintain the traditional Soviet share in Finnish exports. The 1991 collapse in exports could have been even worse, leaving in its wake even more unemployment and outstanding credit than it actually did. The underlying analysis of Finnish policymakers seems to have been vindicated.

Figure 1 shows the extreme variation in Russia/USSR's long-term share in Finnish exports. As Finland was industrialising in the second half of the nineteenth century, its exports became increasingly oriented towards Western markets. This was interrupted by the First World War. In the interwar period, the isolation of the Soviet Union from international markets was also reflected in trade with Finland.

The Soviet share in Finnish exports declined further in 1990 to about 10 per cent and then to 5 per cent in 1991. After having declined by 11.1 per cent in 1990, the value of Finnish imports from the USSR declined by 27 per cent in 1991 while exports collapsed by 65 per cent.<sup>3</sup> This is substantially more than the overall decline in Soviet imports and, in particular, much more than the decline in Soviet imports from the traditional convertible currency area. Indeed it seems likely that Finnish exports to the USSR declined in 1991 faster than those of any other major trade partner. Only the Eastern European countries are comparable in this respect. Finland's share of Soviet imports from the OECD area can be estimated to have dropped from 9 per cent in 1990 to about 4 per cent in 1991.<sup>4</sup> (The trade balance, traditionally in Finland's favour, turned into a deficit, as seen in Figure 2.)

It seemed therefore natural at the time to assume that the change in the trading regime contributed to the exceptional collapse of Finnish exports to the USSR. Yet, even the post-collapse Russian share in Finnish exports has been notably high for developed market economies. Even today Finland is (after Lithuania) the EU country with the highest trade share with Russia.

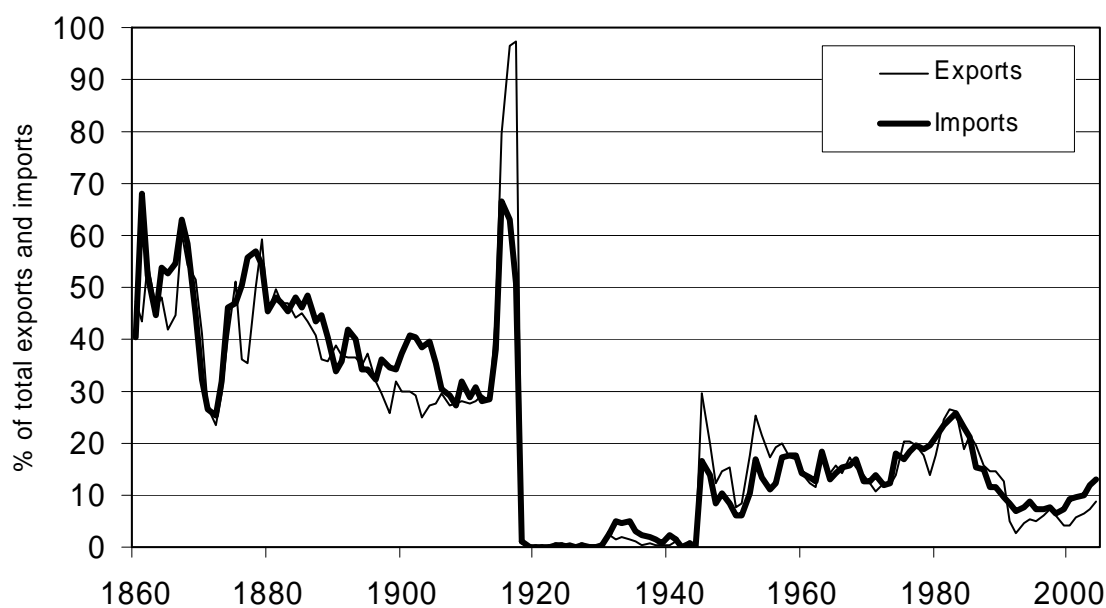
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<sup>2</sup> The only available general introduction to the traditional mechanisms of Finnish-Soviet trade remains Möttölä, Kari et al, eds: *Finnish-Soviet Economic Relations*. London and Basingstoke 1983. Also see Oblath, Gabor – Pete, Peter: *Mechanism and Institutional System of the Finnish-Soviet Economic Relations*. In Friedländer, Michael, ed.: *Foreign Trade in Eastern Europe and in The Soviet Union*, Boulder 1990.

<sup>3</sup> As late as in early 1991, the most common guesstimate for the decline in exports to the USSR was 'only' 40 per cent. Sutela, Pekka: *Trading with the Soviet Union: Some Microeconomic Aspects for Finland*. In: *Osteuropa-Wirtschaft* 4/1991, p. 301-315.

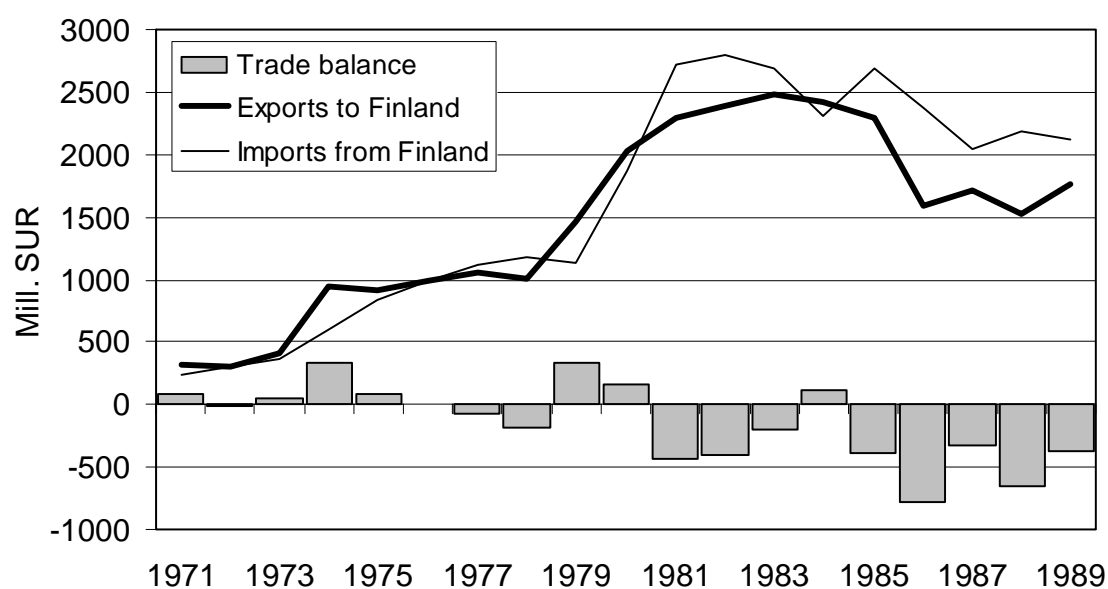
<sup>4</sup> Rautava, Jouko – Hukkinen, Juhana: *Russia's economic reform and trade between Finland and Russia*. In: *Bank of Finland Monthly Bulletin* 4/1992, p. 6-9.

Figure 1. Share of Russia / Soviet Union / Russia in Finland's Foreign Trade, 1860-2004



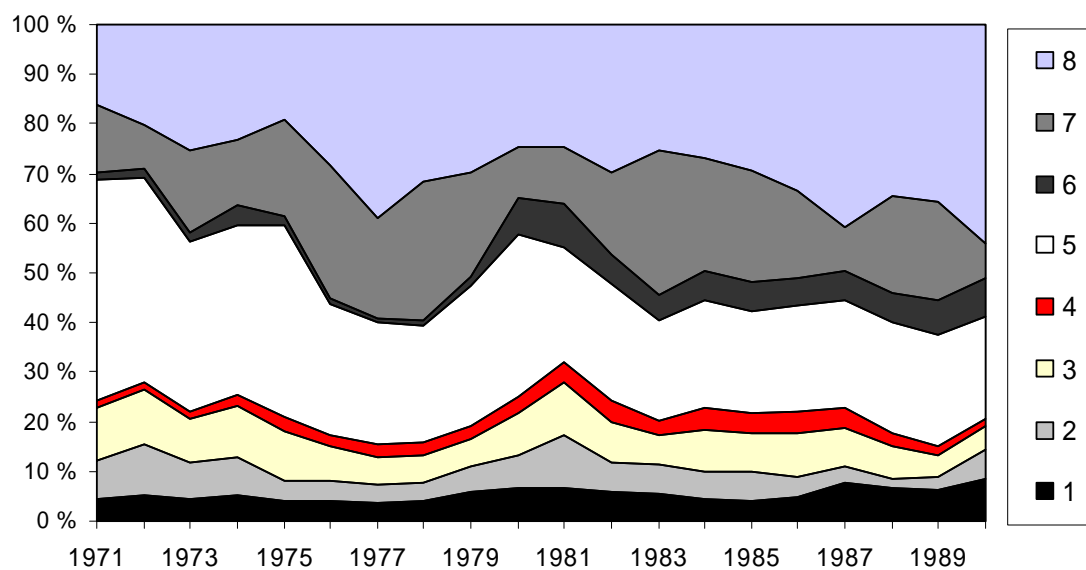
Sources: Finnish Customs, Bank of Finland

Figure 2. Finnish – Soviet Trade, 1971 – 1989



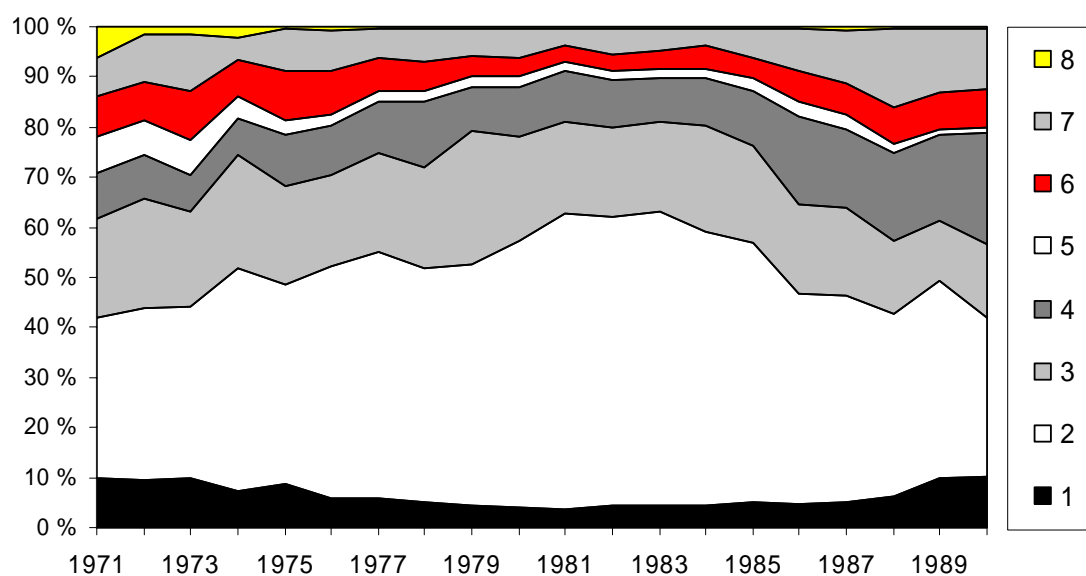
Sources: Finnish Customs, Bank of Finland

Figure 3. Structure of Trade, 1971 – 1990



## Structure of exports

- |                         |   |
|-------------------------|---|
| 1 Other exports         | 5 Paper and paperboard and articles thereof |
| 2 Food and beverages    | 6 Chemicals and related products            |
| 3 Textiles and clothing | 7 Ships                                     |
| 4 Footwear              | 8 Metallurgy                                |



## Structure of imports

- |                         |                                     |
|-------------------------|-------------------------------------|
| 1 Other imports         | 5 Metallurgy                        |
| 2 Crude oil             | 6 Wood material                     |
| 3 Other oil products    | 7 Machinery and transport equipment |
| 4 Other energy products | 8 Food and beverages                |

Sources: Finnish Customs, Bank of Finland



However one should not jump to conclusions here. It is presumably true – though we cannot be sure – that the existence of the clearing arrangement meant that Finland had a special niche in Soviet foreign trade planning. However that 'fact' per se does not at all imply that the planned Finnish trade share would necessarily have been larger than 'normal'. Clearing could also have been used to discriminate against trade with Finland. But in fact that was not the case, and clearing arrangements must be seen as a vehicle for implementing politically ordered priorities. Thus, in this sense, the collapse of trade was not a consequence of the abolishment of clearing, but rather of the abrogation of political decisions that had previously given Finland a high priority in the USSR's foreign trade with the West.

Unfortunately, there appear to be no studies available on the historical 'natural' level of Finnish-Soviet trade. As already noted, the actual historical share hardly provides a clue either. In a rational world, the factors of size, proximity and resource endowments would undoubtedly imply a relatively high share for the USSR in Finnish exports. It is therefore not clear whether the high level of past or present trade shares is normal or abnormal. One thing that is clear is that, because of limitations on market access, the USSR imported from Finland goods such as textiles, footwear and foods, in which Finland was not a major world market supplier.<sup>5</sup> This was then seen as a major benefit of Eastern trade, but later of course it hugely hindered the adjustment to Soviet collapse.<sup>6</sup>

Due to the peculiarities of clearing trade – to be discussed below – Finnish exporters were eager to export to the USSR. These factors also imply that, when Russian trade relations with major world market competitors began to normalise and the clearing trade system between Finland and the USSR was abolished, the mutual foreign trade shares of Finland and the USSR were bound to be lower than those reached in the 1980s. No wonder then that many Finnish exporters campaigned for the preservation of the clearing system in 1990.

Furthermore, the cost level of Finnish industries increased rapidly in the late 1980s, as the country was building up a bubble that was to burst in the early 1990s. After 1985 Finland rapidly lost market share in the major Western countries. The changed emphasis in Soviet foreign trade decision-making, from political to economic, which was also reflected in the abolishment of the clearing arrangement, implied that these negative factors together would reduce Finnish market shares in the Soviet economy.

In 1990 Finland was the only developed market economy still trading with the USSR on the basis of bilateral clearing.<sup>7</sup> Given the relative sizes of the economies, the value of Finnish exports under this arrangement was effectively constrained by Finnish imports from the USSR – in practice by Finnish absorption, Soviet availability and world market prices of Soviet energy, primarily crude oil, which made up the bulk of Finnish imports from the USSR (see Figure 3).<sup>8</sup> In this respect Finland's trade with the USSR was in

<sup>5</sup> Some such Soviet imports from Finland in the late 1980s were even paid for in currency and so cannot be explained by the peculiarities of bilateral clearing trade.

<sup>6</sup> Thus Urho Kekkonen, President of the Republic and a very active promoter of trade and economic co-operation with the Soviet Union, wrote in a private letter on 20 November 1972: 'We must of necessity maintain a relatively large trade with the West, but of much importance is the fact that we are able to sell to the Soviet market in the main such goods that would be very difficult to market into the West.' Cited in Suomi, Juhani: *In the Countercurrent of Detente: Urho Kekkonen 1972-1976* (in Finnish). Helsinki 1998, p. 302.

<sup>7</sup> As will be seen below, by 1989 clearing was in fact already moving rapidly towards normal currency trade.

<sup>8</sup> In 1989 Finland imported 94 per cent of its crude oil from the USSR. In 1991 the share dropped to 34 per cent, and in 1992 the share was even lower. The end of clearing trade, more stringent environmental standards, and of course Russian supply problems all contributed to this development. Later, Russia supplied

essence similar to that of East European countries, in so far as it has been bilaterally balanced.

In reality, Finnish-Soviet trade has not been nearly as tightly fettered as the need for balancing the clearing account – first on an annual, later on a five-year basis – would seem to imply. As the volatility of energy prices increased, making the mechanical balancing of payments difficult, various financial arrangements were developed so that trade volumes would not fluctuate as much as energy prices. In fact, by the latter half of the 1980s, such arrangements, as alien as they are to the basic philosophy of clearing trade, actually covered the larger part of Finnish-Soviet trade, although they in fact failed to stabilise trade volumes. Because of the impact of oil price volatility, exports to the USSR actually continued to fluctuate much more than overall exports. The share of outright currency trade in total turnover also increased rapidly, reaching a level of about one-third.<sup>9</sup> This is an interesting topic in its own right but not crucial for the arguments of this paper.

There was also a countercyclical pattern of exports to the USSR, much discussed at the time in Finland. While oil price shocks sent Western markets into depression and thus decreased overall Finnish exports, they tended – through bilateral balancing – to increase Finnish exports to the USSR. While the terms-of-trade effect was similar in both markets, the volume effects of oil price shocks differed. This is statistically evident for 1975-1990 and is arguably a major factor behind the exceptionally long Finnish boom of the 1980s. In the 1980s, the trade mechanism was also purposely used as a countercyclical policy tool.<sup>10</sup>

### 3 Soviet trade and the Finnish economy

In spite of its obvious economic importance and inherent interest, the bilateral trading system has been much neglected in Finnish research<sup>11</sup>. One reason for this is that trade with the Soviet Union used to be an integral part of Finland's corporatist political economy. Though state trading with the USSR was embedded in the overall market economy framework of Finland, in fact this aspect of the Finnish way of doing business was even more highly concentrated and politicised than is the economy at large<sup>12</sup>. More than half of all Finnish imports from the USSR used to be handled by a single company, the state-owned oil and chemical corporation Neste. Exports have also been highly concentrated.

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about half of Finland's crude oil needs, the rest coming mainly from the North Sea. As the latter source will eventually dry up, Russia's share might well increase again. Transportation logistics would also tend to make Baltic harbours natural supply sources for Finnish crude oil imports if Russia continues to be unwilling to build an oil pipeline to the main Finnish refinery, which is situated quite close to the Russian border.

<sup>9</sup> For a compact discussion of these trends see Kivilahti, Terhi – Rautava, Jouko: New Framework for Trade between Finland and the Soviet Union. In: Bank of Finland Bulletin, 12/1990, p.2-6.

<sup>10</sup> Kajaste, Ilkka: Soviet Trade and the Finnish Economy. In: Ministry of Finance, Economics Department, Discussion Paper No. 33, Helsinki, February 1992.

<sup>11</sup> For a first attempt at an economic analysis, see Alho, Kari et al: Soviet Trade in The Finnish Economy (in Finnish). Helsinki 1986.

<sup>12</sup> For a general analysis of Finnish social corporatism in a comparative framework see essays in Pekkarinen, Jukka – Pohjola, Matti – Rowthorn, Bob, eds.: Social Corporatism: A Superior Economic System? Oxford 1992.

In 1989 the total number of Finnish exporters to the USSR was 1688.<sup>13</sup> The five largest exporters accounted for 39.9 per cent of all exports, the fifty largest for 78.7 per cent and a total of 116 exporters for 90 per cent. Such concentration is clearly higher than in overall Finnish exports.<sup>14</sup> It should however be noted that production alliances and consortia were widely used in Eastern exports because of the large size of shipments needed. Therefore, the figures just cited tend to exaggerate the degree of concentration on exports to the USSR.

Looking at the matter from the Soviet side, such concentration of Finnish export activities can be explained by the scale preferences of the specialised Soviet importers. In the Finnish perspective, two partially competing explanations for this state of affairs seem possible. Concentration may be due to the fact that the main proportions of trade used to be agreed in five-year framework protocols. Though these agreements were solemnly concluded between states, on the Finnish side they were prepared, negotiated and accepted by (in most cases privately owned) profit-maximising enterprises. Such lengthy planning horizons, though entailing only rather loose quotas – later fleshed out in commercial contracts, may well have exceeded the limits of small companies. But on the other hand, the centralised system of conducting bilateral trade through governmental commissions and associations of industries as such may have rendered large corporations' policy-makers and insiders privy to both essential information and contacts.

Thus shrouded in the twin mysteries of business and politics, Finland's trade with the USSR has traditionally been regarded with some scepticism by large sections of the public. The bilateral trading system, in particular, has been widely seen as something strange, alien to the spirit of a market economy and therefore probably economically disadvantageous to Finland. This paper sidesteps the macroeconomic effects of bilateral trade as well as the intriguing issue of exchange rates.<sup>15</sup>

On the micro level, the view of bilateral trade as being inherently disadvantageous to Finland is not supported by Finnish business opinion. A 1983 survey of companies in light industry found that 66 per cent believed that exports to the Soviet Union were marked by greater-than-average profitability.<sup>16</sup> A 1990 survey found that most companies interviewed opposed the Soviet-proposed changeover from bilateral clearing to conventional trade, based on convertible currencies.<sup>17</sup> And in autumn 1990, as the prospect of having to abandon bilateral trade was becoming evident, this was the view consistently expressed by the associations of Finnish industries. It may thus have been the case that exporting to the USSR was particularly profitable and that this had something to do with the clearing mechanism. This then is the main subject of this paper.

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<sup>13</sup> Sutela, Pekka: Trading with the Soviet Union: Some Microeconomic Aspects for Finland. In: *Osteuropa-Wirtschaft* 4/1991, p. 301-315.

<sup>14</sup> Thus, the share of the ten largest exporters to the USSR in 1989 was 51 per cent, in all exports 42 per cent.

<sup>15</sup> Sutela, Pekka: Trading with the Soviet Union: Some Microeconomic Aspects for Finland. In: *Osteuropa-Wirtschaft* 4/1991, p. 301-315.

<sup>16</sup> Kivikari, Urpo: Finnish-Soviet trade in the light industry. In: *WIIW Forschungsberichte*, 109/1985, p. 25-100.

<sup>17</sup> Koivumaa, Katariina – Valtonen, Timo: Finland's Trade with the USSR and changing environment (in Finnish). Helsinki 1990.

## 4 Were Soviet prices higher?

In spite of an often declared general adherence to the principle of using world market prices as the pricing base in Finnish-Soviet trade, one can conceive of ways in which the prices of Finnish exports to the USSR might have been higher than the corresponding prices elsewhere. The first – and perhaps relevant – case would arise if the clearing rouble had been relatively cheaper to Soviet importers than convertible currencies. This is not inconceivable, as the maze of Soviet foreign trade financial regulations was always notorious, and the Soviet authorities may have had a political reason for such pro-Finnish discrimination. There is, however, no information upon which to either confirm or reject this possibility.

Furthermore, one might at least theoretically consider a peculiar Finnish form of industrial subsidy. Assume that the Finnish authorities decided for some reason to support those industries which currently exported to the USSR. One way of doing this would be to pay higher prices than those currently charged on world markets for oil and related imported products on the understanding that a similar surcharge would be added to Finnish export prices. In this (obviously purely hypothetical) case, the Finnish importer, a state-owned monopoly, would be compensated through consumer prices. Administering such a hypothetical arrangement, however, would probably prove to be quite difficult, and there is no firm evidence that it has been used. But it has been a topic of speculation.

One can also conceive of other ways in which the Finnish state might have used trade with the Soviet Union as an industrial subsidy. Finally, the possibility should not be excluded that, at least during some periods, Soviet officials have simply negotiated bad contracts, because of incompetence, ready availability of earnings from energy exports, or their notoriously soft budget constraints. Other possible reasons could also be given.<sup>18</sup> World market prices for use as references in trade negotiations are not easily defined for most commodities.

It is obvious that in some ways Finnish-Soviet trade arrangements used to be peculiarly advantageous to Finnish exporters. As a somewhat extreme but important example let us consider the payment arrangement for Finnish-built ships, which held sway until the early eighties. Under this arrangement the buyer paid up to a quarter of the value of the deal when it was agreed or when work commenced, sometimes years before the ship was delivered. By the date of delivery, the ships were already fully paid for. This, of course, was in sharp contrast to the conventional practice of export financing and provided profitable opportunities for financial management by Finnish shipbuilders.

All of this must remain a matter of speculation, as the actual export prices paid are, of course, business secrets. However some light can be shed on this matter by unit value indices which can be derived from commodity export statistics. Assuming that structural and quality changes are negligible (over a sufficiently short period of time), changes in unit values are indicative of changes in prices. Kajaste and Mattila<sup>19</sup> have calculated that following the increase in Soviet export earnings and strengthening of the rouble in the early 1980s, unit values of Finnish exports to the USSR rose faster than those of other Finnish exports in such

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<sup>18</sup> One potentially interesting case is the enterprise-specific buy-back arrangement known as 'industrial cooperation' that became widespread in the 1980s. Quite probably, these arrangements tended to increase price levels, but the burden was not necessarily evenly distributed.

<sup>19</sup> Kajaste, Ilkka – Mattila, Anna: Do exports to the West compensate for declining exports to the East? (in Finnish) In: Valtiovarainministeriö, Kansantalousosasto, Keskustelualoitteita 18/1988.

major sectors as food, light industry, paper and forestry, and the engineering industry.<sup>20</sup> This did not, however, take place in the basic metals or chemical industries.

These calculations are consistent with the view that Soviet importers have tended to be liberal with money when it was plentiful. Still, they only refer to changes in unit values of exports, and do not necessarily reveal anything about relevant price levels.

To obtain such information, one must look at homogeneous commodities which are exported to different markets. The choice is of necessity somewhat arbitrary, and the volumes exported to different markets fluctuate. But taking the examples of eleven commodities, ranging from newsprint to polyester-based alkyd paints, one does find some corroborative evidence for the view that Russian markets have provided a profitable outlet at least when Russia's energy earnings have been prodigious.<sup>21</sup>

In seven of eleven cases, the price paid by the USSR in 1985, when Soviet energy income was high, was the highest for any market. In no case was it the lowest, and in the two cases, where the USSR market was among the three lowest-paying, the volume exported to the Soviet Union made up the bulk of Finnish total exports. Economies of scale may thus have compensated for the lower prices. In the interesting case of newsprint, for which the USSR is a relatively small market, the prices obtained in different markets vary only modestly, and the USSR was among the top two customers in 1980, 1985 and 1989.

In 1989, when Soviet export earnings had dwindled, the USSR paid the highest unit prices in only three of the eleven cases. In each of these cases the market in question was relatively small. In five cases the Soviet price was the second highest, and in no case was it the lowest.

In addition to such quasi time-series, more detailed information is available on the prices obtained for exports to the USSR and Western markets in 1985.<sup>22</sup> As noted above, that year is of particular interest, as the very sketchy information cited above seems to imply that the Russians were liberal with their money when oil prices were high. This view is loosely corroborated by data on the prices of 250 export items (46 per cent of the value of exports to the USSR). On average, the prices of exports to the USSR were 109.5 per cent of prices of exports to the West. For about 60 per cent of exports to the USSR, the prices were higher than those received in Western markets. The difference was about one-fifth in non-metallic minerals and foodstuffs. In forestry exports the difference was about 16 per cent and in engineering, textiles and clothing exports somewhat more than 10 per cent. On the other hand, the export prices of chemicals and metals were lower than for exports to market economies.

According to Kajaste, 'these results seem to support the commonly held view that exports to the Soviet Union were exceptionally profitable during the 1980s'.<sup>23</sup> But words of caveat are in order. First of all, this data concerns only one year, 1985, a year when oil prices were high and hence Soviet export revenue was plentiful. Perhaps more importantly, on this disaggregated level the relative price of exports to the USSR varied between 50 and 200 – even after 103 items of the original 353 had been eliminated as outliers. Such variation is surely more interesting than the average price differential of 9.5 per cent.

<sup>20</sup> Kajaste, Ilkka: Soviet Trade and the Finnish Economy. In: Ministry of Finance, Economics Department, Discussion Paper No. 33, Helsinki, February 1992.

<sup>21</sup> The commodities in question are newsprint, women's shoes with leather uppers, a particular class of tights, polyester-based alkyd paints, men's and boys' pants, men's and boys' woollen suits, women's and girls' jackets, sports shoes, parquet, car tyres and combined refrigerator-deep freezers. This information was culled from customs statistics in the early 1990s by Mr. Ilkka Kajaste.

<sup>22</sup> Kajaste, Ilkka: Soviet Trade and the Finnish Economy.

<sup>23</sup> Ibid.

These indicators are obviously far from conclusive. The sample used in Kajaste's quasi time-series is a small one, and commodities assumed to be homogeneous may in fact be quite heterogeneous. For 1985, the high variability of relative prices is at least as noteworthy as the fact that on average Soviet buyers apparently did pay better prices than others. Furthermore, price is only one side of profitability. One should also look at the costs of finance, marketing, other transaction costs – including transportation, obviously an important factor for Finland – and possible differences in production costs. But this is in most cases information which is lacking even in the involved companies. They would not – least of all in the earlier Finnish bank-centred and relatively closed economy, where there was little pressure for a full exposure of all relevant financial information – be in the habit of making a full breakdown of costs according to different markets.<sup>24</sup>

## 5 Profitability levels

No direct evidence is thus available on the market-specific profitability of Finnish exports. Finnish companies have traditionally been very protective about their own financial data. The discussion above indicates that on average the prices obtained in the Soviet market have clearly not been less than those available elsewhere. Ultimately, the most important profitability-related factor in so far as Finnish exporters were concerned may have been the way in which bilateral trade has been financed. Though the Bank of Finland incurred quite high costs in the 1980s as a result of the mostly interest-free financing of Soviet deficits within the clearing system, no such direct costs were incurred by individual companies.<sup>25</sup> On the contrary, the convention of prepayment formerly applied in selling ships must have been extremely convenient for Finnish exporters, operating within a rapidly developing and somewhat abruptly liberalised domestic financial environment. Even after the payment arrangement for ships was changed, trading via the clearing account has actually been equivalent to cash trade for the exporting firms.

It would not seem unrealistic to conclude that this factor – certainly exceptional in modern international trade – was probably the foremost reason for the Finnish exporters' preference for clearing.

Furthermore, there are transaction costs to consider. The highly structured, bureaucratic way in which trade has been conducted with the USSR has meant that those firms with long traditions have had a significant sunk cost element in their total transaction costs. In particular, as long as trade was conducted with a single Moscow-based ministry and foreign trade organisation, marginal transaction costs may well have been less than those encountered in other markets, and the fixed costs may have been compensated for by the lesser degree of uncertainty brought about by traditional contacts and long-term government contracts. All this however remains speculation, albeit with support from a great deal of anecdotal evidence.

As already noted, relatively few Finnish firms exported to the USSR. Accordingly, average shipments probably tended to be larger and economies of scale greater than in

<sup>24</sup> At least one major study did ask companies for such information, but in vain.

<sup>25</sup> An unpublished Bank of Finland study (Rautava, Jouko: Financing Soviet Trade: The Central Bank Point of View. Helsinki 1988) concluded that interest costs incurred by the Bank in 1981-1987 as a result of the interest-free crediting of Soviet deficits in the clearing account amounted to FIM 1.4 - 2.5 billion (USD 380 - 675 million, 1990 rate of exchange). An interest rate was duly introduced later.

other trade. This was cited by Finnish exporters as one of the most important advantages of selling to the USSR.<sup>26</sup> Even here, no quantitative evidence is available. The same is true of the possibly less stringent quality requirements of Soviet buyers. However, in what is probably the only study directly related to the relative profitability of exporting to the USSR,<sup>27</sup> the conclusion is drawn that in general there is no significant difference in the profitability of exporting to the USSR or elsewhere. The most interesting years in this respect are probably the mid-1980s, which are not covered by Tolonen, whose study only goes to 1981.

Mention should also be made of the effects of exchange rate changes. Soviet export earnings were large in the early 1980s, not only because of higher oil prices but because the dollar's value relative to the Finnish markka almost doubled between 1980 and early 1985. After that, the dollar declined almost as rapidly until late 1987. The rouble then seemed to have been tied to a basket of currencies in which (in late 1983) the share of the dollar was close to half. Consequently, the rouble followed the dollar, rising by about 30 per cent between 1980 and late 1982. After that, its rate of exchange against the Finnish markka remained relatively stable, declining between 1985 and 1990 by much less than the dollar did.

Soviet exchange rate policy was never well understood. However, the result of rouble appreciation in the early 1980s is clear. Finnish industries, such as shipbuilding and construction, whose trade with the USSR rose sharply in the late 1970s, must have benefited substantially from their long-term contracts quoted in roubles. The share of building projects, for example, in total Finnish exports to the USSR fluctuated at the time between 10 and 15 per cent. The best known project, the Kostamuksha mining combine in Soviet Karelia, was built in 1977-1985 for the total price of about USD 1.5 billion (current price, 1990 rate of exchange). When asked by a journalist about the profitability of the project, the main contractor claimed that without the changes in the exchange rate it would have been a loss-maker because of higher-than-expected cost increases in Finland, but in fact it brought in 'a lot' of money.<sup>28</sup>

## 6 Relative competitiveness

Two hypotheses have been tested in the Finnish literature concerning the effects of trade with the Soviet Union on the general competitiveness of Finnish companies. First, one can argue that the competitiveness of Finnish companies in the world market has been enhanced by the

<sup>26</sup> Koivumaa – Valtonen, Finland's Trade with the USSR and changing environment (in Finnish).

<sup>27</sup> Tolonen, Yrjänä: Effects of Soviet Trade on the Structure of Finnish Export Industries. In: WIIW Forschungsberichte, 109/1985, p. 101-125.

<sup>28</sup> Cited in Keskinen, Tuomas: Finland's Eastern Trade 1944-1987 (in Finnish). Helsinki 1987. This case, a major construction project spread over a number of years, is a showcase of the pricing problems involved in Finnish – Soviet trade. At the time, Finland went through one of its periods of high inflation, which peaked at nearly 20 per cent per annum. Not unexpectedly, the USSR refused to 'pay for Finland's inflation', while Finnish contractors needed to include not only full cost increases but also a mark-up for expected future inflation. Therefore, negotiations on the Kostamuksha project, which were not originally a Soviet mining priority and may have been implemented for political reasons only, dragged on for years. This case has not been researched, but its progress can be followed for instance in President Kekkonen's published diaries (Kekkonen, Urho: Diaries 1975-1981 (in Finnish). Helsinki 2004). He was very much involved in the Kostamuksha case, also because it directly benefited the relatively low-income region from which he originally hailed.

protected position they enjoyed in the Soviet market because of the clearing system. This stepping stone effect – a variant of the infant industry argument – refers to the fact that the Soviet market acts as a stepping stone for new and expanding firms. Secondly, there may be a survival effect – a variant of the senile industry argument – as protected exports to the USSR enabled old and no-longer competitive companies to survive.

Early studies on these hypotheses were less than conclusive. Tolonen<sup>29</sup> concluded that the stepping stone effect can only be assumed in the case of shipbuilding.<sup>30</sup> Kivikari (Finnish – Soviet) found no stepping stone effect in the light industries studied. The companies exporting to the USSR had originally expanded in the Western markets. As regards the survival effect, Tolonen somewhat peculiarly found evidence for it only with respect to the paper industry, and Kivikari found no trace of it in the light industries.<sup>31</sup>

Only a few years later, Kajaste and Mattila<sup>32</sup> argued that Finnish export production structures had in fact become so specialised that in many cases there was no simple way of compensating for declining Soviet exports by increasing exports to the Western markets. This was a harbinger of things to come.

In another study, Hukkinen<sup>33</sup> points out that Finland's market share in the USSR doubled in 1970-1981, thanks to the joint impact of Soviet oil revenue and the clearing system. After that, the Finnish market share declined. In fact, already in early 1990 it fell to the level it had reached before the second oil crisis. Since then, as seen above, it has deteriorated further. The seeds of decline were somehow imbedded in the earlier success.

The key seems to be that in 1970-1986, the structure of Finnish exports to the Soviet Union was the most rigid of all OECD countries. While the shares of metals, industrial equipment and special-purpose machinery increased the most in total Soviet imports from the West, Finnish companies increased their market shares in such traditionally-traded commodities as ships, clothing, pulp and paper, and footwear. In general, these seem to be sectors where the unit values of exports to the USSR increased faster than those in other Finnish exports. There is also some indication, cited by Hukkinen, that in the mid-1980s the prices obtained in exporting such products to the USSR were higher than those obtained elsewhere.

Overall, the Soviet market may therefore have, in the 1990s, provided a false sense of success and security through advantageous pricing of traditional Finnish export commodities. At the same time, the share of exports in total Finnish GDP declined and the structure of exports actually grew more traditional and one-sided. The country grew fat and lazy, first by selling its traditional goods and then, in the late 1980s, by accumulating foreign debt. Such accumulation had been facilitated by what was, in retrospect, a strangely mercantilist decision of first liberalising inward, only later outward capital flows. This mistake contributed in a major way to the bubble which then burst.

The pattern of change in Finnish export-competitiveness as a whole was similar to that in the Soviet market. Overall, Finland increased its share of world markets in 1970-1986, but performed best in commodity markets that grew at a slower than average pace.

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<sup>29</sup> Tolonen, Effects of Soviet Trade

<sup>30</sup> Kivikari, Finnish-Soviet Trade

<sup>31</sup> For a discussion on the later destinies of Soviet exports of the Finnish shipbuilding and textile industries, see Sutela: Trading with the Soviet Union: Some Microeconomic Aspects for Finland.

<sup>32</sup> Kajaste – Mattila, Do exports to the West compensate for declining exports to the East? (in Finnish).

<sup>33</sup> Hukkinen Juhana: Finland's Export Performance in Soviet markets 1970-1986 (in Finnish). In: Suomen Pankin Keskustelualoitteita [Bank of Finland Discussion Papers], 14/1990.



As Hukkinen shows, the structure of Finnish exports to the Soviet Union however changed faster than the overall structure of Finnish exports, and therefore it would seem difficult to substantiate the claim often voiced in Finland and elsewhere that in general Finland's trade with the USSR retarded necessary structural changes in the economy because of the survival effect mentioned above. On the other hand, one should recall that Soviet import demand changed faster in 1970-1986 than world import demand. As a result, Finnish exporters did not keep up with changes in Soviet demand as well as they did with respect to the slower changing world demand. To put the point more bluntly, relative to the change in demand, Finnish exporters fared even worse in the East than in the West.

It would seem plausible that this is not independent of the way in which trade was conducted. The decades-long traditions of trading, the relatively small numbers of firms involved and the highly structured institutional framework on the Finnish side may all have had an influence. But this is only one side of the coin. As emphasised above, the performance of Finnish export industries in the Soviet market should be viewed in the context of their overall export performance. Fortunately, none of Finland's industries actually specialised completely in exporting to the USSR. However, certain enterprises and corporative units did just that, and it appears that their relative importance increased in the 1980s.

The folklore of Finnish – Soviet economic relations tells of three safeguards adopted early on. First, and this is supposed to go back to President Paasikivi, the share of the USSR in Finnish exports should not be higher than 20 per cent.<sup>34</sup> Second, from the very beginning, Finnish policy aimed at avoiding the complete dependence of any sectors or major companies on sales to the USSR. Even the largest Finnish conglomerates – private or state-owned – have usually sold at most some 10-15 per cent of their output to the USSR.<sup>35</sup> The general policy of avoiding sectoral dependency continued until the early 1980s, when the sudden increase in Soviet demand seems to have overwhelmed at least two Finnish manufacturing sectors, shipbuilding and certain branches of light industry, footwear in particular. Over the period 1982-1985, some 60-80 per cent of Finnish ships were sold to the USSR, while in footwear the share was around 40-50 per cent. Five years later, the sales of these sectors to the USSR had collapsed, as had many of the companies involved.<sup>36</sup> And third, reference has been made – though it is impossible to say how

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<sup>34</sup> I have been unable to locate this alleged rule in Paasikivi's published writings, including his diary, but he did write in his diary on 12 November 1953, after the Soviet share had been (immediately after the end of the war reparations) slightly over 20 per cent: 'It has been a bad thing that we are currently so dependent on trade with the Soviet Union. We have to take care that our dependence on the Soviet Union regarding trade does not increase but decreases. I reminded that I have repeatedly spoken about the danger that is imbedded in economic dependence from Russia'. Paasikivi, Juho Kusti: J.K. Paasikivi's Diaries 1944 – 1956. Second Volume, 25.4.1944 – 10.4.1956 (in Finnish). Helsinki – Porvoo – Juva 1986, p. 725.

<sup>35</sup> A marketing director for a major forestry group characterises exports to the USSR as a 'titbit' due to a wide product assortment (including goods that could not be sold to other markets), good profitability and a flexible shipment schedule, but adds that the share of Soviet exports was not to rise above ten per cent, due to the uncertainties of centralised trading. See Heikkinen, Sakari: Paper for the World. The Association of Finnish Paper Producers Finnpap 1918 – 1996 (in Finnish). Helsinki 2000, p. 388.

<sup>36</sup> Foreign trade statistics for 1985 reveal (on the 7-digit level of CCCN-classification) 133 items for which the share of Soviet exports was over 90 per cent of all exports. These items add up to 38 per cent of total exports to the USSR. Fifteen of them are important, each accounting for more than FIM 100 million in exports. Five of the important items are different kinds of ships and the rest are products of the food, chemical, paper, clothing and electro-technical industries. Of the total exports of these 15 items, 96 per cent went to the USSR in 1985. In 1985-1991 the exports of these items dropped by 83 per cent, which is even more than the overall drop in Finnish exports to the Soviet Union. For these commodities, the collapse of the

seriously – to a 20/80 rule. A fifth of a company's exports should go to the USSR, bringing four fifths of all export profits.

## 7 The demise of clearing in Finnish-Soviet trade

After the USSR had announced its intention to abolish the existing trade regime in its foreign trade with the CMEA area, a similar announcement in summer 1990 concerning clearing trade with Finland should have been no surprise. Many Finnish export industries, however, campaigned for a continuation of clearing or at least for a transitional period of two or three years. They were encouraged by the fact that signals coming out of Moscow were somewhat contradictory.

The analysis of Finnish discussions in 1990 on the future of clearing trade with the USSR will prove an interesting topic for future historians. Here we can only outline the arguments raised in the debate.

The views of the supporters of clearing – mainly the spokesmen of established export industries – can be summarised very easily. Without ever being explicit about how and why, they argued that as clearing had been advantageous to the Finnish economy, it should be continued. If not, there should at least be a transitional period of two or three years to allow time for adjustment.

As the pro-clearing view was argued from positions of power, its antithesis had to be developed at greater length. At least six arguments were used.<sup>37</sup> First, there was no longer a functioning planning and allocation mechanism for foreign trade in the USSR. By clinging to the tail of the earlier mechanism Finland faced the danger of being seen as a supporter of the ancient regime in the USSR. Second, the USSR was obviously depoliticising its foreign trade. There is no reason why bilateral clearing trade with Finland would fulfil the economic trade criteria now crucial in decision-making. Third, indeed, there are good reasons to argue that clearing with Finland was economically disadvantageous to the USSR. Fourth, continuing clearing trade with Finland would have been an anomaly in the overall conduct of Soviet foreign trade. Fifth, bilateral clearing did not go well with the general thrust of Soviet economic reform attempts. Sixth, clearing does not go well with the spatial devolution (or dissolution) of the USSR.

These are admittedly rather self-evident points, and the need to emphasise them in 1990 illustrates the degree to which the perceived short-term interests of the established export industries determined the policies not only of industrialists' associations but also those of the state.<sup>38</sup>

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Eastern market was only to a very limited extent - six per cent - compensated by exports to the West (Kajaste: Soviet Trade).

<sup>37</sup> Though the relevant discussion was rather wide-ranging, these points were probably presented for the first time publicly and comprehensively only ex post facto in Sutela, Pekka: *The Soviet Economy and Trade with Finland* (in Swedish). In: *Ekonomiska Samfundets Tidskrift* 4/1991, p. 201-206.

<sup>38</sup> Need it be said, after the above characterisation of Finnish corporatism, that the state foreign economic policy apparatus did indeed seek to establish a transitional arrangement?

## 8 Macroeconomic implications of the collapse of Soviet trade

Calculations using both the Bank of Finland's BOF4 quarterly model of the Finnish economy and the KESSU model of the Finnish Ministry of Finance showed at the time that the collapse of Finnish exports to the USSR contributed some 2-3 per centage points to the total decline of Finnish GDP in 1991.<sup>39</sup> As the overall decline was 6.2 per cent, the collapse of exports to the USSR would seem to be an important, but not the major cause of Finland's severe economic crisis. The main reason, by general consensus, was the economic bubble of the latter half of the 1980s, that is the excessive Finnish cost level attained over a decade of higher-than- OECD-average economic growth, asymmetric financial deregulation and overfull employment. Also, a deep recession in such important export countries as Britain and Sweden as well as the global oversupply of forestry products contributed to the Finnish crisis.

Though estimates here are very uncertain, it seemed at the time 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. These instant calculations have stood the test of time quite well,<sup>40</sup> though it is naturally possible that the models used fail to catch all relevant causalities, running for instance through the possibly higher profitability level of Eastern exports.

There are, however other ways of looking at the matter. As outlined above, the traditional system of trading with the USSR contributed to and was an integral part of the Finnish corporatist system of governance. There is a widely shared view that though corporatism may have served Finland well in the past, as a whole it had outlived its workability by about the time Soviet trade finally collapsed.<sup>41</sup> According to this view, which was also voiced often in the economic policy debates of the time in Finland, the country now had to undergo readjustment towards competition, flexibility and an opening up of the same kind that many European countries went through during the 1980s. In this perspective, the Soviet collapse in the end did contribute to the strong recovery of the Finnish economy after 1993, in the end giving the country a place of honour in various rankings of competitiveness.

## 9 Directions of future research

Surprisingly, Finnish post-war trade policy in general and Finnish – Soviet trade in particular remain to be researched in any detail, though some episodes such as the de-licensing of foreign trade in 1957 and the agreement with EFTA in 1961 have been

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<sup>39</sup> Rautava, Jouko – Hukkinen, Juhana: Russia's economic reform and trade between Finland and Russia. In: Bank of Finland Monthly Bulletin 4/1992, p. 6-9;

Ministry of Finance: Economic Outlook and Economic Policy Guidelines Until 1996 (in Finnish). Helsinki 1992.

<sup>40</sup> See Honkapohja, Seppo – Koskela, Erkki: Finland's depression: A tale of bad luck and bad policies. Economic Policy 29/1999, p. 401-436 and Linden, Mika: Finland's Depression and Exports to the Soviet Union (in Finnish). In: Kansantaloudellinen aikakauskirja 1/2000, p. 64-72.

<sup>41</sup> Pekarinen, Jukka – Pohjola, Matti – Rowthorn, Bob, eds.: Social Corporatism: A Superior Economic System? Oxford 1992.

studied. On one hand, both Finnish and to a large extent Soviet archives are now available. On the other, many of the active participants of Eastern trade – on both sides – are still available for interviews. Finally, international research on the Cold War period has in recent years shifted increasingly from political and security issues to trade and economic relations more generally. Supported by such research, the traditional weakness of Finnish foreign policy studies – inability to put matters in a wider international context – could be possibly avoided.

There is a need for a comprehensive study. But in addition, case studies on – for instance – the Kostamuksha project would fill a major need.

## Summary

This paper asks why the Finnish post World War II trade with the USSR has been seen – both at the time and in retrospect – as particularly profitable, while somewhat similar trade was seen as a burden to be minimised in Central and Eastern European countries. To provide an answer, it gives an overview of the Finnish experience of trading with the USSR, concentrating on the 1980s, when the trade reached its highest level. In particular, it is asked whether trade with the USSR really was exceptionally profitable to Finnish export companies and whether, on the other hand, the collapse of the Soviet market in 1991 was a prime factor in the unprecedented decline of the Finnish economy in the early 1990s. The paper concludes by pointing out some of the aspects in which Finnish – Soviet trade should be studied in the future.

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