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The Republic of Karelia:  
Its Economy and Financial Administration

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# The Republic of Karelia: Its Economy and Financial Administration

## 1 Introduction

### 1.1 Purpose of the study<sup>1</sup>

Increasing attention has been paid lately on research and follow-up of regional developments in the Russian Federation (Russia). So far, little is known about circumstances in "deep Russia". The international news media still seem to focus more on what is happening in the centres of power, particularly in Moscow. Now, two years after the dissolution of the Soviet Union, all major political decisions still take place in Moscow.

The purpose of this study is to describe the performance and prospects of the Karelian economy and its financing from three points of view:

- 1) **The standard of living** and distribution of economic wealth in Karelia and in relation to other regions and republics.
- 2) **The Karelian economy and its financing from private and public sources.**  
The study focuses on the state, structure and the growth potentialities of the Karelian economy and its financial sector. The structure and recent growth of the economic sectors are studied as are the strengths and weaknesses of the Karelian economy. Specific attention is paid to banking services of Karelia. We must ask ourselves whether foreign firms can act as a catalyst for the Karelian economy.
- 3) **How dependent is the republic of Karelia on the federal government of Russia** in terms of
  - transfers of tax revenues;
  - transfers of foreign exchange ;

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<sup>1</sup> This study is based on findings and material from two fact finding missions to Karelia. The first mission took place in June 1993 and was arranged by the Regional Development Fund Ltd (KERA) and hosted by a private trading company Karelia Trade Ltd; the second one was in November 1993 and arranged and hosted by a major commercial bank in Petrozavodsk, AO Tekobank. Essentially this article is my travel report summarizing information received, and impressions from a number of discussions with officials in the republican and local administration and with bankers in the central bank branch and commercial banks in Petrozavodsk. Valuable information was obtained through the hosts and organizers of the journey. Some updating was made until 8 July 1994.

- the subsidies and exemptions Karelia receives from the central government;
- the success and structure of Karelia's foreign trade; and
- the relationship between large (total cost more than 10 million dollars) and small projects. The assumption here is that the large projects serve the interest of the centre and may increase the dependence of Karelia on Moscow.

The purpose of the study is also to provide general background information on the political history, strategic importance and ethnic composition of the population, including aspects relevant for understanding the dependencies between Karelia and the centre<sup>2</sup>.

## 1.2 Geographical location and notes on the political history of Karelia

In the widest sense, "Karelia" refers to an area originally inhabited mainly by ethnic groups sharing similar cultural traditions and dialects of the Finnish language. The area is shadowed on the map. It roughly covers the Republic of Karelia<sup>3</sup>, the Karelian Isthmus, the province of northern Karelia and the southern Karelia in Finland.

Due to migration, deportations and Russification the situation has changed. For instance, as a result of the wars of 1939–1944 about 420 000 Karelians with Finnish citizenship chose to move to Finland from the Ladogan Karelia and Karelian Isthmus. After the wars Soviet authorities deported all Karelians and Finns with Soviet citizenship elsewhere from the neighbourhood of the Finnish-Soviet border, replacing them with Russians, Belorussians and Ukrainians and leaving the area in the immediate vicinity of the border uninhabited.

"Karelia" here refers to the Republic of Karelia. The territory of the republic extends from the Lake Ladoga and Onega to the White Sea. In Finland the territory of the Republic of Karelia is often referred to as Eastern Karelia (in the past also as "Far Karelia" or "Soviet Karelia"). In current Finnish usage the term "Karelia" refers to Ladogan Karelia and the Karelian Isthmus.

As the result of the wars, Ladogan Karelia was annexed to the Karelo-Finnish Socialist Soviet Republic. The Karelian Isthmus was annexed to Leningrad province.

This somewhat tedious description of the many Karelias also reflects the fate of Karelia as a historical border land. Some wars – like the Crimean War of 1853–1856 – brought temporary prosperity to Karelia due to fact that the present capital of Karelia – Petrozavodsk – grew up around the cannon foundry founded

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<sup>2</sup> This issue can be reformulated by asking to what extent federalism – of the lack of it - is reflected in the financial administration of Karelia. The issue of federalism and its effects on taxation and other features of financial administration in Russia has been recently assessed by Sutela (Sutela 1994). The Russian financial administration has been recently reviewed by Vallich et. al. (1994).

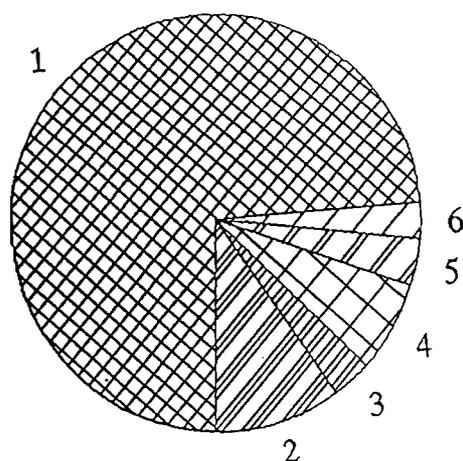
<sup>3</sup> Since 1920 the "Karelian Workers' Commune," 1923 the "Karelian Autonomous Socialist Soviet Republic," 1939 the "Karelo-Finnish Socialist Soviet Republic," 1956 the "Karelian Autonomous Socialist Soviet Republic", and 1991 the "Republic of Karelia" or "Karelian Republic".

by Peter the Great in 1703. Sudden turns of history repeatedly moved borderlines and people. Families were scattered and the ethnic composition of the Karelian population changed when people emigrated or were deported.

Thus the ethnic map remains fairly varied as shown in chart 1. Today the Russian majority consists of 74 per cent, the Belorussian minority 7 per cent and the Ukrainian minority 3 per cent of the total population of 800 200 inhabitants in the Republic of Karelia. The share of the Russian population has increased constantly from 68 percent in 1970 to the present 74 per cent. The increase was 20 per cent during the past 20 years. The shares of all other groups except Ukrainians fell correspondingly.

Currently, Karelians and other groups ethnically close to Finns (all are Russian citizens) still comprised about 60 per cent in the 1920s. Now their share has dropped to 13 per cent (Reuter News Service 9.9. 1993). The remaining 3 per cent consists of other nationalities or ethnic groups - according to the all-Russian census of 1989 92 nationalities or ethnic groups are represented in the territory of Karelia (Rossiiskie Vesti 18.8.1993).

Chart 1. The ethnic composition of the population of the republic of Karelia according to the all-Russian census in 1989



	%
1 Russians	73.6
2 Karelians	10.0
3 Finns & Veps	3.1
4 Belorussians	7.0
5 Ukrainians	3.6
6 Others	2.7
	100

Virtually all of the about 420 000 Finnish citizens chose resettlement in the other parts of Finland as a consequence of the war. Karelians and Finns presently living in the Karelian Isthmus, Ladogan Karelia and the Karelian Republic have never been Finnish citizens. Also those Karelians and Finns who had lived close to the frontier and were then deported to other parts of the FSU after the war, in 1944–1947, were all Soviet citizens.

The nationality composition and its changes can be mainly explained by the policy of compulsion and incentives introduced by the Czarist government and continued by the Soviet regime.

The history of labour camps in Karelia started already in the first half of the nineteenth century, when it became known as "Near Siberia" to the political opponents of the Czar (Verkhoglyadov et al., 26). The railway between St. Petersburg and Murmansk was constructed in 1915 and the Baltic-White Sea channel in by using forced labour. For the most part, labour camps in the Kola peninsula and Karelia were phased out after Stalin's death by the end of the 50s (Luzin, pp. 5–8).

To attract people from other parts of Russia and the Soviet Union higher salaries and better fringe benefits than elsewhere were offered to make the northern areas more attractive. Young people in particular were needed to build the infrastructure and to offset and prevent excessive emigration from these areas.

The system of incentives was established by governmental decree issued in 1869 (Luzin, p. 8). This decree freed settlers from taxes and military service. Presently, immigration benefits for employees of state enterprises and organizations include substantial salary bonuses, longer annual leaves, earlier retirement than the average for Russia, reservation of a flat at the previous place of residence etc.

Recently these benefits have been highlighted by the fact that deregulated prices have also risen, thus reducing real incomes. There is some emigration already southward to lower price areas. Some families emigrate to ensure their rights to citizenship and to retaining a flat in the new republics. Also, government has started to advocate resettlement of the non-productive northern population to the south, this being less costly to a government which is presently trying to cope with the burden of increased state pension payments in the northern regions (Luzin, p. 8).

Large areas have been closed, kept uninhabited and without transportation networks. The areas next to the Finnish border have been considered sensitive and strategically important. The security of the country's second important industrial centre, St. Petersburg with 5 million people, the ice free port of Murmansk with minerals and fishery, and the railway connection between Murmansk and St. Petersburg were concerns of high priority in Soviet military thinking. Therefore large areas had to serve as buffer zones against potential aggression from the west.

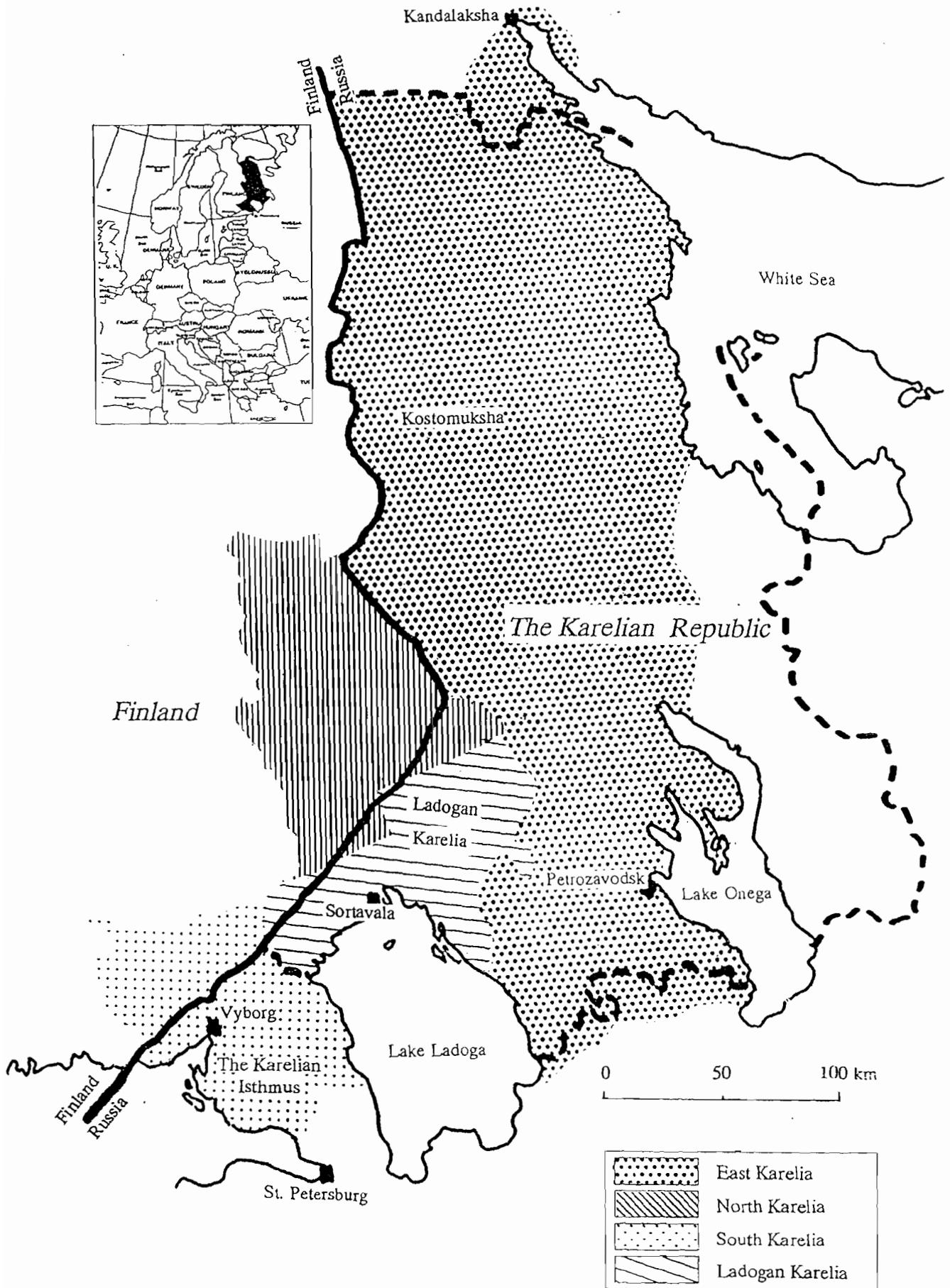
The territory of Karelia is sparsely populated, only 4.6 people per square kilometre (in Finland 16 people/square km). In addition, Karelians live in towns or in major villages, leaving large forest areas uninhabited.

The transportation network (roads and railroads) is poorly developed particularly in the east-west direction. The railways present a traditional mode of transportation in Russia. In 1993 two new railway customs stations were opened on the 800 km long frontier between Finland and the Karelian Republic (Vartiuss and Niirala)<sup>4</sup>. The quality of roads in the Karelian Republic, by western standards is mostly bad.

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<sup>4</sup> Presently there are four railway lines crossing the Finnish-Russian borderline: Vainikkala – Lusaika, Imatrankoski – Svetogorsk, Niirala – Värsilä and Vartiuss – Kivijärvi. The first connection is both for passenger and freight traffic (Helsinki – St. Petersburg – Moscow), the three latter connections serve only freight traffic. Finnish and Russian railroads share the same gauge.

# The Ethnic Karelia (shaded areas) and the Karelian Republic



In the north-south direction there is a railway connecting the strategically important Murmansk province with St. Petersburg and the rest of Russia. They are supplemented with a highway and a canal-lake-river chain connecting Lake Ladoga and Lake Onega to each other and to the White Sea in the north and the Gulf of Finland in the south.



The improvement of the transportation network is one of the key elements for the further development of the economy of the Republic of Karelia. The "lyulka" (cradle) used in Karelia more than a hundred years ago would still be the most comfortable mode of transportation in many remote parts of Karelia. (Source: I.S. Polyakov: *Tri Puteshestviya po Olonetskoj gubernii*, Petrozavodsk 1991).

## 2 Karelian economy

### 2.1 Rural heritage of Karelia

It is not possible to analyze the significance and developments of all factors (housing, public and private services etc.) determining the standard of living in Karelia. Here we confine ourselves to some remarks on a single major determinant of the standard of living: food supply and the state of agricultural production.

The role of Karelian agriculture was set according to the targets of Soviet all-union planning. Karelia was to concentrate on forestry and paper products at the expense of the agriculture. As a result, the present agricultural production in Karelia is confined to the production of milk, meat, potatoes and vegetables. The bulk of grain is imported from the southern parts of Russia; so are the fruits.

The overwhelming majority of the Karelian population, presently 82 per cent, lives in urban conditions. One-third of the Karelian population lives in the capital, Petrozavodsk. The high degree of urbanization makes Karelia exceptionally dependent on a supply of food from other areas of Russia and abroad, and vulnerable to malfunctions in food transport and distribution. The rural population obtains the main part of its diet directly in natura from agricultural production. Also fishery, hunting, picking berries and mushrooms constitute a relatively important addition to the diet, particularly in the countryside.

The high degree of urbanization has two explanations. First the traditional form of settlement in Russia was to build large villages, the largest ones grew in to towns. Second, the Soviet Government made efforts to increase the productivity of agriculture by eliminating small villages (villages without a future, "neperspektivnye derevni", vrt. Eronen 1993, 24) in which it was too costly to maintain the level of necessary services. In Karelia the number of villages fell drastically after the Second World War. Since then, of some 2 700 villages about 650 are left, half of which are currently about to be eliminated (Haataja, p.19)<sup>5</sup>. Instead of settling down in larger villages, most of the people preferred to move to towns, and in the case of Karelia, mostly to Petrozavodsk.

In the 1980s this policy met with increasing criticism. Recent policies aimed at encouraging family farming have redirected some of the migration to small villages (Eronen 1993, 24–25).

In fact, family-owned plots at summer cottages are presently an important source of food supplies for the urban population. Most of the over 600 Karelian villages are "summer villages", comprising summer cottages or "dachas" populated year around only by elderly retired people.

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<sup>5</sup> In one of her most recent studies, Varis mapped two villages in the northern part of Karelia: the "dissipated fishing village" Virma and the "active fishing village" Giridino. Having survived collectivization or other "restructuring", these villages are currently left on their own to find their individual survival strategies. In the cases of Virma and Giridino, the strategies focus on fishing and private gardening supplemented with food collected or hunted in the forests. The future prospects for villages differ from the other, but all in all they tend to be more or less cumbersome (Varis, 1994 pp.62–67).

In summertime the number of inhabitants in the summer villages increases tremendously. Then the active population, children and grandchildren come to spend their vacations and grow vegetables, berries and fruits for their own winter food supply. According to Varis, roughly one-third of the Karelian agricultural production "farm" family plots located in these summer villages (Varis 1993, 11, 39 and discussions).

The rest of agriculture consists of 60 government-owned sovchoses, 50 auxiliary farms for the food supplies of local factories, and 700 privately owned farms<sup>6</sup>. The total cultivated area amounted to 82 800 hectares in 1990 (Varis 1993, 39). The productivity is low, the sales prices are regulated and opportunities to earn additional income from forest harvesting has been decreasing. Subsequently, the prestige of agricultural and forestry is low.

Karelia is somewhat isolated from the rest of the world; this was particularly true during the Soviet era. Even in the capital Petrozavodsk life is far more provincial than in St. Petersburg or Moscow. Still, the bazaar economy has also reached Petrozavodsk. The shops and kiosks on the sidewalks are now filled with merchandise. The assortment is far more diversified than before; so are the prices. Only a relatively small portion of population can afford the prices of imported goods on this fairly vigorous parallel market. According to some estimates the turn over of the parallel market comprises of about one-third of total trade in Petrozavodsk. Less than five per cent of the total population takes advantage of this market. Some of my collocutors have imported second hand cars (made in western countries or Japan) from Finland explained that the demand for them is huge and the prices need not to be discussed.

The official statistics do not record this aspect of life. However, the Karelian Statistical Committee sampled three hundred households in Karelia. Of these households 56 per cent represented blue collar workers, 38 per cent white collar workers and 5 per cent students and retired people.

Of an average monthly income of 145 052 rubles per family, 86 per cent were wages in July–August 1993 and 8 per cent pensions, scholarships or support from public sources. The remaining 6 per cent originates from other sources. The major part – about 44 per cent – was used to buy food. The share of incomes used to buy food is relatively high and seems to increase over time. The share of incomes spent on the consumption of milk, eggs, potatoes and cheese is decreasing, but at the same time the share of bread, grain products and macaroni is increasing. Around 30 per cent of the above mentioned income is spent on other consumption, including housing. Income tax takes 10 per cent away and the remain in 16 per cent includes diverse expenses (2 per cent goes to alcohol).

Table 1. also shows regional differences in the personal incomes, expenditures and the distribution of expenditures in Karelia and in its neighbouring regions (Komi, Archangelsk, Murmansk and Vologodskaya) in the third quarter of 1993. As mentioned above, it has been a traditional policy to attract people from the cities and from the southern parts of the country with higher salaries. However, the higher income levels seem to consistently pull up prices, resulting in roughly equal purchasing power. The inter-regional trade evens the price

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<sup>6</sup> These farms are formed by part of the land of a sovkhos to someone willing to by the land initiated his own farming. The number of farms is increasing, but their share of total agricultural production has sofar been negligible (Varis 1993, 39).

differentials slowly due to the long distances and poor connections. However, the low income levels in southern Russia and the wide price differences between the north and south together with heavily subsidized rail and air fares explain the large number of business-minded southerners their wares peddling in Petrozavodsk, Karelia and in the north and north western areas.

Table 1. **Monthly incomes and expenditures of representative Karelian family in 1988–1992 and a regional comparison: cross section for the third quarter of 1993**

Karelia									
Year	Rubles per month		Per cent of total expenses						
	Income	Salary	Expenses	Food	Other	Housing	Alcoh.	Tax	Other cons.
1988	595	513	525	29	34	12	3	13	10
1989	636	538	576	28	35	12	4	12	9
1990	664	571	614	26	40	9	4	12	9
1991	1301	990	1183	30	43	8	3	8	7
1992	12439	10401	11284	41	33	8	4	10	6
1993:3	145052	124838	129202	44	30	8	2	10	6

Per family member 1993:3

Year	Rubles per month		Per cent of total expenses						
	Income	Salary	Expenses	Food	Other	Housing	Alcoh.	Tax	Other cons.
Karelia	46582	41678	44	30	8	2	10	6	
Komi	76252	71451	32	40	10	2	8	8	
Archangelsk	48906	46849	40	34	9	2	9	6	
Murmansk	81514	76531	37	34	12	2	10	5	
Vologodskaya	44548	42233	37	39	7	3	8	6	

Source: Karelian Goskomstat.

The impact of inflation and a declining standard of living can be seen in the drastic increase in the share of expenditure used to buy food, from a low 26 per cent in 1990 to 44 per cent in 1993. The sharpening of the living conditions can also be seen in the narrowing of the residual.

The annual rate of inflation in Russia was 2500 per cent in 1992 and 900 per cent in 1993. The pace of inflation has been slightly above the Russian average in Karelia – over 1200 per cent according to the preliminary estimates. Incomes in Karelia increased 954 per cent in 1992 and 1166 per cent in 1993. According to the Goskomstat statistics, salary increases did not keep up with prices, and real incomes therefor declined by nearly 12 per cent from October 1992 to September 1993.

At the same time the differentials between the lowest and highest salaries increased. Banks pay the highest salaries in Karelia, the average salary being 140 000 rubles a month, the commercial banks paying as much as even 180 000 rubles a month. At the lower end employees in hospitals (including physicians and nurses) earn 43 000 rubles, teachers in the schools and universities 30 000–35 000

rubles a month. The incomes of people supporting themselves with various kind of business, mostly trade and trading, are not included in these statistics. If included, they would only increase the contrast between the rich and poor.

Falling standards of living is one of the factors that manifests itself in adverse demographic trends. For the time in 30 years the population of Karelia fell, the decrease was from 802 000 inhabitants to 80 0200 in January 1993. All indicators in the table point of decline. The number of births and marriages have decreased and the number of divorces and deaths increased (table 2).

Table 2. **Demographic indicators of the Karelian population, per 1000 persons**

	1980	1985	1990	1991	1992
Births	16.6	17.1	13.2	11.2	10.0
Deaths	10.0	10.7	10.1	10.4	12.3
Natural birth rate	6.6	6.4	3.1	0.8	-2.3
Number of marriages	9.9	9.6	8.3	8.3	6.8
Number of divorces	4.2	3.9	3.3	3.9	4.7

Source: Rossiiskije Vesti 18.8.1993.

The fall of the natural birth rate continued in 1993. However, these negative trends were observed throughout Russia; the natural birth rate was -0.8 in the 9 months of 1992 and -4.7 in I-IX 1993 (the State Committee on Statistics)<sup>7</sup>.

## 2.2 Structure of production

The Karelian economy is essentially based on forestry and forest industries, which account for over one-third of total production. The forest stock consists of about 850 million cubic meters (over half that of Finland). The forests cover about 100 thousand square kilometres or nearly 60 per cent of the 172 thousand square kilometres of the republic.

The Karelian economy depends heavily on the forest sector or the so called "forest industrial complex" covering acquisition of raw material, mechanical and chemical forest industries. "Karellesprom", the forest administration, comprises over 60 enterprises employing over 90 000 workers. The assortment includes round timber, sawn timber, plywood, furniture, paper, board and pulp. The Karelian forest sector played an important role in the Soviet Union. Karelia

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<sup>7</sup> Population aging is a fact both in Karelia and in Russia. In her recent papers, Shapiro notes that public discussion has indicated far more alarm because of the fall in the birth rate than because of the rise in the death rate. She notes that the former is " - after all, a voluntary phenomenon", whereas the latter, reflected recently fg. in a sharp increase in deaths attributed to cardiovascular diseases, probably has its roots in deteriorating living standards, nutritional deprivation, or social crisis related to the insecurity connected with the economic transformation (Shapiro 1994, pp. 6-7).

supplied more than 10 per cent of the pulp, 20 per cent of newsprint the paper for newspaper printing and 2/3 of the paper sacks.

In addition Karelia produces machinery (paper machines and equipment for chemical industries at the Petrozavodskbummash factory, machinery and processing lines for mechanical wood processing and tractors at the "Onega" tractor factory), iron ore (Kostomuksha), titanium and a variety of minerals. Granite and marble are quarried and exported in fairly large quantities for use as construction materials. In addition, aluminium, electronics and ships are produced, and some small-scale food processing (slaughterhouses, dairies and bakeries) exists to serve local needs.

Chart 2 shows the structure of Karelian production. The figures refer to 1992, but the distribution has remained roughly the same over the years. During the past 15 years the machine construction industries and black metallurgy have increased at the expense of pulp and paper production. Almost half of production originates from industry, less than one quarter from forestry and construction and more than one quarter from services.

The labour force accounts for over 50 per cent of total population or 354 000 people. The number of registered unemployed was 16 000 in November 1993 (Karjalan Sanomat November 20, 1993). The Karelian territory is about twice as large as the St. Petersburg and the Leningrad region but the labour force consists of only little 10 per cent of the labour force of St. Petersburg. More than one third of the labour force is employed in industry. Forest industries account for 40 per cent, metal works and machinery almost 35 per cent of the industrial labour.

According to chart 2 nearly half the labour force was employed in trade, transport and communications and other diverse services. The service sector is labour intensive and mostly badly paid. Municipal services are considered "free" and seen as a cost factor only. Most commercial activities taking place on the streets and marketplaces fall outside these statistics.

The relative importance of the forest sector fell during the 1980s. Over aged forests comprise 330 million cubic meters or almost 40 per cent of the forest stock of Karelia. The volumes harvested have been reduced and presently amount to about 6 million cubic meters a year. For compensation Karelia is importing some timber from Siberia. Most of the forest exports have comprised round timber instead of a more refined form. The equipment is also outdated and does not guarantee competitiveness.

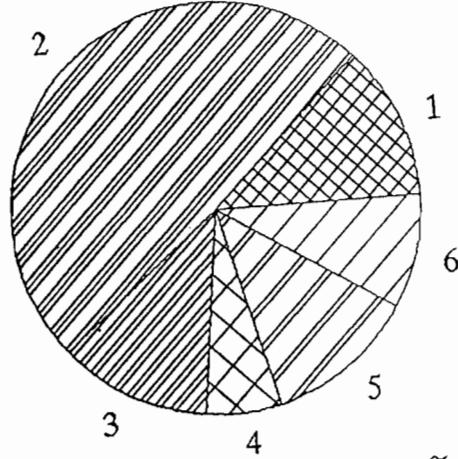
The second reason is the relative increase in the iron-based metallurgical and machine building industries. Their relative share has increased from 15 per cent in 1970 to 31 per cent in 1990 and they presently account for per cent of the total production. A single major step was taken when in the 1983 metallurgical collective combine in Kostomuksha was established to mine and enrich iron ore. Around 30 000 people live in the town of Kostomuksha; 10 000 work for the collective combine. There is also another factory, Wärtsilä, in the southwestern part of Karelia. Both factories were constructed in cooperation with Finns.

The largest entities in the machine construction industry are Petrozavodskbummash and the Onega tractor factory. The Onega tractor factory produces tractors, forest harvesters and other metal fabricates. Petrozavodskbummash is of national significance to Russia. It employs around 7 000 workers (10 000 5 year ago) and makes pulp and paper machines and also instruments for the chemical industry.

Chart 2.

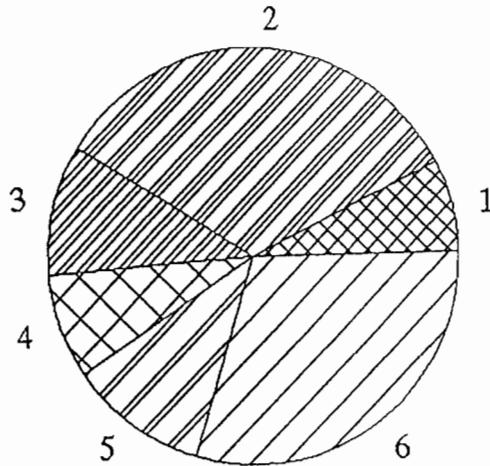
**Distribution of the production (SUR 5 532 million) and employment (353 700 employees) by main economic sectors in 1992**

**Production**



	%
1 Forestry & agriculture	12
2 Manufacturing	49
3 Construction	12
4 Trade	6
5 Transport & communication	12
6 Other	9
	100

**Employment**



	%
1 Forestry & agriculture	7
2 Manufacturing	34
3 Construction	10
4 Trade	8
5 Transport & communication	11
6 Other	30
	100

Source: Karelian Goskomstat.

Other economic sectors are more modestly developed; agriculture and food production, energy, "light industries" producing consumer goods, and the service sector. As mentioned above, agricultural production focuses on milk and meat production whereas the bulk of the grain is imported. However, there has been a marked decrease in the share of the forest-based production in the last twenty years. The share of the forest-based industries still accounted for more than of the half production of the Karelian economy at the beginning of the 1970s.

The "light industries" consist of handicraft and repair shops. A major entity for handicraft industries is a factory "Karjalan Matkamuistot" ("The Karelian Souvenir Factory") in Petrozavodsk producing souvenirs. This factory plans to diversify its production and has already signed contracts to supply major storehouses in Moscow with furniture.

Fairly large enterprises form the core of Karelian industry. A typical feature is that only one major factory supports an entire town or municipality. Factories have borne the cost of the construction and maintenance of housing and social services (such as kindergartens) for their employees. Factories of this kind tend to be quite independent in their decision-making. However, most enterprises would like to be free of these obligations due to the financial burden. Due to budgetary difficulties of its own, the federal government had increased these obligations without being able to assign corresponding funds.

There are also small enterprises. At the beginning of 1993 there was 712 small trading companies with fewer than 15 employees (Karjalan Sanomat October 5, 1993).

### 2.3 Growth

Production in all economic sectors has been falling for three consecutive years. Agricultural production fell by 12 per cent in 1992. The production of milk and meat suffered from shortages in the feed supply. The only positive developments were an increase in the sown areas of potatoes and vegetables mainly on farms.

Industrial production fell 21 per cent in 1991 and 17 per cent in 1992; the estimated decrease during 1993 is expected to be close to 20 per cent. The reasons for the fall have been the shortage of raw materials, financial difficulties and reduction of orders. Production stoppages accounted for about 16 per cent of working time. The construction of the industrial infrastructure, transport networks and houses lagged 20–50 per cent behind corresponding production in the preceding year.

The progress of privatization has been slower in Karelia than elsewhere in Russia. In addition, measures taken in the privatized enterprises to improve management, profitability, productivity and financial solidity have been extremely modest, or non-existent. Some factories have reduced personnel. This has not been so much due to efforts to increase productivity or rationalize production but to bring the number of personnel into line with the reduced level of production. The soft budget constraint still prevails the firms waiting their financial deficits to be covered from the government budget or through soft loans from the banks. Bankruptcy is not a socially accepted way to cut the circle of unsound financing.

According to Goskomstat statistics, industry and construction enterprises owed suppliers of goods and services about 24 billion rubles, out of which arrears

comprised more than one-third at the beginning of April 1993. The debt to the banking sector amounted to about 13 billion rubles, of which 11 billion consisted of short term credits. The claims of these enterprises from their clients amounted to 31 billion rubles, of which 42 per cent were in arrears (Goskomstat 1993, 13).

Table 3. **Progress of privatization in Karelia**

	1992			1993, end of September		
	S	P	Pr	S	P	Pr
Industry						
- No. of entities	182	-	1	80	81	1
- Production SUR mill.	40	-	0	80	22	0
Retail sales						
- No. of entities	1128	300	33	1205	336	44
- Production SUR bill.	19	3	2	71	20	38

S = state owned

P = privatized

Pr = private

Source: Goskomstat, Karelia.

Rapid inflation and the non-payment problem has led to the replacement at monetized trade<sup>8</sup> with barter. These problems tend to shrink total output and usually lead to price, quantity and export controls. Karelia was in fact already imposing controls on its staple deliveries to other regions in late 1991. This kind of government intervention "on behalf" of the republic or province is bound to increase shortages and the high level of monopoly in most markets. These phenomena are not typical to Karelia only, but are increasingly shared by many provinces; they go hand in hand with a high rate of inflation, falling production and the non-payment problem (Hanson 48-49).

## 2.4 Direct investment

Finnish entrepreneurs constitute a majority in the Karelian enterprises in terms of number of participations. Measured in terms of founding capital, Finnish investments are relatively small in comparison, for instance, with German investments.

Most Finnish investors are small entrepreneurs seeking commercial cooperation on the basis of regional affinity. In contrast, investors from further away are likely to be more selective and establish their presence with larger stakes. Moreover, Finnish investors have probably been in a less favourable position to acquire financing from Finland than for instance German investors from Germany.

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<sup>8</sup> Some forest firms, for instance, have stockpiled furniture, refrigerators and other major durables having accepted them as partial compensation for their deliveries.

Table 4. **Firms with foreign ownership in Karelia, registered by January 1, 1993**

	Total	FIN	GER	USA	SWE	AUT	POL	EST
Production of goods of which:	57	26	4	5	1	-	2	3
- consumer goods	5	4	-	-	-	-	-	-
- food	3	3	-	-	-	-	-	-
Trade & services of which:	77	60	4	-	2	4	1	-
- consulting	2	-	-	-	-	2	-	-
Unclassified	27	-	-	-	-	-	-	-
Total	161	93	8	5	3	6	3	3
of which operative	80							

Source: Karelian Goskomstat.

The number of foreign owned firms registered at the end of September 1993 was 265, of which 165 were Finnish-owned. Out of the firms with Finnish partnership 116 were operative (Karjalan Sanomat, November 11, 1993, 2). The total amount of foreign investments in Karelia is estimated to about USD 20 million in 1993. (Izvestiya 10.8.1994).

Karelia has sought to attract foreign investment. Karelia's Ministry of Foreign Relations in northern Russia recently published a list of 22 projects in need of foreign investments. For instance, USD 500 million is needed to overhaul the Lyaskelya paper mill with a projected annual capacity of 200 000 tons; USD 350 million will be necessary to update the Nadvoitsy aluminum plant; and USD 80 million is needed to build an electric power station with a capacity of 40 mW (Segodnya, 24.3.1994) at Kostomuksha.

Finnish industries have worked out special programmes for energy consuming and the rational use of timber, development of mobile radiotelephone communications systems, modernization of transport routes, and projects involving transport across the Russian-Finnish border. Provision has been made for the payment of subsidies from Finland's state budget to joint enterprises, tax concessions for small and medium-sized enterprises, and for subsidies for exporting specific categories of products to Russia. Projects in Karelia are wholly or partly exempt from taxes, customs duties and other payments. Sixteen large projects, which pose a potential threat to the environment, need significant investment on a priority basis.

## 2.5 Foreign trade

Exports from Karelia to all countries outside the CIS amounted to USD 263 million (growth of 390 % from the preceding year) and imports to USD 125 million (growth of 320 per cent from the preceding year). Finland is the most important trade partner, accounting for USD 63 million or 24 per cent of

Karelias's total exports, and USD 53 million worth of imports amounting to 42 per cent of total imports. Imports from Karelia to Finland accounted for 0.3 per cent of Finland's total imports and 4.4 per cent of Finland's imports from Russia. Exports to Karelia accounted for 0.2 per cent of Finland's total exports and 4.8 per cent of Finland's exports to Russia.

About half of the direct exports from Karelia to Finland consisted of forest products, 11 per cent paper and paper products, 24 per cent minerals, and 5 % travel and transportation services. Foodstuffs accounted for 35 per cent of total imports from Finland, industrial equipment and spare parts for 28 per cent. Most of the remaining part consisted of consumer goods.

Unfortunately the distribution of exports and imports by countries is available only for joint ventures and foreign-owned enterprises. Their foreign trade amounted to only 11 per cent of total foreign trade in 1993. There are reasons for believing, that the distribution of their foreign trade by countries or commodities would be representative for the entire foreign trade of Karelia. They probably tend to deal more intensively with their country of origin than the other countries.

Table 5. **Exports and imports of firms with foreign ownership in 1992**

	Imports from		Exports to	
	% 1992	% 1993	% 1992	% 1993
Finland	75	46	44	45
Netherlands	-	-	10	0
Austria	1	1	21	-
United Kingdom	1	1	6	0
Yugoslavia	14	-	7	1
Germany	1	27	12	30
United States	2	12	-	0
Denmark	0	4	0	2
Others	6	9	0	22
Total	100	100	100	100
	7.3	20.7	19.8	21.7
	mln	mln	mln	mln
	USD	USD	USD	USD

Source: Goskomstat, Karelia.

Imports by the joint and foreign-owned ventures have increased rapidly, though exports still exceeded imports in 1993. The number of foreign-owned firms has increased and exports seem to be more diversified. Countries such as China, Grenada, Israel and the Baltic countries have made their purchases in Karelia through the daughter or partnership companies.

Virtually all foreign-owned enterprises are exporting more than importing – for instance exports to Finland amounted to USD 8.8 million dollars and imports from Finland to USD 5.5 million in 1992.

Karelia has had difficulties in exporting manufactured products to western countries. For this reason Karelian exports consisted mainly of sawn timber, pulp,

minerals and other raw materials or pre-fabricated products. Imports consist by and large of food and consumer goods. The percentage of investment goods stays fairly small. Although figures on Karelia's foreign trade with the rest of the CIS are not available, there is reason to assume that this pattern of trade is repeated there. In the current economic situation foreign trade does not constitute source of economic growth. It only contributes to maintaining a tolerable standard of living and some replacement investments.

On the one hand, specialization mechanical and chemical forest industry creates export potential both for the rest of Russia and to the western countries. On the other hand the other economic branches such as agriculture, construction and light industries producing consumer goods are neglected. This one-sidedness makes the Karelian economy vulnerable and, in any case, dependent on the Russian economy in the future as well.

## 3 Financing

### 3.1 Public financing

#### 3.1.1 Karelian financial relations with Moscow

New legislation passed in 1991 and 1993 is important to the economy of the Republic of Karelia. According to this legislation, Karelia will decide independently on barter deals, licensing within given quotas, registration of enterprises with foreign trade rights, and licensing of outward direct investment.

Karelian financial autonomy is decreed by the Presidential decision of the Supreme Council of the Russian Federation, which dates back to May 29, 1991. According to this decision

- all foreign exchange revenues earned by Karelia which would otherwise be transferred to the budget of the Russian Federation, will remain in the Republic of Karelia during 1991–1993. During 1994–1998 they will remain in Karelia in the form of credit bearing interest of 3 per cent per annum.
- Karelia is also entitled to retain payments which would otherwise be paid to the extra budgetary fund of the Russian Federation. However, Karelia is not entitled to receive any support from the fund during this period.
- Having established their own foreign exchange funds, firms are obliged to sell 75 per cent of their hard currency earnings to the Karelian foreign exchange fund and 25 per cent to the foreign exchange fund of the Russian Council of Ministries.

In addition:

- Karelia will henceforth use the resources obtained to modernize industries and raw material processing and to expand the production of consumer goods and development of services.
- Concerning trade between the Russian Federation and Karelia, Karelia will be obliged to export timber, crushed rock for road building and other rock products, fur, fish and fishery products. In exchange Russia will deliver food-stuffs and consumer goods in quantities comparable to deliveries to other areas.
- Karelia will assume responsibility for servicing a part of Russia's external debt.
- Privatization will be promoted.
- A customs system beneficial to export enterprises in the territory of Karelia will be improved in cooperation with the Finnish customs authorities.

The investment program also includes corrective measures such as

- promotion of foreign trade that would increase opportunities to sell raw materials at world market prices;
- allowing Karelia to retain a larger amount of the foreign currency and tax revenues for financing its investment programme.

The decree mentioned above (No. 3192) was reinforced by another signed by President Yeltsin on August 12, 1993 (SAPP 34/93). In the latter decree the Russian Federation undertakes to plan and confirm measures to develop the customs infrastructure on the Finnish-Karelian border, to promote travel, traffic connections and communications, and to develop forestry, the pulp and paper industry and the energy sector until the year 2015. In addition, the Russian Federation is committed to grant "tax credit" (i.e. tax alleviations which will be compensated later) in order to finance the investment program in the presidential decree No. 318/26.12.1991. In practice, the Karelian Ministry of Foreign Trade is given the right to deal directly with Finland. To maintain coordination with Moscow, the Russian Foreign Ministry has established a liaison office in Petrozavodsk to work closely with the Karelian Ministry of Foreign Affairs.

A Special Arctic developmental status was granted to Karelia on December 20, 1993, entitling Karelia to higher salaries and allowances than before to attract talented people from other provinces of Russia and to encourage its own educated people to stay and work in Karelia (Karjalan Sanomat December 30, 1993)<sup>9</sup>.

An investment fund has been established (the Fund for Reconstruction and Development) and it is administered by the Economic Council of Karelia. Under the new legislation, 90 per cent of the tax revenues which should be paid to Moscow will stay in Karelia and will be allocated to the above-mentioned fund to be used for productive investment. This tax holiday will continue throughout the five-year period 1994–1998, despite the fact that under the new constitution all regions and republics are equal.

Currently, Karelia has the right to withhold 90 per cent of the funds which it would otherwise be obliged to transfer to Moscow. In practice this means that the following amounts were retained in Karelia:

1991	6 bill. rubles,
1992	43 bill. rubles, and
1993	158 bill. rubles

Source: Ministry of Finance, Karelia.

These funds are transferred to the growth and development fund of Karelia under the auspices of the Ministry of Economy. Based on decisions of the Council of Ministers of Karelia, these funds will be used for investments in

- 1) forest and wood processing industries

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<sup>9</sup> The status was given to the Belomorskiy, Kalevalskiy, Kemskiy and Loukhskiy rayons of Karelia. A similar status was assigned to 3 towns ( Petrozavodsk, Kostomuksha and Sortavala ) and 11 rayons in the Republic of Karelia ( BBC Monitoring service, 23 Dec. 1993 ).

- 2) improvement of the transportation network
- 3) energy production (mainly small power stations burning coal or peat or run by water)<sup>10</sup>
- 4) foodstuff industries.

According to some estimates, the necessary investments in Karelian industries, transportation and communications and forestry amount to USD 1.1 billion (Kauppalehti Optio, April 21, 1994, s. 61–66).

One project of the highest priority, the North-West Railway, is presently nearing completion. The new railway will provide the shortest link between existing rail networks in Scandinavian countries and northern Russia and carry tens of millions of tonnes of transit goods every year. The line begins at the Ledmozero settlement and will run a distance of 124 km through bogland and uninhabited taiga as far as Kochkoma station. It will carry tens of thousands of trainloads of crushed road stone. Production of the quarried stone has already begun at a factory in the town of Kostomuksha. The Russian Government is expected to support the project by allocating the 9 billion rubles in investment credit needed to complete it.

The line will be the first in Russia to be built and operated by shareholders rather than the state. The owner of the railroad is the Gelleflint Corporation. The shareholders of this corporation include the municipal authorities of Moscow and St. Petersburg, the government of Karelia and the Oktyabrskaya railway administration. The total cost of construction of the railroad itself is USD 106 million. The cost of regional developments will be an additional USD 100 million (Memo of Kainuun Liitto, March 24, 1993).

The purpose of this project is to take advantage of the presently under-utilized capacity of the Finnish ports of Kemi, Oulu and Raahе for all-Russian transports. The purpose of the regional development part of the project is to benefit the Republic of Karelia by using the railroad for transporting crushed stone to the rest of Russia and abroad. Karelians expect some financing for this project from international and specifically Finnish sources.

Cooperation between Finland and Karelia is close. Agreements on regional cooperation have been concluded with the Finnish government. Finnish industry has worked out special programmes for power consumption and rational use of timber, development of mobile radiotelephone communications systems, modernization of transport routes, and projects involving transport across the Russian-Finnish border. The sector of transportation is considered to be one of the first priorities and comprehensive studies on the subject have already been prepared<sup>11</sup>.

Regular international passenger and cargo flights between Helsinki and Petrozavodsk in Karelia began at the end of March 1994.

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<sup>10</sup> Karelia already cooperates in this area with the Finnish firms IVO and VAPO. Vapo of Finland is to set up a joint venture peat company in the Republic of Karelia. Vapo will have a 50 % stake in the Karelian peat processing company, while the other 50 % will be held by the state-owned companies Lestopprom, the Karelian geological expedition, Tekobank and the state property management committee of the Karelian republic.

<sup>11</sup> For instance "A Study on the Transport Infrastructure of the Republic of Karelia", prepared by the Ministry of Transport and Communications of Finland, Helsinki, May 1993.

### 3.1.2 The administrative structures and practices

The budget system is fairly complex due to the existence of hierarchical administrative levels (chart 3). Tax revenues are channelled from the lowest local (including the county level, see chart 3) through the regional (republican) level to the central government. The central government again redistributes these resources regionally, partly by sending the funds back along the same channels and partly by handing them out directly to different hierarchical levels to cover expenses traditionally considered the central government's responsibility (maintenance of defense installations, universities or main arteries of the transportation network). On the one hand, due to budgetary problems, the central government has lately pushed these responsibilities down to regional and local levels. On the other hand, some distant regions, including Karelia, being important to the central government as suppliers of raw material and energy, receive special subsidies or rights to retain tax or hard currency revenues.

#### 3.1.2.1 Finances of the Republic

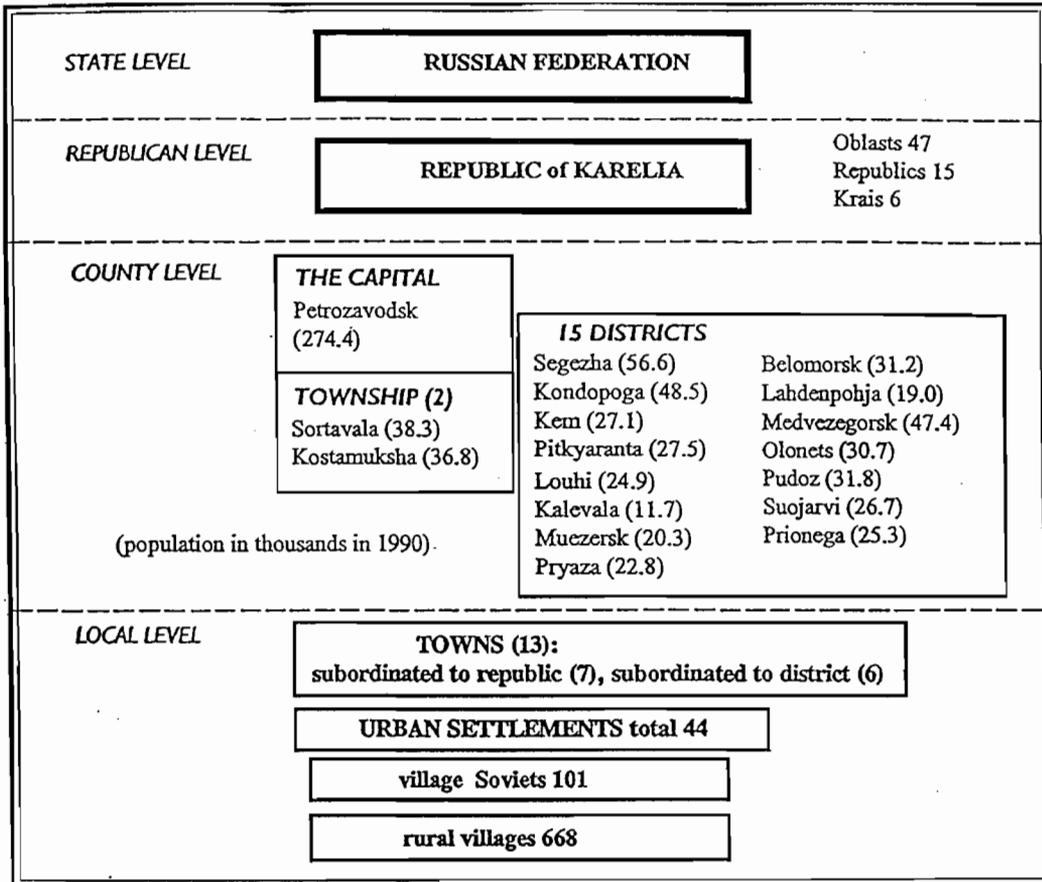
The fiscal administration of Karelia, of which a part is handled by Russia, is quite complex and not very transparent. The complexity of the system derives from the very Russian feature of never having been planned but having instead evolved out of to changing political needs (Sutela, p. 24, Wallich, p. 33).

The Republic of Karelia is authorized by the central government of Russia to withhold 90 per cent of the tax revenues it should normally transfer to the federal budget. This tax holiday started in 1992 and will continue until 1998. From the beginning of 1994 it will continue in the form of credit with 3 per cent interest. The revenues hence accrued will be transferred to a special "Fund for the Reconstruction and Development of Karelia". For this extra budgetary fund 6 billion rubles were withdrawn from budget revenues (to be transferred instead to the Federal Government). During 1993 the fund will be increased by 43 billion rubles and in 1994 by 158 billion rubles.

Total revenues in the Karelian budget for 1993 amounted to 189 billion rubles. These revenues covered transfers to funds outside the budget. They also include transfers from Moscow necessary to maintain the property owned by the Federal Government in Karelia (part of the transportation networks, military installations, research institutes including the University of Petrozavodsk, some enterprises). In most cases these objects are financed jointly by the Federal Government and the Republic of Karelia. 53 billion rubles of a total of 123 billion rubles from the republican budget proper, are used to finance projects considered to serve all of Karelia.

Chart 3.

**Territorial Administrative Structure of Karelia**



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Table 6. **The revenues of the budget of the Republic of Karelia, in 1993, billions of rubles**

Revenues to be used to finance the maintenance and running of all-Karelian property	53
Revenues determined by local expenditures	70
Revenues of the Karelian budget proper	123
Revenues to be transferred from the Karelian budget proper to extra-budgetary funds plus funds received from the federal budget to cover the maintenance of federal property located in Karelia	66
Total budget revenues	189

Source: The Ministry of Finance of Karelia

Revenues from the republican budget amount to 123 billion rubles and expenditures to 126 billion rubles – the difference of 3 billion rubles will be covered by the federal budget.

The main sources of budget revenues are the tax on entrepreneurial profit (58 billion rubles in 1993), the income tax paid by physical persons (28 billion rubles) and the value added tax (19 billion rubles in 1993). The rest, 18 billion rubles, is collected through various taxes and payments (tax on property, land, privatization).

The local tax rates are based on expenditures and decided jointly by the republican and local authorities. Consequently, the tax rates in more prosperous industrial areas (Petrozavodsk or Kostomuksha) are relatively low, say 3–10, where as in agricultural areas such as Pudoski or Suojärvi they are often in the neighbourhood of 40 per cent. For instance the metallurgical collective combine at Kostomuksha finances almost everything. Consequently, little remains to be financed from the republican budget or locally.

At first sight, this regime seems to lead to huge regional disparities because the poor areas are taxed more heavily than the rich ones. However, nothing so definite should be concluded. The tax base may be extremely narrow in a poor area- a 40 per cent rate applied to a new zero base in Pudoski might mean less tax revenue than a 3 per cent rate in the better-off company town of Kostomuksha. The need for municipal expenditures and social support may be lower in agricultural than in urban areas, etc.

Public finances suffer from the non-payment problems. For instance, Kostomuksha has presently 3.1 billion rubles in arrears, Suojärvi rayon 1.5 billion and Pudoski rayon 0.5 billion rubles. The total amount of payments in arrears is 6.5 billion rubles. In addition, a large amount of revenues is assumably lost due to tax evasion.

### 3.1.2.2 Local administration

The local administration has been given more obligations by the central administration due to the latter's lack of money. Consequently, the budgetary deficits on the local level keep increasing. For instance the expenditures of the City of Petrozavodsk for the budgetary year 1993 were 35.5 billion rubles. Table 3 shows the distribution of expenditures between different activities.

Table 7. **The budget for the city of Petrozavodsk for the budgetary year 1993**

Expenditures		SUR 35.5 bill.
Repair and maintenance of municipal buildings	35 %	
Running hospital and medical care	11 %	
Other municipal services (transport etc.)	21 %	
Schools and cultural services	17 %	
Municipal investments	9 %	
Social support	4 %	
Administration	2 %	
Other diverse expenses	1 %	
Revenues		SUR 26.5 bill.
Deficit		SUR 9.0 bill.

Source: Administration of the City of Petrozavodsk.

To cover the budgetary deficit the government of Karelia has already promised 5.2 billion rubles and granted short-term credit of 0.2 billion rubles. The remaining 3.6 bill. rubles have not yet been set aside.

The budget figures have been revised quarterly to accommodate the high rate inflation no model or guideline is available to make such adjustments in advance. Together with deferred payments problems, this has resulted in a chronic inadequacy of actual cash flows. Municipal and local employees have not been paid their salaries for several months and many municipal services have either ceased or are on the verge of collapse (BBC Monitoring Service, 28Jan. 1994).

### 3.2 Private financing

As a part of the Russian banking system, the Karelian banking community shares a structure inherited from the Soviet Union; the central bank (branch office), the successor banks of the former specialized banks and the new commercial banks. Table presents general data on the Karelian banks<sup>12</sup>.

The Central Bank of Russia (CBR) has its branch office in Petrozavodsk. The main functions of the branch office are provision of the means of payment, implementation of all legal foreign exchange operations and licensing, supervision and inspection.

The former specialized banks, Promstroibank, Zhilsotshbank, Agroprombank and Sperbank were all resurrected as commercial banks and joint stock companies under the names Nordwestbank, Petrobank, Bank of Karelia and Savings Bank. The CBR is a major shareholder in the Savings Bank and the Russian Foreign Trade Bank (Rosvneshtorgbank) in the Nordwestbank. The inertia of the past specialization is still visible in the clientele and orientation of these banks' policies.

The new generation of commercial banks is represented by Tekobank, founded by its shareholders in 1989, Bank Alisa and AvtoVAZbank, both founded in 1991. Quite recently two more banks were founded – the Municipal Bank and the Social Security Bank. In addition, bank branches have been opened by three Moscow banks (Bank Vozvrasheniye and Pervoi Russkii Bank) banks and one bank from St. Petersburg (Baltiskii Bank, which has mainly financed railways).

The major part of banks' lending of SUR 17.9 bill., 40 per cent, went to industry in 1992. Trade and trading received 24 per cent, construction 10 per cent and agriculture. All commercial banks promise their support to small and medium sized enterprises. Still they admit that established customers enjoy a preferential position as potential borrowers.

Table 8. **General Statistics on Karelian Banks, January 1, 1993**

Number of banks	7
Number of shareowners in the banks	2 105
Number of correspondent accounts	22
Number of clients (having opened an account)	40 940
of which: physical persons	31 455
juridical persons	9 485
of which:	
– industrial enterprises	129
– agricultural enterprises	268
– construction firms	85
– commerce and trading	2 149

Source: Karelian Goskomstat

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<sup>12</sup> A concise description of the three largest commercial banks in Karelia (Nordwestbank, Tekobank and Petrobank) is enclosed in the Appendix.

There are no interbank markets in Petrozavodsk, nor a foreign exchange market. In the event a bank needs to strengthen its ruble cash flow, it has to turn to the local Gosbank branch for short-term financing. The interest rate at the moment is 210 per cent p.a.

The Karelian licensed banks may buy and sell foreign exchange in the Moscow or St. Petersburg foreign exchange market. Transactions usually take 3 days. The bank makes an offer to buy/sell foreign rate at certain exchange rate. If the actual rate is higher/lower than the offer, the bank has the right to withdraw its offer.

Banks consider that investment funds offering interest rates of 500 per cent p.a. or even higher too risky.

Bank inspection is conducted by the central bank, which has a special department for this purpose. Tekobank reports every month. The inspection act contains 11 rules out of which 4 are obligatory and the rest recommendations. These rules relate to the liquidity of banks. In addition, Tekobank has a contract with an independent accounting firm in Moscow, which supervises the bank's accounts once a year. Naturally Tekobank also has its own internal supervision.

The banks live in day-to-day uncertainty due to the unpredictable changes in Russian banking legislation. Banks feel defenceless towards these changes.

Currently competition between local banks is more or less limited to attracting deposits. Success in this competition is measured by the number of new deposit accounts opened. The floor interest rates are set by the CBR on deposits with the local Savings Bank network. Currently these rates range from sight deposits of 40 per cent p.a. to 190 per cent p.a. for time deposits exceeding 5 million rubles for more than one year.

Competition between the banks operative in Petrozavodsk is confined to attracting deposits from the public. For this purpose Tekobank offers interest rates of 170 per cent p.a., which compares with 150 per cent offered by the Sperbank.

Petrobank also collects deposits and pays interest of 197 per cent p.a. if the depositor does not withdraw the deposit during the year, but only 125 per cent in the event the depositor uses his funds. The lending rate is 220–235 per cent p.a. If the borrower is a new firm, the bank analyzes the firm's ability to service the debt.

The banking services of the three banks concentrate on transferring ruble and foreign exchange payments in Russian territory as well as foreign exchange payments to and from abroad. All three banks mainly offer short-term financing to their customers, often with direct participation to the enterprise and possibly including technical assistance in accounting and financial management.

According to the Karelian Goskomstat statistics, credits to clients consisted at 42 per cent of the assets in the banks balance sheets as of January 1, 1993. However, 95 per cent of these claims had less than one-year maturities, and 43 per cent had less than three-month maturities at the beginning of 1993. As a rule, the borrowers could roll over their credits.

Table 9.

**The distribution of credits among the principal economic sectors as of January 1, 1993**

	Per cent
Industry	41
Agriculture	6
Construction	10
Commerce and trading	24
Other purposes	19
Total bank claims from clients	SUR 100 or 17 892 mill. SUR

Source: Karelian Goskomstat

### 3.3 Problems of the enterprise sector

There are at least two conceptually separate problems that are closely intertwined in practice: the problems caused by the payments system and those caused by financial problems. Quite often the sluggishness of payments is due to inadequate technical capacities, deficient communications across the vast territory, at the country and tendencies to centralize payment traffic through monopolistic trading companies and the CBR.

Payments for strategic exports (timber, forestry products) must be funnelled through a special trading company (Karellesexport) which collects the payments and converts at least half of the export earnings of each delivery into rubles. These operations take 50–60 days. The central bank settles the domestic payments, i.e. nearly all<sup>13</sup> payments are funnelled through the central bank accounts. The central bank admits that it simply does not have the capacity to process all payments promptly. However, to solve these problems the CBR has allowed Russian commercial banks to open correspondent accounts.

However, it is difficult in practice to assess the magnitude of excessive indebtedness apart from that caused by claims due to payments in arrears for technical reasons. Usually the firms include index clauses in their delivery contracts to accommodate the effect of inflation, or contract in terms of advance payments. However the relative prices of production input have been raised to the world market level, thereby eating up any comparative advantages the firm might have had due to former price distortions. Quite often the enterprises have overestimated their demand; by the time of delivery the potential buyer has disappeared, is unwilling and/or unable to pay. According to Karelian entrepreneurs, this goes for foreign customers as well<sup>14</sup>.

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<sup>13</sup> There are a number of banks which have established direct correspondent relations between each other to avoid payment delays.

<sup>14</sup> The Nordwestbank confirms that the Karelian enterprises have bad experiences concerning the reliability of western payers. According to that experience there are western purchasers (French, Dutch and Finnish customers were singled out) which have filed in their orders. Being asked for guarantees they pointed out that they are absolutely creditworthy; it is the Russian side which has problems. Having received the delivery they fail to pay, or, in cases of advance payment the merchandise has been produced as contracted but the foreign customer had totally disappeared. One reason for this behaviour, as presumed by the Russian entrepreneurs, is that the western party

The Karelian enterprises are not able to pay for their production inputs or service their other debts because they do not receive payments for their deliveries or payments are received but badly delayed. As a result these firms are unable to settle their own debts. The Russian enterprises continue production, as the alternative would be to close down. Many of the enterprises also had payments in arrears from abroad.

Usually two explanations are given for inter-enterprise arrears. The first explanation refers to the primitive state and slowness of the Russian payment system. Even when customers have effected payment in time, settlement may take anything from a few days to several months. Payments accumulate at the central bank's clearing centres through which most payments were funnelled.

The second explanation refers to the discrepancy between cash and non-cash money. Wholesalers tend to increase the prices of merchandise above what consumers are willing to pay. Hence the cash money earnings of the retailers are not adequate to cover the non-cash money claims of wholesalers and lead to huge build-ups in arrears between them within a short period of time.

The enterprises suffer from payment arrears and from the fact that the arrears coincide with the period of high inflation (about 2 500 per cent in 1992 and presume about 1 000 per cent in 1993). To protect themselves against inflation Karelian enterprises usually contract their sales and/or export deliveries with terms for advance payments, advance payments in instalments or indexation. However, the enterprises are unable to defend themselves against the losses against the intermediators of payments, because they are not partners to the contract.

The most frequently mentioned intermediaries causing payment arrears were the Russian State Bank and/or the foreign trade organizations through which the payments of exports of a strategic nature had to be implemented. The Russian State Bank has an inadequate technical capacity to promptly effect a large number of payment transfers. The same goes for the foreign trade organizations. According to my collocutors in the Karelian enterprises, intermediating banks and foreign trade organizations accumulate major payments in rubles and particularly in foreign exchange and then use the accumulated funds to protect themselves against the high rate of inflation at the expense of payers.

There is shortage of trained and able managers and sales promotion is nearly non-existent in the Karelian enterprises. Privatization does not seem to have much effect on the activities of the old Karelian enterprises. Factory management has not changed. Not much seems to be moving due to the stalemated financial situation without any prospects for improvement of opportunities for new investments. The experience and competence to produce the products is there, whereas the concepts of selling, advertising and promoting are alien. Even the major factories still seem to expect customers to come to them. Even then they seem fairly unprepared to promote their products or even present themselves. Sales managers do not have any financial information with which to convince potential customers of their financial credibility. Even in the major factories, collective combines, there are only a few managers in charge of sales promotion, and none of them have a very clear idea about what to do and how to do it.

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believes that the Russian party does not know how to secure his legal rights or that such rights and/or channels to enforce them do not exist, or, that those western customers were not interested in establishing continuous business relations with Karelia!

Another source of dissatisfaction is heavy taxation. The tax on profits constitute the main source of fiscal revenues. Russian enterprises are not entitled to deduct the cost of production inputs. An enterprise in forestry may pay nearly 60 per cent of its annual sales income. The remaining 40 per cent were not enough to cover salary and other expenses. To finance the deficit the enterprise had to borrow at high rates of interest. The enterprise cannot even afford necessary maintenance, to say nothing of new investments. The maintenance of employee housing and other social services (schools, kindergartens) adds to the financial burden which the enterprises, even when privatized, have to accept<sup>15</sup>.

Heavy taxation has led to large-scale tax evasion. Enterprises take advantage of the loopholes and inconsistencies in the existing legislation and the deficient controls to hide part of the sales proceeds that should be declared as taxable income. For instance, exporters make side contracts and thereby divert part of the export revenues. The government is criticized for encouraging foreign investment while discouraging domestic investment by excessive taxation at the same time<sup>16</sup>.

The tax rate may vary greatly from year to year due to retroactive taxation. Such uncertainty undermines financial planning and forces firms to hold excessive liquid funds.

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<sup>15</sup> Karjalan sanomat 2.12.1993, Kova verotus tappaa yritykset (High taxes kill off enterprises)

<sup>16</sup> Karjalan Sanomat 2.12.1993, Mihail Bockharov:"En tunne yhtään yrittäjää, joka maksaisi normaalisti veroja". (I don't know a single entrepreneur who pays taxes normally.)

## 4 Concluding remarks

The politico-economic approach of the Republic of Karelia seems to be a balance between region and centre. According to Anulova (p. 12) there are four main issues on which the struggle with the central authorities centres:

- (1) fiscal transfers
- (2) control over local resources
- (3) foreign trade rights
- (4) privatization.

In the case of Karelia, the objectives (1)–(3) have been fairly well achieved. This seems to have taken place without a major political struggle or tension between the region and the centre. Here the cautious, conservative, low-profile policy of the Karelian government has to be credited. The support of ethnic groups has been won because they obviously expect that these achievements will improve their standards of living. As a result, they seem to direct their efforts towards cultural areas with the objective of preserving their own cultural heritage<sup>17</sup>.

Aiming at gaining controls over its own national resources, aware of the opportunities opened through economic and commercial cooperation with Finland and aware of its special geopolitical location between St. Petersburg and the province of Murmansk, and by pursuing a conservative and cautious policy, the government of Karelia has succeeded in winning a number of concessions from Moscow and in balancing local and federal interest. Karelia has gained control of its national resources, a special arctic status, the right to deal directly with Finland and the right to keep 90 per cent of federal taxes to finance its own investments.

Karelia does not have aspirations for greater political independence, and no intention of introducing its own currency. Karelia has its own governmental and administrative organs, its own flag – as do the other republics within the Russian Federation.

The scale of ethnic conflicts in Karelia is small. They are confined to resentment expressed from time to time to the absence of the ethnic minorities in the decision making organs. There is some concern about preservation of the ethnic heritage and language. All political forces in Karelia, including the Karelian ethnic minorities, support an extensive degree of regional autonomy. The evidence from Karelia does not necessarily support the idea that privileges encourage

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<sup>17</sup> The original Karelian ethnic groups (Karelians, Karelian Finns, Veps) are presently under-represented in the different echelons of administration. They have not been able to agree on political means of promoting their cause. For these reasons the ethnic groups are scattered and weak (Reuter News Service 9. Sept. 1993, BBC Monitoring Service, 20. Nov. 1993). A number of new developments continue to oppose the interests of these ethnic minorities. For instance, in the northern part of Karelia, completion of the construction programme of hydroelectric power stations threatens to flood the old Karelian villages along the rivers, the last strongholds of Karelian cultural heritage. Sometimes ethnic tensions culminate in cultural vandalism, like destroying cemeteries (Helsingin Sanomat, 7.7.1994).

disintegration<sup>18</sup>. On the contrary, in the case of Karelia, the special privileges serve more as a regional subsidy to compensate the population for the harsh living conditions and increase regional cohesion.

One way to balance policy between Karelia and the centre has been to promote projects designed in such a way that both the benefits and the costs can be shared by the region and the centre. Transportation serves this purpose well and is therefore given high priority; the construction of Russia's first commercial railroad is an example. Improvement of self-sufficiency in energy production and modernization of industries would rank as the next important areas. Development of trade with Finland by exporting raw materials and importing – now food and consumer goods but in future increasingly capital goods – is also assigned fairly high priority. These priorities define by and large Karelia's relations to the central government in Moscow and to Finland.

The history of Karelia also bears evidence that the centre (Moscow) has always been concerned and interested in Karelia, not only in its forest and raw material resources, but as an area connecting two industrially and strategically important areas of Russia, namely St.Petersburg and the Murmansk province. The most recent political developments in the Baltic states and Ukraina, leading to reduced port facilities and the withdrawal of Russian troops from these and Strategic importance of Karelia. For these reasons Moscow is interested in financing improvements in transportation and other infrastructure through direct participation or indirect fiscal privileges.

The **advantage of Karelia** is its geographical location between two economically and strategically important areas. St. Petersburg is the second major centre for industry and commerce with over 5 million people. The province of Murmansk is a strategically and economically important region. The importance of the railroad connecting St. Petersburg and Murmansk via Karelia has increased due to the loss of some of the port capacity in the Baltic and Black Sea. Use of Finnish ports on the Gulf of Bothnia could alleviate this problem. To offset these all-Russian interests and satisfy local needs, the commercial ideas incorporated on the railway projects in aim at increasing local employment and economic activities.

In addition, the Republic of Karelia is endowed with relatively rich natural resources. This creates a base for increased commercial cooperation with Finland and other western countries which is seen as one source of wealth and opportunity. The key here is improved transportation and communications. These ideas are met on the Finnish side with "gateway" thinking.

The **disadvantage of Karelia** is its dependence on imports of grain, other food, consumer goods and oil which, combined with poor transportation and non-payment problems, causes shortages from time to time. The foreign trade of Karelia reflects this dependence; Karelia exports raw materials (timber, pulp, plywood and minerals to Finland as well as to other western countries and to the rest of the CIS, and imports mainly consumer goods, food and chemicals. Few investment goods are imported. The paper industry of Karelia remains one of Russia's largest, including the paper-making machine sector, whereas the grain pro-

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<sup>18</sup> In her study on Tatarstan, Anulova considers the "special rights accorded to regions such as Karelia, Sakha-Yakutia, Komi or the provinces of Murmansk or Irkutsk "one of the most serious disintegrating factors" (Anulova, 8). She maintains that 1/4 of Russia's area and 1/3 of its productive capacity put under "special regimes would increase regional wealth differences and nourish separatist ideas.

duction is virtually nil and the production of milk, meat and vegetables is small-scale and in most cases inefficient.

The Karelian economy is still very far from a market economy, as is most of Russia. Privatization has proceeded slowly and the monolithic decision-making structure still exists. Privatization has not been associated with an increase in productivity and competition. Supply and demand determine prices imperfectly. Business opportunities are therefore based on taking advantage of price distortions created by subsidies, existence of a parallel economy and skewed distribution of income and wealth. Decision-making power is centralized and supported by political inertia and state ownership of land and a major part of wealth. Entrepreneurship is essentially restrained by the regulatory authorities in the multi-echelon administrative system that still adheres to bureaucratic practices from the Soviet period.

As to financial administration, Karelia still depends on the budgetary management inherited from the Soviet Union, as do the other republics, provinces and rayons. Not that the present stage of the ongoing reforms would have offered any solid basis for redesign of the system according to the requirements of a market economy. Thus, Karelia's financial administration and the procedures and principles applied still share in the unclear and even chaotic status of the Russian fiscal system.

The state and condition of industrial plants seem to vary from plant to plant. Some factories could be beefed up with new efficient management and marketing; some again are physically collapsing or at least hopelessly out of date. Heavy social obligations obviously slow down or prohibit the of ten painful decisions needed to correct the situation. The situation is even worse in those villages and small towns that have grown up around a factory that is still a sole major employer. In most cases privatization alone has not been an adequate measure for changing attitudes so as to promote restructuring and reforming enterprises.

Burdened by social obligations, Karelian enterprises and municipalities are left without adequate resources to replace their aging infrastructures and machines. Also, privatized major enterprises seem to suffer from inadequate management and the almost total absence of any kind of sales promotion. The young people often prefer to move away from the villages and towns and to seek the opportunities offered by a bazaar economy. The deterioration of the age structure, together with the increasingly skewed distribution of income, is likely to increase social problems and add to the burden of social expenditures.

The present state of the Karelian forests is most likely linked with the depopulation of the rural areas. The absence of private interests has led to a situation wherein there is no one to take care of the forests. This has resulted in wholesale felling and neglect of re-forestation. This raises the question of whether repopulation of the rural areas with incentives and obligations to care for the forest resources would serve the purpose of introducing an economically and environmentally acceptable sivilculture. If feasible at all, a lengthy period of time would be necessary for implementation of this solution.

The one-sidedness of production has made Karelia vulnerable for interruptions in the exchange of goods with other areas caused by 1) the political and economic fragmentation of the FSU, 2) bottlenecks and malfunctions in the transportation network, or 3) non-payments. These problems have been approached by 1) maintaining good relations with the centre and by creating new alternative sources for imports of necessities by foreign trade promotion to Finland and other

western countries, 2) emphasizing the importance of improving transportation networks and 3) increasing the autonomy of the republic in the areas of public finances, use of foreign exchange and exploitation of natural resources.

In the economic policies of the Republic of Karelia improvement of the economic preconditions for successful economic reform (by improving technical infrastructure and increasing autonomy) now has precedence over economic reform itself. The economic development of Karelia will depend on its ability to reorganize its own production and economize the use of its resources.

## Annex

### Three largest commercial banks in Karelia

#### Nordwestbank

**Nordwestbank** is the largest bank in Karelia in terms of share capital. Ranked according to total assets (102 billion rubles) and performance in 1993, Nordwestbank was the 122nd. largest bank in Russia (Business World Weekly No. 14/107, 7, "150 largest banks in Russia"). The share capital was raised to 3 billion roubles in 1993 (Delovoi Mir 20.9.1993).

Nordwestbank is a successor of the former Promstroibank, converted into a commercial bank on December 21, 1990 with a founding capital of 41 million rubles. Nordwestbank was reorganized again on November 29, 1991. Then the Russian Vneshtorgbank (a commercial bank specialized in the financing of foreign trade) bought 24 per cent of the bank's share capital. The rest of the share capital of 65.7 million rubles was divided among 81 organizations.

Nordwestbank currently has staff of around 350 persons, of which fewer than 150 works at 11 branch offices throughout Karelia.

By virtue of reorganization, Nordwestbank received foreign and domestic correspondent connections and a general licence to implement foreign exchange transaction both domestically and internationally. Nordwestbank presently effects payment transfers from Karelia abroad. For that purpose the bank has correspondent bank connections with 14 foreign banks including four Finnish banks. Payment transfers take a maximum of three days.

Nordwestbank was specifically developed to finance Karelia's foreign trade. For this reason the Karelian Foreign Trade bank is one of the shareholders. Many of the other founders are also involved in foreign trade; the fleets of Lake Onega and the White Sea are in charge of freight transportation to most western European countries (mainly to the United Kingdom and Turkey).

More than 2600 enterprises opened more than 5800 accounts with Nordwestbank and used all services. The Nordwestbank finances the largest paper machine constructor in Karelia, "Petrozavodskbummash", including its more than 300 subcontractors. Furthermore, Northwestbank finances exports of paper and paper products to Finland, Sweden, Austria, the People's Republic of China and Rumania. This foreign trade is channelled through Karellesprom, trading company linked with the 94 forestry enterprises in Karelia, which has 3 500 subcontractors and exports to 30 foreign countries.

#### Tekobank

**Tekobank** (the TErritorialny KOMmertsheskii BANK) is the only bank in northwestern Russia which has actively developed investment projects with Finnish firms (in with construction firms in particular) in Karelia for the past 2–3 years. Tekobank prefers, particularly if compared to its competitor Nordwestbank, to be seen as the most dynamic of the Karelian banks; it seeks cooperation with

Finland and the Scandinavian countries with a special emphasis on creating special knowledge and experience in the financing of export-import operations. Being authorized to conduct foreign currency operations, the bank describes itself as a bank of the new generation, aiming at "creation of a transnational zone between Russian and Western economies via Scandinavia".

The share capital of Tekobank is now around 1 billion rubles. It has been increased seven times during 1993 in order to keep abreast of the current yearly inflation of 1 000 per cent.

Tekobank prefers to finance small and medium-sized enterprises. In addition to buying shares in enterprises, it also provides firms with technical assistance. Tekobank finances the projects of the firms in which it participates. The rate of interest charged for that kind of financing is fairly low, around 3 per cent p.a.

There are presently about 120 employees at the headquarters in Petrozavodsk and around 60 in the 11 branches throughout Karelia. Tekobank also has agents in about 150 post offices, most of which are located in the southern part of Karelia along the shores of Lake Onega and Lake Ladoga.

#### Petrobank

**Petrobank** was founded on July 29, 1990 by 15 enterprises which subscribed shares worth 29 million rubles. Petrobank was formed from the former Zhilzotsbank. It was formed as a joint stock company in April 1992 with share capital of 130 million rubles. Petrobank is owned by some 190 enterprises, and only 7–9 per cent of total capital is in the hands of governmental organizations. The capital of the bank is presently 301 billion rubles and will be increased by 1 billion rubles. There are 190 persons working in Petrobank, of whom 100 are employed at the headquarters in Petrozavodsk. Petrobank has a department in Petrozavodsk and a branch in Sortavala.

Like the other banks, Petrobank also lends and buys shares in enterprises. It is a shareholder in more than 30 enterprises and finances private enterprises, particularly in light industries such as foodstuffs, trade, cooperatives and also agriculture.

Petrobank has correspondent bank connections with Finnish commercial banks KOP, SYP and OKO. Transfers of payments from Petrobank to Finland take place rapidly because Petrobank debits its accounts with these Finnish bank for that purpose. Transactions are effected by telex. In Russia transfers take 3 days.

Petrobank has outstanding claims of 19 billion rubles. About 5 per cent of these claims were rescheduled at the request of debtors unable to continue servicing their debts as originally contracted.

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