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Finland's Changing Economic Relations
with Russia and the Baltic States

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Finland's Changing Economic Relations with Russia and the Baltic States

1 Background

Among the western industrialized countries Finland probably suffered most from the disintegration of the economy of the former Soviet Union (FSU)¹. In the 80s Finland ranked second in importance after Germany as a trade partner of the FSU. At present Germany still occupies first place while Finland has dropped back to about tenth place. In the trade with the Baltic countries Finland is still second after Germany and is the most important trade partner for Estonia.

The trade with the FSU accounted for more than 25 per cent of Finland's total foreign trade in the peak years of 1982 and 1983. During the second half of the 80s it declined almost continuously to slightly over 11 per cent in 1990, the last year of the Finnish-Soviet clearing regime. With the collapse of the Soviet economy and the disruption of conventional business relations, Finland's trade with the FSU fell sharply to only 6.6 per cent of her total foreign trade in 1991. This share levelled off at 6.0 per cent in 1992 (table and figure 1) and before increasing again to 7.6 per cent in 1993. The rapid expansion of Finland's total trade in recent years conceals the fact that volume of eastern trade actually grew slightly already in 1992. Still, the real around turn took place in 1993, when trade with the FSU increased by 48 per cent.

The clearing trade regime between Finland and the FSU was abandoned at the end of 1990 after having been in existence for 44 years. Those Finnish firms that had been involved in the clearing trade with the FSU were left with but a few options: to establish new business relations with the FSU, to win new markets in the west or to close down or at least cut back their production. Unfortunately, the bill arising from the excessive allocation of resources to eastern trade under the protective shelter provided by the clearing regime fell due at the onset of Finland's worst post-war recession.

The recession has been severe both in terms of its depth and length, with exceptionally high rates of unemployment and external debt. According to the latest OECD survey, Finland was the only OECD member country to record slightly negative growth for exports of manufactured goods in 1990–1992. GDP fell by 7.1 per cent in 1991, 3.8 per cent in 1992 and 2.6 per cent in 1993. One third of the decline in real output in 1991 is estimated to have originated from the collapse of sales to the FSU (Rautava and Hukkinen).

The financing of exports to the FSU was abruptly terminated once it became known that the FSU could not service her debts. The non-receipt of contractual

¹ In the following, the FSU refers either to the Soviet Union as it existed up to December 1991 or to the area comprised by it.

payments from the FSU related to claims of some 7.3 billion marks and coincided with the serious financial difficulties of Finnish banks stemming from their mounting credit losses and the decline in the value of their asset portfolios.

The most recent trade figures point to some signs of recovery in 1993: exports to the FSU increased by 92 per cent and imports by 22 per cent. The corresponding growth figures for trade with Russia are 100 and 17 per cent and for Estonia 75 and 50 per cent. Low inflation and moderate wage policies have substantially improved Finland's international competitiveness, which has received a further boost from the depreciation of the Finnish markka; the value of the markka fell by 25 per cent after it was floated in September 1992. This has enabled Finnish exporters to compensate for part of the fall in sales to the FSU by regaining shares in western markets.

The abolition of clearing had far-reaching effects not only on the volume of trade but also on the sales approach applied, the commodity structure of trade and the forms and geographical incidence of the trade. The implications of the institutional change – trade was transformed from centralised protected clearing rouble trade in to decentralized hard currency trade exposed to external competition – are considered in section 2. The principal changes in the commodity structure are examined in section 3 and the developments in forms of trade other than direct trade (project exports, direct investments) in section 4.

2 Changes in the formal relations

The abolition of the clearing regime and the dramatic changes in the FSU fundamentally reshaped Finland's economic and commercial relations with Russia and the Baltic countries. The change implied a sudden shift from a centrally controlled and regulated trade regime to trade based essentially on private initiative. The depth of these changes can be best understood by contrasting the present situation with the form of trade that prevailed under the Finnish-Soviet clearing system.

Two basic factors contributed to the growing imbalances in Finnish-Soviet clearing trade in the 80s: the differences in the demand and supply potentials of two economies of unequal size, and the fact that more than two thirds of Finnish imports from the FSU consisted of oil and oilrelated products priced at world market prices in US dollars. The value of oil imports from the FSU was inflated by any rise in the oil price and/or in the external value of the US dollar. The room for additional clearing exports that this created was readily filled by a corresponding increase in Finnish exports to the FSU, a reflection of the huge potential demand of the FSU for Finnish products. When the price of oil subsequently declined, thus reducing the value of imports, exports could not be flexibly adjusted downwards or the volume of imports could not be increased enough to bring the clearing trade back into balance. Consequently, given the strong political pressures to maximize the trade, the clearing trade could only be balanced upwards. The administrative means for balancing the trade downwards turned out to be inadequate.

As Finland gradually relaxed her foreign exchange controls in the 80s, it became increasingly costly and inefficient to administer the two-currency system comprising the fully convertible Finnish markka and non-convertible clearing rouble. Currency administration was further complicated by the preference of the Soviet party to pay for their purchases from Finland in clearing roubles but to sell to Finland against Finnish marks or other freely convertible currencies.

To be fair, it should be noted that clearing system also offered substantial benefits to Finland. The clearing regime was very efficient in minimizing transactions costs. Moreover, Finnish exporters could count on continuing demand for their products even when markets in the west were in recession. Owing to the special status of the Finnish-Soviet clearing arrangement, the soft budget constraint and the secondary role played by money in the economy of the FSU, Finnish exporters were often able to negotiate good prices for their merchandise².

The trade with Russia and the Baltic countries is currently being taken over by small and medium-sized firms, which were usually crowded out by large companies under the clearing regime. Though the volume of trade has fallen since

² This argument is not conclusive. For instance, according to **Kajaste** the prices varied greatly between commodity groups and over time. There are other explanations for the profitability of the clearing trade, such as lower unit costs due to economies of scale and low expenditure in marketing. **Sutela** draws attention to the cash payment nature of the clearing account. Costs of financing the clearing trade were covered by the Finnish central bank, which made the clearing trade attractive from the viewpoint of the exporter. **Hirvensalo** points out that the abolition of the clearing system substantially reduced the negotiating power of Finnish exporters, because they had to compete with suppliers from other countries.

the abolition of clearing, the number of Finnish firms participating in this trade has increased. In 1989 the share of the five largest exporters to the FSU was 35 per cent; in 1992 the corresponding share in exports to Russia had fallen to 17. In fact, Finland's exports to western countries are dominated by forest products, and as a result the concentration of these exports is still fairly high, between 30–40 per cent, with the exception of exports to the other Nordic countries, where the share is 25 per cent. On the imports side, the five largest importers from the FSU accounted for 72 per cent of Finland's total FSU imports in 1989. In 1992 these imports were still fairly concentrated, as the corresponding share had only fallen to 67 per cent. Finnish imports from western countries have always been far less concentrated in 1992 the five largest importers from any western country accounted for 15 to 25 per cent of the total imports from that country³.

Under the clearing regime firms had to compete for import and export shares within the quotas agreed by the ministries in Helsinki and Moscow. Since the beginning of 1991 the trade has increasingly been based on private initiative and direct contacts between firms in Finland and enterprises in different regions in Russia and the Baltic countries. Being cut off from Moscow, Finnish firms had to create their business contacts from scratch. From the Finnish point of view, this change introduced the regional aspect into the present trade, formerly concealed behind the all-union planning performed in Moscow.

The priority area for Finnish exporters is the Baltic states and the areas of Russia adjacent to Finland's border. This neighbouring region of Finland consists of the Murmansk region, the Republic of Karelia, the City of St.Petersburg and the Leningrad district. This region of almost 10 million people is considered by the Finns to be the most promising one and a natural growth area owing to its geographical and cultural proximity. The same applies to the Baltic countries and Estonia in particular, except that the potential growth in the volume of trade will remain relatively small. The focus on this regions does not, however, exclude the maintenance of the old relations with Moscow and other areas.

³ Statistics from the Finnish Customs authorities. Foreign Trade: Concentration of Foreign trade in 1989 and 1992. The figures cover only exporters or importers with exports or imports exceed 100,000 Finnish marks a year in 1989 and 1992.

3 Changes in the structure of trade

Exports from Finland to the FSU countries declined from 12.9 billion marks in 1990 to 8.8 billion marks in 1993. The collapse of the share of paper and paper board exports (figure 2) provides a good example of the adverse consequences of the abolition of clearing, although there was already some revival in absolute terms in 1993. When the Soviet government was replaced as a counterparty in trade by several potential customers, Finland, not being able to extend export credits, lost these markets. The increase in exports of foodstuffs is explained by shortfalls in agricultural production in St.Petersburg and other neighbouring regions.

Table 1. **Finland's trade with the FSU, 1990–1993, in millions of Finnish marks**

	1990	1991	1992	1993	Distr. %
Exports to					
Russia	..	..	3.0	6.0	69
Baltic states	..	..	1.2	2.3	27
Other FSU	..	..	0.3	0.4	5
Total FSU	12.9	4.5	4.6	8.8	100
Growth, %	-11	-65	1	92	
Imports from					
Russia	..	..	6.7	7.8	84
Baltic states	..	..	0.7	1.0	10
Other FSU	..	..	0.2	0.5	6
Total FSU	10.2	7.5	7.6	9.3	100
Growth, %	-15	-27	2	22	
Trade balance					
Russia	..	..	-3.7	-1.8	
Baltic states	..	..	0.6	1.4	
Other FSU	..	..	0.1	-0.1	
Total FSU	2.7	-2.9	-3.1	-0.5	

Sources: Official Statistics of Finland, National Board of Customs.

The value of Finland's imports from the FSU decreased from 10.2 billion marks in 1990 to 9.3 billion marks in 1993. The most striking feature during this period was the change in imports of energy products. No longer bound by the need to maximize her imports from the Soviet Union in order to balance the clearing trade, Finland has been free to purchase oil on the basis of price, quality and reliability of deliveries. Consequently, the share of energy imports from the FSU declined from 59 to 36 per cent of Finland's total energy imports in 1990–1992 and from 69 to 64 per cent of her total imports from the FSU.

Some changes in the structure of imports (figure 3) reflect increased cooperation with the neighbouring areas of Russia and the Baltic countries. A fairly sharp increase in the share of imports of wood, metal scrap, textiles and clothing from the FSU was already discernible in 1992 and during the first half of 1993. The increase in imports of wood is mainly attributable to the trade with the Republic of Karelia. These imports consist mainly of birch, which is readily available in Karelia and the basic raw material for plywood.

The increase in the share of textiles and clothing in imports and exports is due to the fact that many Finnish firms have shifted part of their production to the Baltic countries, and particularly to Estonia, to take advantage of lower labour costs there. The increase in imports of metal scrap and non-ferrous metals from the Baltic countries suggests that a major part of this trade originates from Russia.

Finland quickly became Estonia's most important trade partner. By the end of September 1993, Finland accounted for 22 per cent of Estonian exports and 26 per cent of her imports. However, almost 27 per cent of Estonian exports to Finland consisted of metals, ores and metal scrap which, though they may not be included in Estonia's imports from Russia, probably inflate the figures for exports to Finland and other countries. Estonia's share of total Finnish imports was 0.7 per cent and her share of Finnish exports 1.4 per cent.

4 Project exports, direct investments and trading

Over half of the construction projects abroad still uncompleted at the end of 1993 were in the FSU and particularly in Russia. There are twice as many projects in progress as in the peak years of 1982–1983, but the average size of the projects measured in terms of the number of employees, is one third and the price in real terms roughly about one sixth of what they were ten years earlier. One of the reasons for this is the current absence of mega projects like Kostamus or Svetogorsk. Finnish project exports to Estonia have declined from their level in the 80s as a result of lack of financing and large projects (such as the port of Tallinn etc.)

A major part of project exports consists of the construction of housing for Russian military personnel repatriated from Germany. Finns are involved in the construction of 14 of the 40 different projects. Total invoicing in 1992–1994 will amount to about 4-5 billion marks. Finnish participation in St.Petersburg has been relatively modest. In most cases, Finnish construction firms have participated as sub-contractors, providing the projects with modern machinery, equipment, materials and servicing, which are readily available owing to the short distances involved and the markka's favourable exchange rate.

Efforts have been made to launch new projects aimed at improving municipal infrastructures, transportation (ports, roads etc.), exploitation of forest and mineral resources and environmental protection in the neighbouring regions. With some exceptions, there has been only little progress, for a host of fairly well-known reasons: Russian legislation in the areas of ownership rights concerning land and natural resources, excessive or arbitrary bureaucracy concerning acquisition, taxation and customs and lack of financing. A more recent problem is the high rate of inflation, which is not reflected in changes in the external value of rouble. This has caused problems when paying for purchases of project-related services and materials priced in roubles.

In addition to direct trade and project exports, direct investments in Russia and the Baltic countries have continued to increase. There are more participants from Finland than from other countries in the Russian enterprises with foreign ownership operating in the neighbouring regions. At the beginning of 1992 there were more than 200 foreign-owned and 60 Finnish-owned enterprises operative in the neighbouring areas (Laurila, p. 59, table 6). At the end of 1993 there were over 500 enterprises with foreign capital operative in the neighbouring areas, slightly more than 200 with Finnish participation. Germany ranks next, followed by the USA and Sweden⁴. Lately, direct investments have increased markedly. In St. Petersburg alone there are currently more than 110 operative enterprises with Finnish participation⁵.

The first direct investments in Estonia were made in 1987. At the beginning of 1991 there were less than 100 Finnish enterprises operative in Estonia. At present, Finnish participates in almost 1400 of the more than 2500 foreign enterprises estimated to be operative in Estonia at the end of 1993. Measured in terms

⁴ A rough estimate based on a number of statistical sources and news releases.

⁵ List up-dated by the Finnish Trade Representation in St. Petersburg.

of the amount of participation Finland has been the most active country in Estonia as well. Finland accounts for almost 30 per cent of the total amount of about 0.2 billion dollars invested in the Estonian economy, which places her second behind Sweden (Ministry of Finance, Estonia). Most of the direct investments have been made in small and medium-sized enterprises in services, travel and consulting and in labour-intensive production to take advantage of the low cost of Estonian labour.

Trading was fairly modest under the clearing regime owing to the bilateral nature of clearing. Apart from the official oil trading occasionally resorted to as a means of balancing clearing trade in the 80s, clearing accounts could only be used to transfer trading-related payments on special conditions set and monitored by the Bank of Finland. Since the abolition of the clearing regime, the volume of trading transactions has increased. In 1991 about 20 per cent (1.5 billion marks) of import payments and 9 per cent (0.4 billion marks) of export payments were generated by trading operations. Corresponding shares in 1993 were 18 and 2 per cent (1.7 and 0.2 billion marks)⁶.

⁶ Internal monitoring statistics of the Bank of Finland.

5 Summary

The abolition of the clearing regime, together with the political and economic developments in Russia and the Baltic countries, has significantly increased the need for, but at the same time also improved the possibilities of, Finland to serve as bridgehead in the promotion of business and trade interests between east and west. Given the continuation of reform-oriented political and economic developments in Russia and the Baltic countries, Finland's trade with them will continue to grow until a natural level has been reached. This natural level probably implies a lower level for Finland's trade with Russia than that which prevailed under the protection of the clearing regime but higher than that in the present transitory stage.

Clearing was abandoned on the initiative of the Soviet authorities. The collapse of Finnish-Russian trade was mainly caused by the breakdown of the Russian economy, not by the abolition of the clearing arrangement itself. Furthermore Finnish firms needed some time to establish new contacts and create and adapt their business strategies to the new circumstances. The increase in trade in 1993 represents a revival of the trade on a renewed basis.

The new approach called for replacement of centralised indirect contacts with decentralised direct contacts established on private initiative. On the one hand transaction costs and commercial risks increased, and there was no longer protection from foreign competition. On the other hand trade is now open to any Finnish firm. Clearing favoured large firms and many of small and medium-sized firms participated at best as sub-contractors. Currently, the number of participating firms has increased drastically even though the average size is smaller than in the past.

The commodity structure has changed. The need to maximise oil and energy imports from the FSU, coupled with the transitional changes, has reduced imports and seen a shift way towards other products like wood, metallic ores and scrap, textiles, clothing and other items. On the export side the export of machinery and transport equipment has maintained its share while paper and paperboard products have lost theirs. All in all, the share of consumer goods such as food and beverages, miscellaneous manufactures etc. has increased significantly.

Currently, there is more variety in the way in which trade is conducted. Clearing favoured direct trade but discriminated against transactions involving a third party (trading) or capital movements (projects, direct investment). Activities and operations in these areas have increased substantially since the abolition of clearing. However, the average size of individual transactions tends to be smaller than in the past due to the absence of governmental support, lack of financing and guarantees.

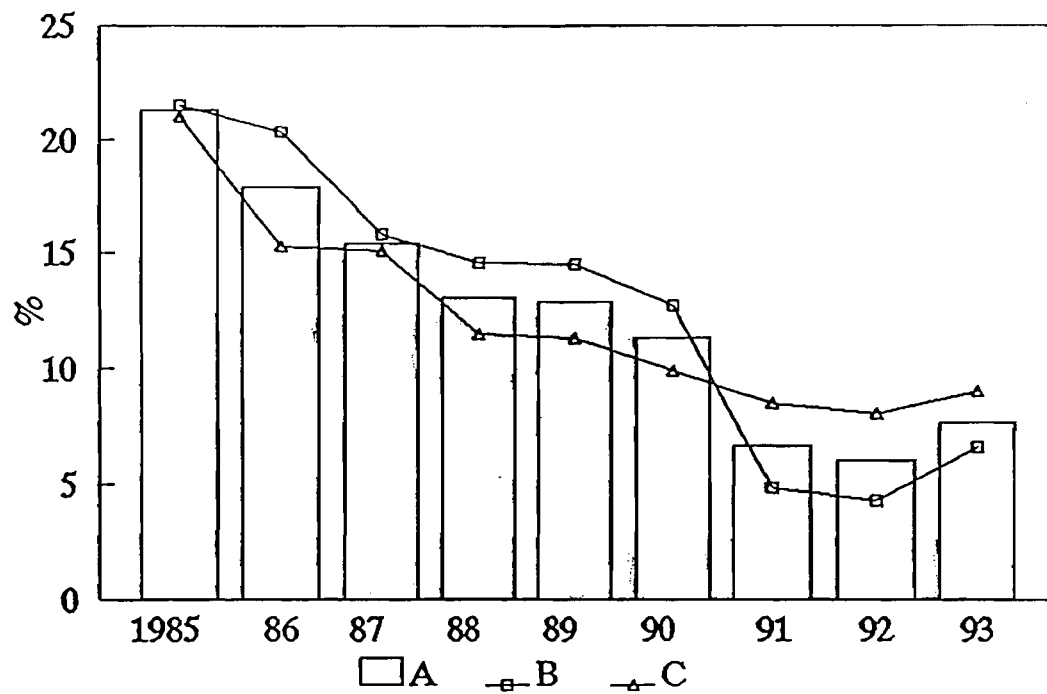
In contrast to the past, Finland's trade with Russia and the Baltic countries is conducted on a regionally diversified basis, with the focus on the neighbouring regions and Estonia. For the present, trade and investment transactions are likely to be relatively modest because of uncertainties and lack of financing. The investment opportunities for large-scale business in the northern and north-western areas of Russia still await adequate Russian legislation on land ownership and the use of natural resources as well as adequate political and economic stability to

ensure that the laws protecting their interests will be consistently implemented by the Russian authorities.

Trends in Russia towards regional fragmentation, strengthening of local powers and economic activities based on private initiative are in harmony with the ongoing economic reforms in Russia. Trends in the opposite direction towards increased centralization and interventionism would have an adverse effect on political and economic cooperation between the industrialized countries and the FSU countries. The prospects for Finland's – as too for other countries' – trade with the FSU will essentially depend on future economic and political developments in the FSU area.

Figure 1.

The Share of the FSU area in Finland's foreign trade

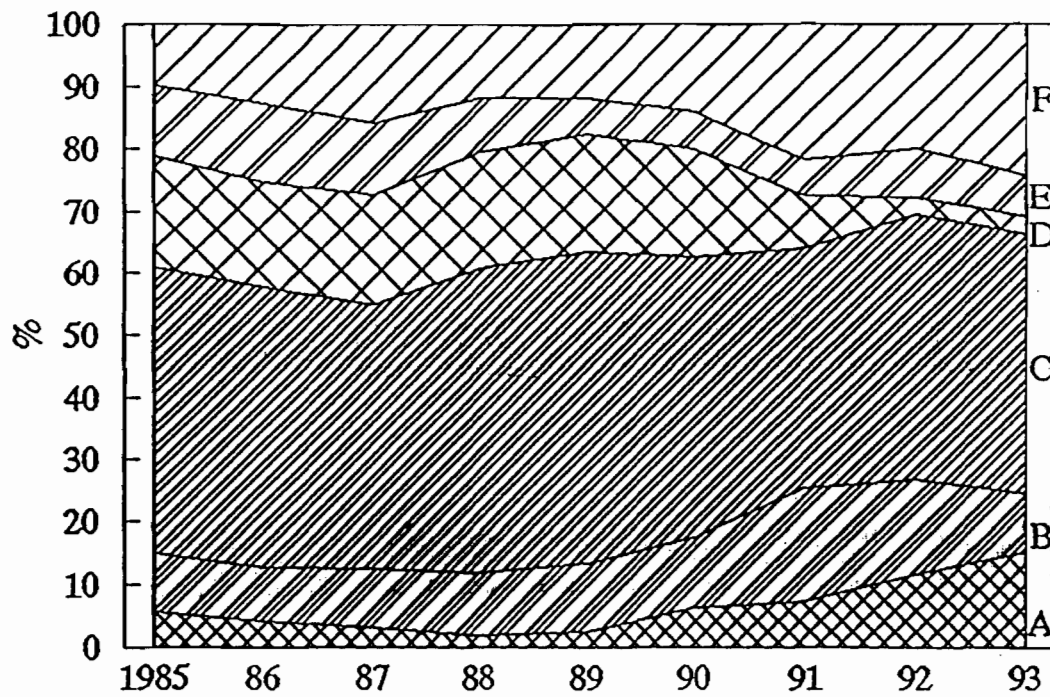


- A Trade with the FSU as % of total foreign trade
- B Exports to the FSU as % of total exports
- C Imports from the FSU as % of total imports

Source: Official Statistics of Finland, National Board of Customs

Figure 2.

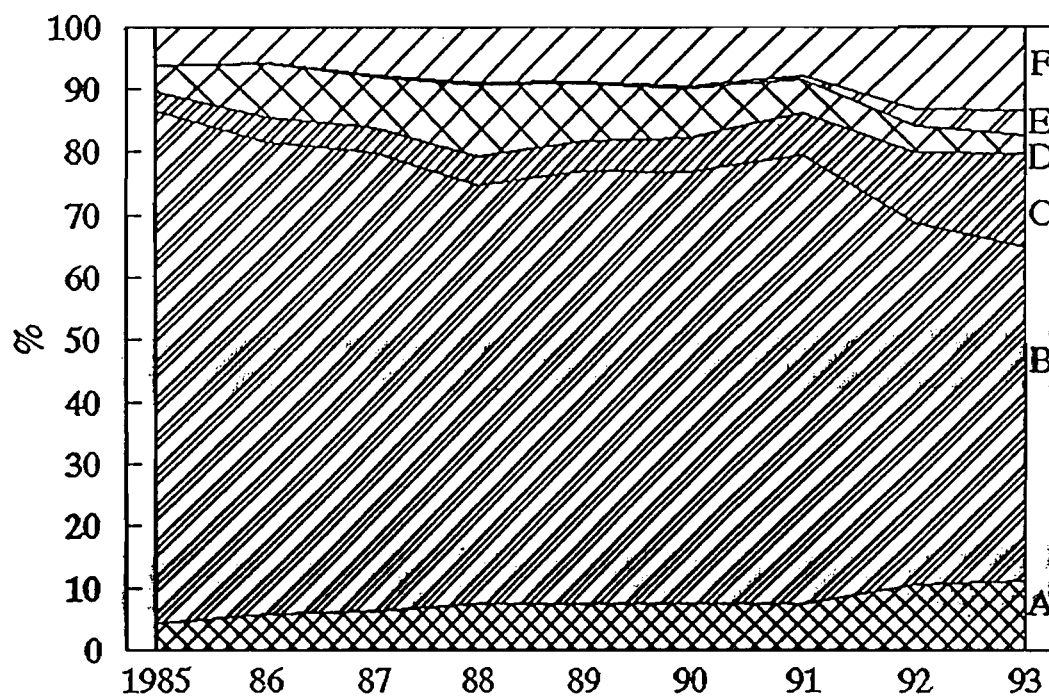
The structure of Finnish exports to the FSU area



- A Food and beverages (SITC 0-1)
- B Crude material and mineral fuels (SITC 2-4) and
Chemicals and related products (SITC 5)
- C Machinery and transport equipment (SITC 7)
- D Paper and paperboard and articles thereof (SITC 64)
- E Textiles and clothing (SITC 65, 84, 85)
- F Other manufactures and articles (SITC 6, 8, 9)

Source: Official Statistics of Finland, National Board of Customs

The structure of Finnish imports from the FSU area



- A Wood (SITC 24)
- B Energy (SITC 32 – 35)
- C Metalliferous ores and metal scrap (SITC 28) and
Iron, steel and non-ferrous metals (SITC 67, 68, 69)
- D Machinery and transport equipment (SITC 7)
- E Textiles and clothing (SITC 65, 84, 85)
- F Food and beverages (SITC 0 – 1) and
Crude materials (SITC 2 – 4, except 24, 28, 32 – 35) and
Chemicals and related products (SITC 5) and
Other manufactures and articles (SITC 6, 8, 9)

Source: Official Statistics of Finland, National Board of Customs

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