BOFIT
Online

2003 • No. 2

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China's Economic Development in 2002

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BOFIT Online
Editor-in-Chief **Tuomas Komulainen**

ISSN 1456-811X (online)
31.1.2003

Helsinki 2003

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Abstract

2002 was a significant year for China's economic development in many ways. The economy continued to grow rapidly in 2002. Domestic investment – particularly public investment – surged ahead. Home buying and private car purchases became the pillars of private consumption. Exports surged despite a global economic slowdown. Expansionary fiscal policy continued to be the main policy instrument to stimulate growth in 2002. Despite this strong performance, Chinese economic growth was also deflation-prone, jobless and profitless due mainly to the distorted structure of the economy. State-owned enterprises still dominate many sectors and enjoy preferential treatment such as easy access to bank loans. Policymakers face substantial challenges in sustaining high growth in the medium term. The leadership change and the restructuring of the state asset management system could have a significant impact on the outlook for 2003 and beyond.

Key words: China, macroeconomic development, policy challenges

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1 Introduction

Despite the global economic slowdown and China's own difficult transition, the Chinese economy expanded rapidly in 2002 with GDP growing 8 %. The boom was particularly pronounced in the service sector. Housing, catering services, transportation, logistics, financial, and other professional services expanded briskly. Among the emerging middle class in urban areas, home buying and private car ownership became the pillars of private consumption. Domestic demand remained robust, led by public investment. Growth in exports picked up as multinationals shifted their production to China.

2002 was a significant year for China's economic developments in many ways. The following events or milestones deserve mention:

- The economy powered ahead, growing 8 % despite a weak global environment. The size of economy exceeded RMB 10 trillion in nominal terms.

- The inflow of foreign direct investment reached USD 52.7 billion, overtaking the US to make China the world's number-one recipient of foreign direct investment.

- China's first year as a WTO member had a more salutary impact that anticipated. The trade surplus increased by 35 %.

These figures indicate China gained global competitiveness, enjoyed economic expansion and became the preferred choice of international investors in 2002. Less apparent, but equally significant, events in 2002 included:

- Hu Jingtao replaced Jiang Zeming as party general secretary and president. The leadership change was seen as a smooth transfer of power from the third generation to the fourth generation.

- The break-up of key state monopolies in telecom, civil aviation, and electrical power generation continued.

- Foreign banks, retailers and other service providers established strong presences.

- Housing and cars became the big consumer items in urban areas.

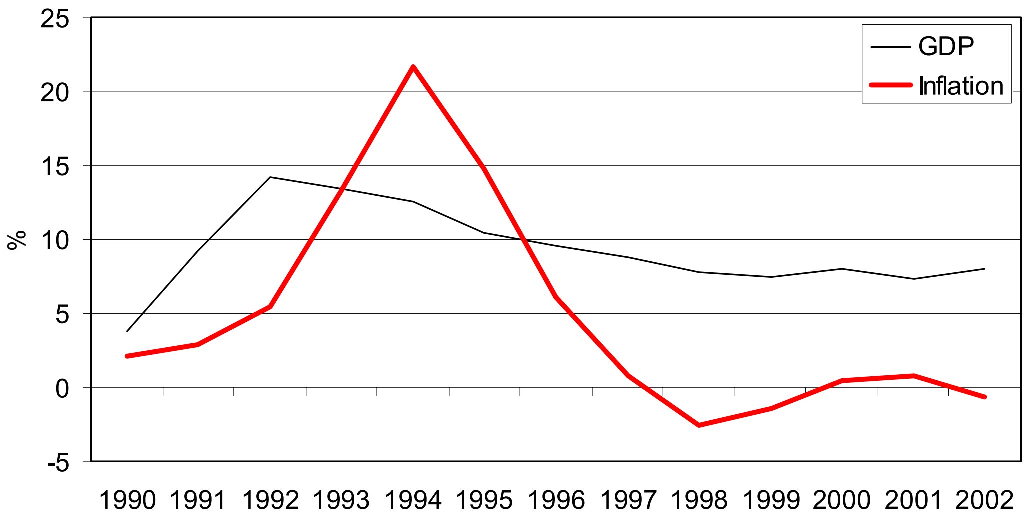
The strong economic performance lays a solid foundation for continued high growth in 2003. China's domestic demand should remain steady this year and FDI will continue to flow in, compensating for the likely ease in public investment. Export growth may slow a bit, but will generally remain at healthy levels.

Despite the recent bullish trend, it will be harder for China to achieve robust growth in the future. The country cannot circumvent the most demanding aspects of reform, which are deeply embedded in the foundations of the current economic system. Thorough reform of state-owned enterprises and the banking sector will require a new approach to managing colossal state assets and clear definitions of personal and real property rights. Moreover, income disparity has increased at an alarming pace. The leadership change in the top at the end of 2002 may add impetus to the acceleration of economic restructuring and pursuit of equitable growth.

2 China's economic performance in 2002

In 2002, the performance of the Chinese economy exceeded the most optimistic expectations, growing 8 %, compared to 7.3 % in 2001. China's total nominal GDP surpassed RMB 10 trillion. Industrial production grew 12.6 % year-on-year in 2002, up from 10.2 % in 2001 and the fastest growth since 1992.

China's macroeconomic performance



Source: China State Statistics Bureau

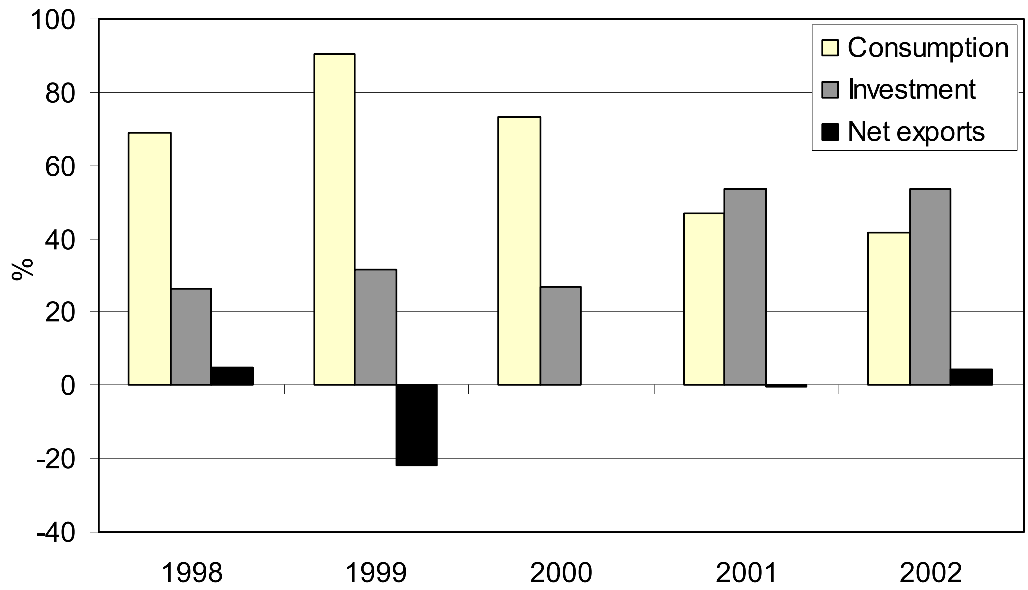
The recovery in domestic demand and surge in exports drove growth in 2002. Growth in private consumption also picked up, while massive infrastructure investment programs supported fixed investment. Strong export growth stimulated business investment and service-related sectors.

Total asset investment rose by over around 20 %. Public investment, supported by large infrastructure projects, grew by 23.4 % over the previous year. Private investment also took off, growing 18 % (up from 9 % in 2001). Residential building investment surged by around 28 % in 2002.

Growth in private consumption held steady. From January to November 2002, retail sales of consumer goods grew 10.3 % in real terms, the same growth rate as in 2001. Residential housing and automobile sales surged 37.1 % and 70.6 %, respectively, during January-November 2002. The changing consumption structure ignited a boom in the service sector. Housing, catering, transportation and logistics services all expanded rapidly.

China's exports surged by 22.3 % in 2002 to USD 325.6 billion. Imports also rose by 21.2 %, reaching USD 295.2 billion. The resulting trade surplus was USD 30.4 billion, a 35 % increase from 2001. The relocation of manufacturing by multinationals to China is one of the main reasons for the surge in trade growth, although global trade growth was stagnant in 2002.

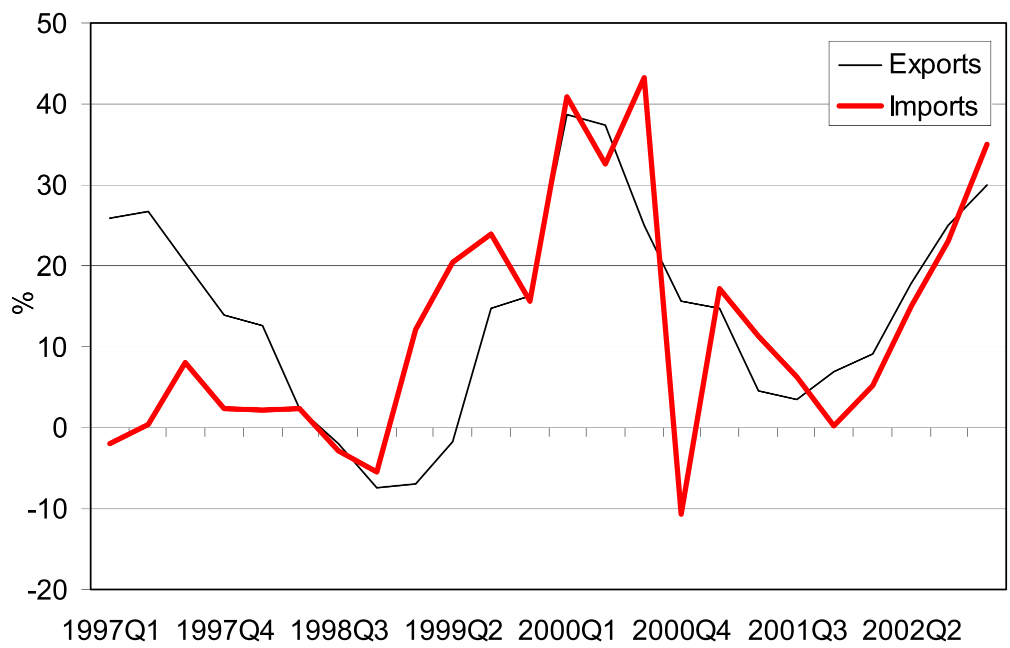
Contribution of demand to GDP growth



Source: China Statistics Yearbook 2002

Trade remained focused on Asia in 2002, accounting for over half of China's total trade. Japan was China's most important trading partner, accounting for 16 % of China's total trade volume. The US and the European Union ranked second and third, respectively, with 15.7 % and 14 % of China's total trading volume. The US was the single most important export destination for China.

China's foreign trade, y-o-y growth



Source: Ministry of Foreign Trade and Economic Cooperation of China

China's exports-to-GDP ratio exceeded 26 % in 2002. Large proportions of these exports were processing activities. Exports were mainly composed of manufactured goods, particularly machinery and transportation-related products, electronics and telecom products, garments, shoes and toys. Machinery and transportation-related products were the dominant import goods, accounting for almost half of the total imports. Other important import goods were electronics and telecom, chemical and raw materials.

The inflow of FDI accelerated following China's WTO accession, climbing to USD 52.7 billion (up 14.4 % y-o-y). The forward momentum was even more pronounced as evidenced by the increase in contractual FDI amounts. During the period of January-November, China approved 30,728 new foreign investment projects, an increase of 34 % over the previous year. The total contractual foreign capital exceeded USD 78.7 billion, an increase of 26.5 % over the same period in the previous year. It indicates that a large amount of FDI will continue to pour into China in 2003 and beyond.

Foreign direct investment has been instrumental in transforming China's manufacturing base. The trend among multinationals to shift production to China strengthened in 2002. China has an unparalleled advantage in labour cost, which attracts global capital to build up export-oriented manufacturing businesses. Slower economic growth and soft product prices in the developed world have also helped push multinational firms to relocate their production in China.

While low labour cost and improved infrastructures are China's traditional advantages, after WTO accession, China's huge domestic market and convenient logistic connection have become more important, as almost all the components needed to manufacture a wide range of electronics, plastics, machines and other products are available in China. Big multinational firms are increasingly engaged in exporting products of much more technology content to a wider market exposure from China and are boosting the size of their research and development operations in China.

China's foreign exchange reserves grew to USD 286.4 billion at the end of 2002, an increase of about USD 74.2 billion for the year. Only Japan's foreign exchange reserves are larger than China's. Total foreign debts amounted to 170 billion, of which around 40 % were short-term debts.

3 Macroeconomic policies

For various reasons, the Chinese government continued to pursue expansionary fiscal and monetary policies in 2002. Fiscal policy was main channel for spurring fixed investment and stimulating economic growth. The monetary policy stance remained relatively loose as money supply (M2) grew over 16 %.

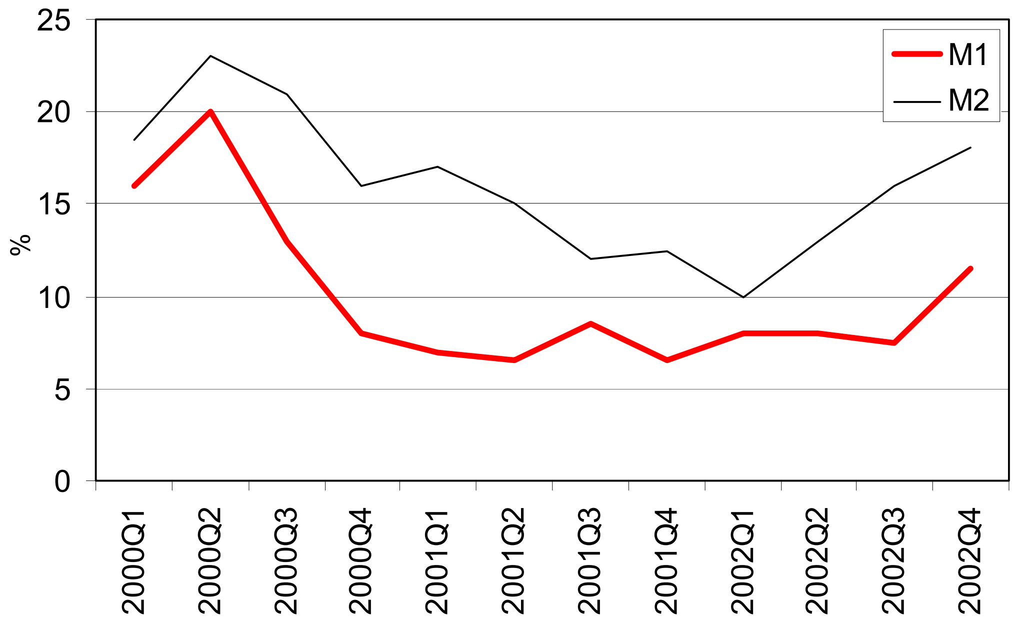
Following the slowdown in economic growth in 1997 in the midst of the Asian financial crisis, the Chinese government began to rely on expansionary fiscal policy as its main means of stimulating growth. 2002 was no exception as the government issued an additional RMB 150 billion in bonds. The practice has now been used for several years to accelerate infrastructure investment, especially in the western parts of the country.

China's fiscal revenue increased around 12 % in 2002, down from around 20 % in 2001. Growth of fiscal expenditure was estimated at around 18 %, leaving a fiscal deficit of 2.9 % of GDP.

Fiscal revenue and expenditure, y-o-y growth

Source: China Securities Daily, January 2, 2003

Growth of money supply, y-o-y



Source: China Securities Daily, January 2, 2003

Monetary policy is rather ineffective in the current situation because distortions in the financial system disrupt the monetary transmission mechanism. In general, monetary policy stayed loose with the money supply increasing 16-17 % in 2002. Nevertheless, deflationary pressures persisted. The surge in housing price was offset by a decline in the prices of durable and non-durable consumer goods. Interest rates were still regulated by the central bank, which cut interest rates aggressively from October 1997 to September 1999. After two years of inaction, the central bank cut interest rates in February 2002 to support consumption and investment. The one-year time deposit and lending rates currently stand at 1.98 and 5.31 %, respectively. These are the lowest levels ever seen in China.

At the end of 2002, the governor of China's central bank, the People's Bank of China, was replaced. Former governor, Mr. Dai Xianglong, was demoted from the post of central bank governor to mayor of Tianjin city. His demotion probably reflects his failure to make progress in banking sector restructuring and his opposition to establishing a banking supervision agency separate from the central bank. The new governor, Mr. Zhou Xiaochan, is the former chairman of the China Securities Regulatory Commission and is generally regarded as keener on promoting reforms.

4 The paradoxes of high growth

Despite this bright picture of the Chinese economy in 2002, there are several ironies to this stellar performance:

- The employment situation remains poor.
- Despite high industrial production growth, state-owned enterprises show low profitability.
- Deflation threatens in the face of high economic and money supply growth.

The employment situation was still rather grim last year, especially for new college graduates. A substantial share of the two million college graduates had difficulties in finding proper jobs, notwithstanding a huge pool of laid-off workers at state-owned enterprises (SOEs) in urban areas. In 1998, half of laid off workers found new jobs. In the first half of 2002, only 8 % found jobs.

Many listed companies (almost all SOEs) gave dismaying financial reports, and the Shanghai stock price index declined by 17 % in 2002. Although the money supply grew around 16 % in 2002, the consumer price index (CPI) declined 0.8 % during January-November 2002.

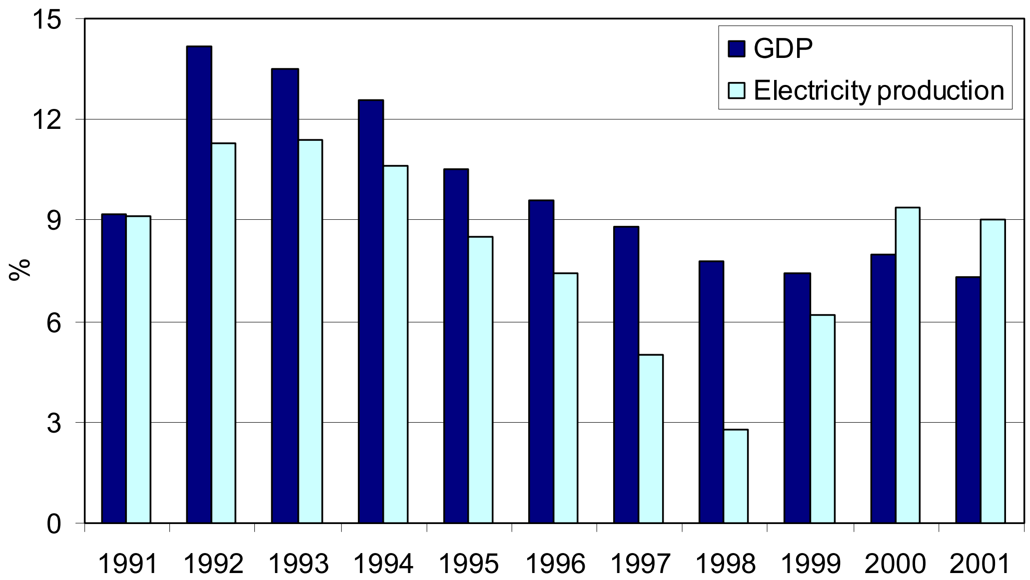
Given the contradictory data, it is hardly surprising that the quality of Chinese statistics is under scrutiny – particularly the figures for 1998.[1] Some claim Chinese growth figures are simply a fiction, so there may well be no growth at all in China. The quality of Chinese statistics certainly falls below the standard in developed countries; even the head office of China's Statistics Bureau does not trust the figures given by the local statistics establishments so they send their own survey teams to get samples.

Despite data gathering problems, other evidence seems to indicate that China's high growth is real. The double-digit growth figures for exports, imports, household deposits,

[1] In the midst of the Asian financial crisis, China's premier Zhu Rongji pledged to keep the growth in 1998 above 8 %. By year's end, it was clear the economy had performed well below target. As an institution under the State Council, the Statistics Office was under heavy pressure to report 7.8 % growth figure. The bogus number was so obvious that the premier personally announced the government cease to set growth targets in the future.

FDI, fiscal revenues, steel production and imports, and electricity production are hard figures that are easily verifiable. These figures correspond to high GDP growth.

Growth of GDP and electricity production



Source: MSDW

Thus, these apparent paradoxes surely reflect the complexity of the Chinese economy at its current stage of development. The economy is moving from an agricultural to an industrial economy, from central planning to a market orientation. The economy is simultaneously in a process of industrialisation, transition, urbanisation and globalisation amid with vast diversity in education, income and culture within the country. The complexity of this process was as prominent as ever in 2002.

Chinese economic growth last year may thus be characterised as deflation-prone, jobless and profitless due mainly to the distorted structure of the economy. State-owned enterprises still dominate many sectors and enjoy preferential treatment such as easy access to bank loans. SOEs still face soft-budget constraints and thus can compete simply by cutting prices.

China's high saving ratio translates into abundant domestic capital formation. China's household deposits amount to 85 % of GDP with deposits in banks increasing rapidly. China also has a huge pool of surplus labour, which depresses the average labour wage to near the subsistence level. Given that productive inputs remain very cheap in China, the years of high investment in China has built up huge production capacity whereby China can produce most products cheaply. Any industries showing high profits attract huge amount of investment immediately, driving down profits quickly. Low inflationary pressure is the result of a supply driven economy.

The poor job market also reflects the incomplete restructuring of SOEs. Most SOEs are still overstaffed. To avoid massive layoffs, the government allows the continuation of soft-budget constraints. Of course, this strategy hampers the expansion of more efficient private enterprises and ignores the fact that most new jobs will be created in the private sector. Thus, while the current policy avoids the short-term pain, it nurtures a long-term problem and allows for simultaneous rapid economic growth and slow job creation. Due to the de facto soft-budget constraint of big SOEs and the failure of the financial institutions to facilitate efficient resource allocation and discipline less efficient enterprises, many producers are able to endure a profit margin near zero. In addition, due to low innovation capability and widespread copycats, producers have little pricing power. These two facts combined explain to a large extent why China's high growth is profitless and inflation-free.

5 Main risks and policy challenges

Is China's high growth sustainable? What is the role of government investment programs whose viability can only be seen years after the initial investment? How sustainable is the booming real estate market? These issues suggest major risks to sustained growth scenarios. The main questions facing policymakers include:

- How does the state gradually phase out expansionary public investment and return to long-term fiscal sustainability while maintaining adequate growth?

- Can the overheating in the housing market be subdued without causing a collapse in housing prices?

- How can the incomes of the poor, especially the rural poor, be increased?

- How should the state establish a public asset management system to manage its assets of RMB 10 trillion – an amount equal to 2002 GDP – while regaining the confidence of retail investors?

- Although a banking crisis is unlikely, what course should the state pursue in establishing a sound banking system and a system to deal with the stock of bad loans?

Public investment has risen rapidly. In the period 1998-2002, the government issued RMB 660 billion in bonds specifically for infrastructure investment and induced total fixed investment of RMB 3 trillion (bank loans, and private and local government investment). This active public invest policy has added 1.5 to 2 percentage points to GDP growth but also driven up public indebtedness. Thus, the current expansionary fiscal policies are unsustainable. Moreover, the viability of many big projects is still widely disputed.

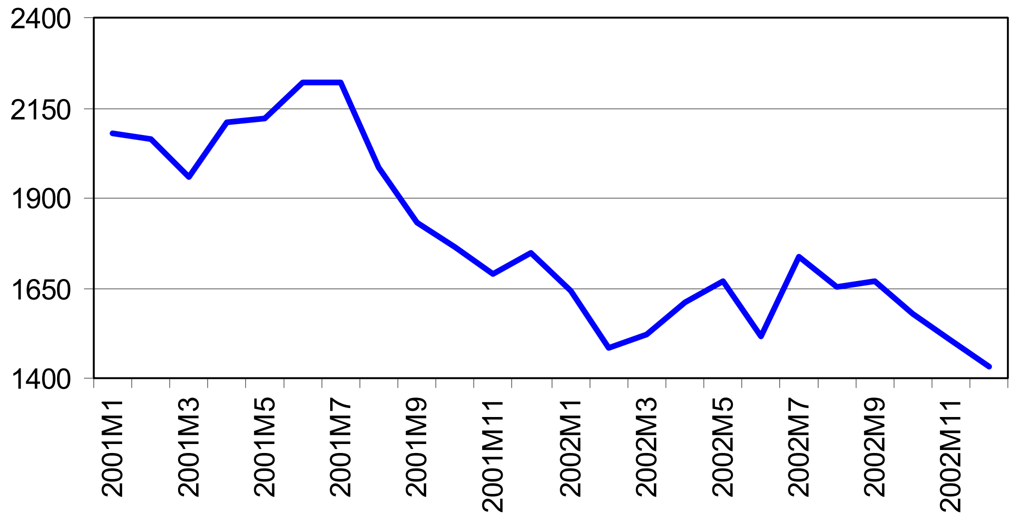
The infrastructure investment boom has thus raised concerns about over-investment and inefficiency of certain projects. Total government debt corresponds to 16 % of GDP. While this figure is low by international standards, the debt ratio has increased rapidly in recent years. There are also substantial implicit government liabilities such as bad loans of the state-owned banks and rural credit cooperatives, under-funded pension funds and off-budget debts of local governments. According to the World Bank, this total contingent liability could be as high as 100 % of GDP!

The construction ministry reports that, at the end of 2002, housing space-per-person in urban areas averaged 21.5 square meters and that 80 % of urban households own one or more apartments. Housing prices have shot up in some areas; for example, in Shanghai, housing prices increased over 10 % on-year in 2001 and 2002. Of course, the regional disparity is huge. At the national level, the unsold housing stock reached 125 million square meters at the end of August 2002. In a single month, October 2002, the unsold stock increased by 8.8 % over the same period in the previous year. Housing investment accounted for 57 % of Beijing's total fixed investment. Such levels are clearly unsustainable.

The income disparity across the country and among households is increasing at an alarming speed. Corruption is obviously a factor, but the current fiscal system itself is a source of unfair redistribution, especially to rural residents. Without adequate fiscal transfers to farmers, China's rural residents must bear a heavy fiscal burden. Farmers must pay agricultural taxes, as well as various fees to support rural education, administration and infrastructure investment. The falling growth of farmers' incomes has resulted in a growing income gap between urban and rural households. Urban households now earn nearly four times as much as their rural counterparts. According to China's State Bureau of Statistics, China's Gini coefficient reached 0.46 in 2000, well above the "alarming level" of 0.4. This huge income disparity has resulted in intensification of widespread discontent and social tensions.

The performance of the SOEs and listed firms also gives cause for concern. Low profitability and asset stripping in SOEs have led to huge waste and a massive burden for the banking sector. To solve this, fundamental solutions including the massive privatisation and the rule of law are articulated. The existence of China's buoyant private sector bodes well for a drastic approach. The new leadership appears to have a more favourable attitude towards the private sector than the previous one. China's total capitalisation of domestic equity markets equalled around 50 % of GDP in 2002. The improvement in market information and tightening of financial supervision has revealed faults and manipulations of the markets and improved overall transparency. This, together with expectations of weak earnings and more listings, has resulted in a steady decline in the stock prices since mid-2001.

The Shanghai Stock Exchange Composite Index, (beginning of the month)



Source: Shanghai Stock Exchange

China's banking sector has been plagued with massive non-performing loans (NPLs) for years. There are no exact figures about the total NPLs in the banking sector, but estimates range from 30 to 50 % of total bank assets. Two reasons are often cited for the high NPL ratio. The first is the banking sector's own structural faults. The second is the old system of using commercial banks to extend policy loans.

The structural problems China's banking system are due in part to a legacy of central planning and in part to the stunted development of the financial system. The banking system remains essentially a monopoly. The largest four state-owned banks overwhelmingly dominate, holding 83 % of total deposits in the banking system and providing nearly 72 % of total loans. China's state-owned banks still look more like bureaucratic organisations than commercial banks. The lack of proper incentive structure and internal control mechanism leads to mismanagement of many state-owned banks. These banks lend mostly to SOEs, which in turn are willing to borrow as much as possible because the punishment for not repaying the loans is often mild. Private enterprises, in contrast, have little access to bank lending unless they turn to foreign investment enterprises. While SOEs account for less than half of GDP, they absorb over 80 % of banking lending. Due to the declining profitability of SOEs, Chinese banks have difficulty improving the quality of their assets.

6 Outlook for 2003 and beyond

The following factors will be important in shaping the outlook for the Chinese economy in 2003 and beyond:

- The policy priorities of the new leadership and the restructuring of the state bureaucratic system.
- The government's approach to state-owned enterprises and privatisation.
- Restructuring in the financial sector, including banking and capital markets.
- Urbanisation and regional development strategy.

In November 2002, new leaders of the Communist Party were chosen. In March 2003, the government will have new leaders. These events are termed as the "transfer of power from the third generation leadership to the fourth" and thus the turnover rate of leaders in various party and government organisations will be substantial. This will have tremendous impact on economic policies. Although highly reform-minded, retiring premier Zhu Rongji was known for favouring big SOEs and the state-administrated grain distribution system. Upon his retirement, new approaches to dealing with SOEs and the rural economy will likely emerge. The new leader, Hu Jingtao, has already indicated that priority will go to abatement of rural poverty, a long-neglected issue. The change of leadership will likely accelerate government restructuring of the bureaucracy, redefinition of the status of civil servants and reform of management of state assets. Among the significant changes will the redefinition and regrouping of the function of key ministries.[2]

[2] Two prominent changes under discussion are the formation of a Ministry of Commerce, incorporating the State Economic and Trade Commission and Ministry of Foreign Trade and Economic Cooperation, and the merger of the State Planning Commission and the Commission of Restructuring into a State Development Commission.

The most significant changes in economic policy will be the privatisation strategy and a new system for management of state assets. A state asset management commission will be formed to take over the functions previous shared by the Ministry of Finance, the State Economic and Trade Commission, the Planning Commission, and the Ministry of Personnel. Many of the less significant SOEs will be sold to private or foreign entrepreneurs or institutional investors. The role of private enterprises will be elevated, and they may enjoy the same treatment as SOEs. Some monopolies will be broken up and there will be sweeping entry of private and foreign enterprises in many sectors.

2003 could also see significant progress in China's financial restructuring. Central bank governor Zhou is expected to oversee separation of the banking supervisory board from the central bank, improve monetary policy instruments (including the liberalisation of interest rate and foreign exchange controls), clean up the bad loan messes at major state-owned banks and impose discipline in China's scandal-ridden stock markets.

One of the more significant issues in China's financial markets is the gradual liberalisation of interest rates and development of the exchange rate mechanism (which infers changes in China's virtually fixed exchange rate regime). A corresponding measure is to allow non-state-owned banks, such as the incorporation of rural credit cooperatives into rural commercial banks with the ownership switched from the state (state council/central bank) to local governments and private entrepreneurs. The central bank currently plans to liberalise interest rates gradually over the coming years; first in rural areas, then in urban areas, first in loan rates, then in deposit rates.

2002 witnessed several breakthroughs in China's exchange rate system and capital account control measures. The government will try the QFII system and a regulation on the sale of state assets to foreign investors should lead to a relaxing of capital account controls. As development of capital and money markets, capital controls and the banking sector restructuring are interrelated, each change will affect other areas indirectly.

The prospects for China's medium- to long-term growth remain challenging. Although China currently benefits from the gains of transition from a rural to an industrialised economy, from a centrally planned to a market economy, and from a closed to an open economy, the transitional path is by no means unobstructed or free of risks.

In China's case, problems are seldom small. Consider, for example, the challenge of alleviating rural poverty. The rural poor are often illiterate. Many poor rural families cannot afford the education of their children, and in many rural areas, basic social, health and safety services remains insufficient. Mere investment in rural infrastructure is inadequate to reduce rural poverty. It needs a whole set of new policies, especially labour mobility and urbanisation policies. Moreover, with the relaxation of the household registration system, millions of rural residents will head for the cities to find jobs.

New urban areas are emerging and large metropolitan areas are expanding rapidly. It is estimated that over 100 million farmers now work in cities. As more people migrate to urban areas, the employment issues pose a huge challenge to policymakers. In the past decade, some 30 million workers were laid off by urban state-owned enterprises. Creating jobs for rural migrant workers and unemployed urban workers is thus a key policy challenge – to maintain high growth and reduce income disparity and social tensions.

Urbanisation and regional development policy are thus the keys to China's future development. The coastal areas remain the economic powerhouses of China. Most economic activity, FDI and trade focus on just three "metropolitan clusters." The first is the Pearl River Delta which includes Hong Kong, Guangzhou, Zhuhai, Dongkuan and nearby areas. The second is the Yangtze River Delta, which includes Shanghai, Suzhou, Kunshan, Nanjing, Ningpo and Hangzhou. The third is the Beijing-Tianjing-Tangshan metropolitan area. These three areas have attracted increasingly large amounts of capital and labour. One urbanisation strategy could therefore be to strengthen the development of these metropolitan clusters and encourage the migration of rural labour into these areas. In this scenario, many smaller urban centres would emerge around these big cities that are closely connected to the global markets and tied to the international division of labour. Whether these areas will have vibrant local economies and create enough jobs for their own residents and the migrant rural workers has strong implications on economic development and poverty reduction in China.

The strong economic performance in the Chinese economy in 2002 has laid a solid foundation for the continued high growth in 2003. China's domestic demand will grow steadily as both private consumption and investment will continue to maintain reasonable levels of growth. Fiscal stimulus policy, however, will be less prominent, and surging FDI will instead compensate for the slowdown in public investment. Exports may no longer expand at blistering rates, but will generally maintain healthy growth.

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