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The 1998 economic crisis in Russia and  
Finland's foreign trade

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# Contents

Abstract.....	4
Introduction: Some historical facts .....	5
The effect of the crisis .....	6
Weaknesses of the Russian economy hamper foreign trade .....	8
Future prospects .....	9
References: .....	10
Notes: .....	11

Tuomas Komulainen and Lauri Taro<sup>1</sup>

## The 1998 economic crisis in Russia and Finland's foreign trade

### Abstract

In August 1998 Russia experienced an economic crisis as the Central Bank of Russia floated the rouble and the government defaulted on its bonds (GKOs). By May 1999 the rouble had lost 70 per cent of its pre-crisis value and Russian citizens had lost 35 per cent of their purchasing power. Total output plummeted again in 1998 by five per cent. The volume of Finnish exports to Russia declined by 11 per cent in 1998 compared to 1997. Positive developments in the first half of the year helped to offset huge losses after the August crisis. Finland's exports to Russia in March 1999 was FIM 750 million, which is 45 per cent lower than in March 1998. For all of 1998, Finland maintained its trade surplus with Russia, but since September, Finland's imports from Russia have exceeded exports.

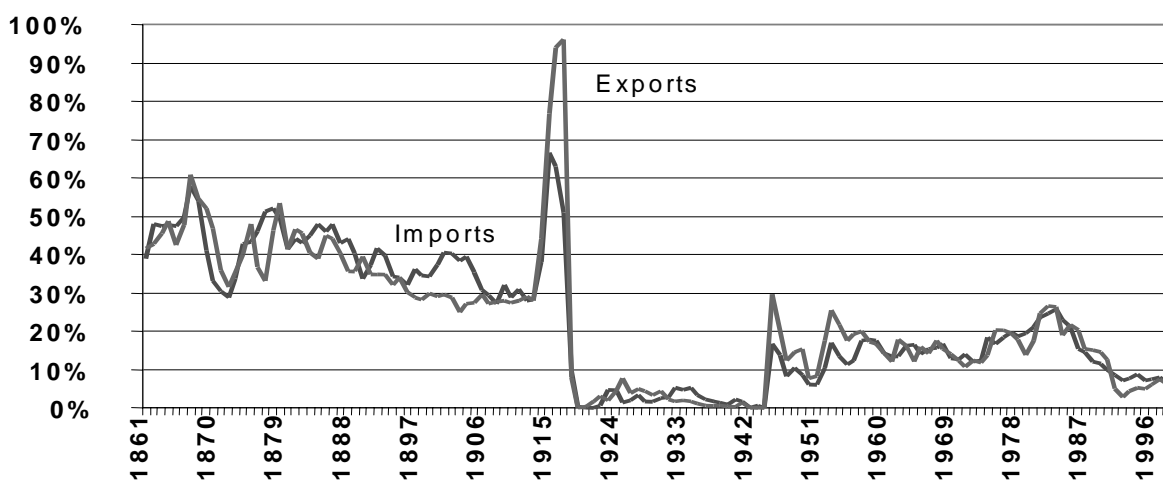
The 1998 Russian crisis will not have a large impact on the overall Finnish economy. The impact will be different and far less severe from that of the collapse of Soviet trade in 1991, because in 1998 exports to Russia accounted for only 6 per cent of total exports and for some 2 per cent of Finland's GDP. However, for some sectors of the Finnish economy, the Russian crisis has already had more serious consequences.

**Keywords:** Finland, Russia, foreign trade

## Introduction: Some historical facts

Finland's trade with Russia/Soviet Union has fluctuated widely over the years, often in response to political events. Thus it is difficult to define a natural level of such trade (figure 1). After the Second World War, bilateral trade arrangements between Finnish and Soviet authorities ensured a special position for Finnish enterprises in the Soviet market. At their peak in 1982, exports to the Soviet Union accounted for 26.7 per cent of Finland's total exports and the Soviet Union was Finland's most important trade partner. During the Perestroika era of the late 1980s and early 1990s, Finland's trade with the Soviet Union decreased sharply. In 1991 Finland's exports to Soviet Union actually fell by 65 per cent.

Figure 1. Finland's trade with Russia/Soviet Union, share of total foreign trade, %



Source: Finnish Board of Customs, *Sutela-Rautava*

After the collapse of the Soviet Union, enterprises began to search for new trading channels and partners. Finnish enterprises were quite competitive in the Russian market during the period 1992-1997, as exports to Russia grew by about 30 per cent a year (figure 2). During the same six-year period, the value of Finnish exports to Russia increased fivefold. This occurred despite economic recession in Russia. The value of imports from Russia has not grown as rapidly. Over the period 1996-1998 Finland's trade balance (goods) vs Russia posted a surplus.<sup>2</sup> Before the crisis of August 1998, Finland was the fourth largest exporter to Russia, behind Germany, Sweden and the United Kingdom. Russia was the third largest import market for Finnish goods.

During 1992-1997 the focus of Finland's exports to Russia shifted to new sectors, such as foodstuffs, printed matter and furniture, while the export shares of textiles and paper declined. In addition, this trade is now increasingly carried out by small and medium-sized enterprises. Finland imports mainly raw materials from Russia. In 1997 energy (oil, natural gas and electricity) alone accounted for 54 per cent and all raw materials for about 75 per cent of total imports from Russia. In addition, Russian wood products have become an important raw material source for the Finnish paper industry (table 1). In 1998 over 13 per cent of the paper industry's wood consumption was imported from Russia. The basic structure of imports from Russia reflects the poor restructuring of the Russian economy and its enterprises.

Finnish enterprises have been rather cautious about investing in Russia. Whereas Finland is among the four biggest Russian trade partners, it is not even among the ten biggest investors in the Russian economy. In 1997, direct investments to Russia by Finnish companies were only FIM 319 million. As a result, Finnish enterprises have not been hurt by the recent crisis as much as some of their competitors.

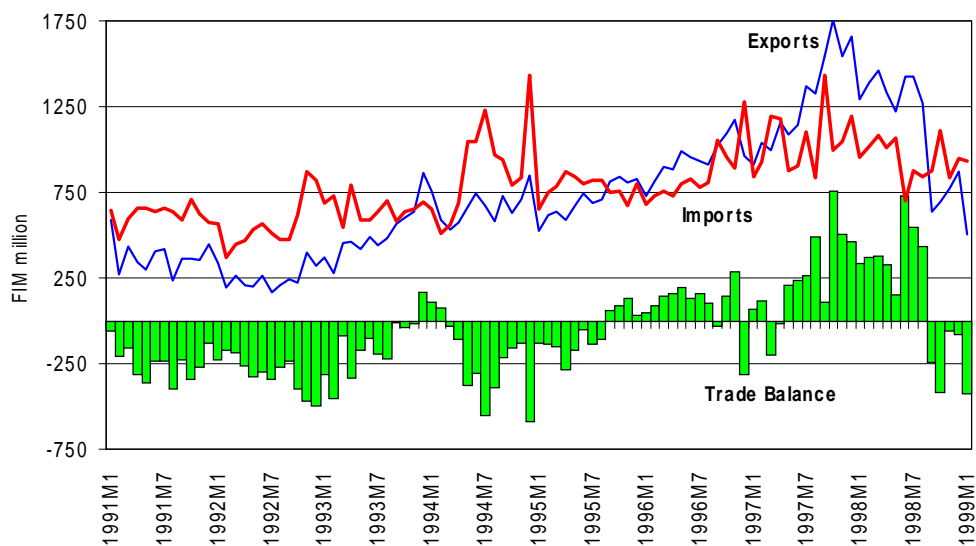
### The effect of the crisis

In August 1998 Russia experienced an economic crisis as the Central Bank of Russia floated the rouble and the government defaulted on its bonds (GKOs). By May 1999 the rouble had lost 70 per cent of its pre-crisis value and Russian citizens had lost 35 per cent of their purchasing power. Total output plummeted again in 1998 by five per cent.

The volume of Finnish exports to Russia declined by 11 per cent in 1998 compared to 1997. The decline was quite moderate considering the condition of the Russian economy. Positive developments in the first half of the year helped to offset huge losses after the August crisis.

The crisis notably reduced Russia's share in Finland's total exports, to just 6.1 per cent (FIM 13.8 billion) in 1998, which is low also by historical standards (figure 1). For all of 1998, Finland maintained its trade surplus with Russia, but since September, Finland's imports from Russia have exceeded exports (figure 2).

Figure 2. Finland's monthly trade with Russia, 1991M1 – 1999M2, in million FIM

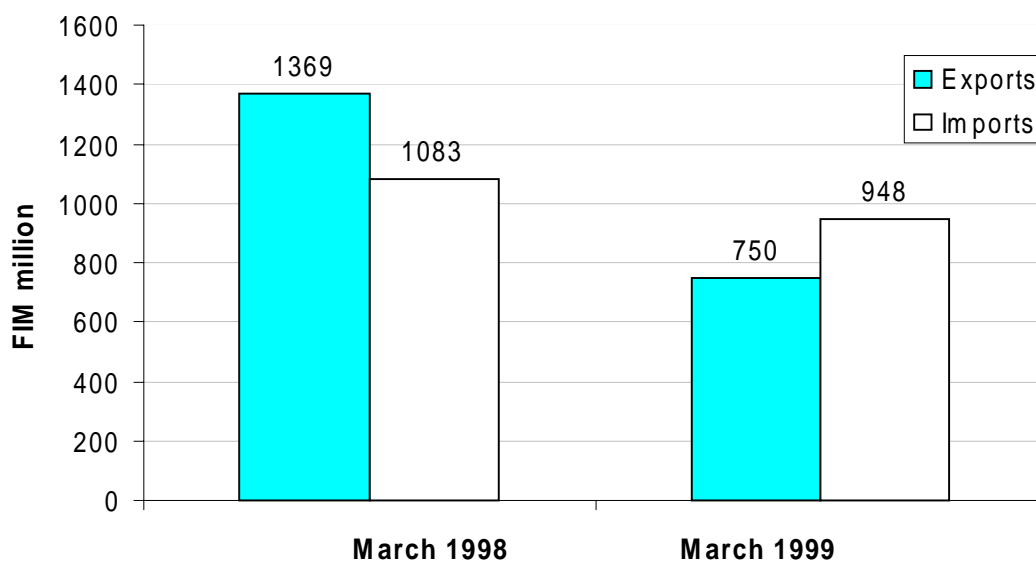


Source: Finnish Board of Customs

During the first months after the August crisis, Finland's exports to Russia declined by some 60 per cent from the pre-crisis level, to about FIM 600-700 million per month. This huge decline was partly due to the Russian banking crisis. The government default and rouble depreciation caused a banking crisis and payment system problems. Finnish exporters and their Russian counterparts were unable to receive their claims from illiquid Russian banks.<sup>3</sup>

During the early months of 1999 most of the problems with the Russian payment system were resolved and Finland's exports to Russia recovered slightly, to around FIM 800 million per month, which is still 45 per cent lower than in March 1998 (figure 3). In the first quarter of 1999, Finnish exports to Russia were 53 % lower than a year earlier.

Figure 3. Effect of 1998 crisis on Finland's foreign trade with Russia, FIM million



Source: Finnish Board of Customs

Finland's imports from Russia also declined moderately after the crisis, but in recent months the value of imports has increased, mainly due to rising oil prices. In March 1999 imports from Russia decreased by only 12 per cent compared to the year-earlier period.

The 1998 Russian crisis will not have a large impact on the overall Finnish economy. The impact will be different and far less severe from that of the collapse of Soviet trade in 1991. In 1998 exports to Russia accounted for only 6 per cent of total exports and for some 2 per cent of Finland's GDP. Consequently, the contribution of the collapse of Finland's exports to Russia is probably only about a one percentage point decrease to Finland's GDP.<sup>4</sup> Most forecasters see Finland's GDP still to grow by 3-4 per cent in 1999.

However, for some sectors of the Finnish economy, the Russian crisis has already had more serious consequences. In the 1990s, food, printed matter and construction enterprises increased their capacity of production, which was directed at the Russian market. About 30-70 per cent of exports of the food, printed matter and construction sectors went to Russia.<sup>5</sup>

Consequently, several Finnish food producers have already had to close their operations due to the Russian crisis. The food and construction sectors are also quite labour intensive, which acerbates their problems.

Table 1. Structure of Finland's trade with Russia, 1997-1998, % of total

Share of total Exports to Russia	1997	1998	Share of total Imports from Russia	1997	1998
Food and beverages	13	11	Textiles and clothing	1	1
Crude material and fuels	5	3	Wood	11	17
Chemicals	11	11	Ores and metal scrap	8	9
Machinery and transport equipment	33	36	Energy	54	52
Paper and paperboard	8	7	Chemicals	7	8
Textiles and clothing	3	3	Machinery and transport equipment	2	2
Other manufacturing	27	28	Iron, steel and non-ferrous metals	9	6
			Other manufacturing	7	3
Total exports	100	100	Total imports	100	100

Source: Finnish Board of Customs

Finland's biggest sectors for exports to Russia are machinery and other manufacturing products (table 1). Some Finnish machinery enterprises were also hard hit by the Russian crisis of 1998. The shortage of capital and declining investments in Russia makes the situation very difficult for exporters of machinery to Russia.

Russian tourism to Finland increased substantially during the 1990s, which brought important clients to the cities close to the Russian border. Russian tourism to Finland has not yet decreased substantially, but the huge depreciation of the rouble might lead to further declines, which could cause additional problems in the future for some Finnish regions and holiday resorts.

## Weaknesses of the Russian economy hamper foreign trade

Several weaknesses of the Russian economy make this a very difficult market for foreign enterprises. Russia is not a monetary economy. Instead of cash money, Russian enterprises rely widely on barter trade and various other money substitutes. About half of total industrial output is exchanged via barter trade. For a foreign enterprise, it is difficult to operate and compete in an economy in which money is not used and bartering and non-payment arrears are common.

Tax evasion is widely common among Russian enterprises.<sup>6</sup> Foreign enterprises operating in Russia usually pay their taxes properly. Consequently, foreign enterprises have an disadvantage compared to Russian enterprises. According to many studies of corruption, Russia is very high in country rankings by amount of corruption. Inefficient public administration hampers foreign enterprises operating in Russia. Small enterprises in Russia encounter considerably more local government bureaucracy than they would eg in Poland. Confusing legislation, its interpretation, and particularly its execution cause reluctance among foreign enterprises to start trading with Russian counterparts and particularly to invest in Russia.<sup>7</sup>



## Future prospects

The decline of purchasing power due to the rouble devaluation and the weaknesses in the Russian economy will restrain Finnish exports to Russia for years to come. In the first three months of 1999 Russia's total imports fell by about 50 per cent from the previous year. Thus, without any radical change in trade flows, it seems that in 1999 the total amount of Finland's exports to Russia will be some 40 per cent less than in 1998. In 1999 Finnish imports from Russia might stay at roughly the level of 1998 or might even increase slightly, depending on oil and raw material price developments. Thus it is likely that Finland's trade with Russia will be in deficit for the year 1999.

Table 2. Russia's major macroeconomic indicators

	1996	1997	1998	1999E
GDP, % change	-3.5	0.8	-4.6	-4.0
Inflation CPI, % p.a.	22	11	85	60
Budget deficit, % of GDP	7.9	6.7	4.9	2.5
Exports, USD billion	88.4	86.7	73.9	65.0
Imports, USD billion	61.5	66.9	59.5	45.0
Fixed investments, %	-18.0	-5.0	-6.7	-2.2

Source: Troika Dialog, Goskomstat, CBR

Finnish enterprises will continue in the future to be important players in the Russian market. Due to the huge depreciation of the rouble, Finnish enterprises must consider even more seriously the possible establishment of production facilities in Russia. In this way, Finnish enterprises could take advantage of the cheaper means of production there. This will require even more knowledge of the risks in Russia and how to operate in an economy where bartering, tax evasion and corruption are rampant.

The restrictions on rouble convertibility and on raw materials exports from Russia have caused additional problems for foreign enterprises. Any further administrative hurdles would render foreign enterprises even more cautious with respect to the Russian market. Thus, possible new IMF agreement and Russia's efforts to join the WTO are important factors in the process of integrating Russia into the international markets.

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## Notes

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<sup>2</sup>Because of double billing, which is done by Russian importers in order to circumvent taxes, the figures on imports to Russia provided by Russian officials are 30- 40 per cent lower than the corresponding figures of the Finnish customs board. This, and other distortions, make the comparison of data provided by Russian and Finnish officials difficult.

<sup>3</sup> Finnish exporters have however used mostly pre-payment arrangements with their Russian partners, which again reduced the losses of Finnish enterprises due to the recent crisis.

<sup>4</sup> Some of Finnish exporting companies might have partly compensated their losses in Russian trade by aiming their exports at other CIS countries. Consequently, the value of exports in 1998 to Ukraine grew by 16 per cent and to Kazakhstan by 19 per cent compared to 1997.

<sup>5</sup> For all of 1998, food industry exports to Russia declined by 25 per cent compared to 1997 (total exports declined 11 per cent).

<sup>6</sup> See EBRD 1998 and Yakovlev 1999.

<sup>7</sup> Foreign investment in Russia dropped 70 per cent in the first quarter of 1999 compared with the first quarter of 1998. The amount of Finnish investment has also declined notably. Another handicap to foreign enterprises attempting to do business with Russia is the current restrictions on foreign banks' operations in Russia.