Finnish-Russian Economic Relations

Russia is a more important trading partner for Finland than it is for other EU countries. Russia's share in Finnish merchandise exports has been around seven per cent in recent years. The corresponding share in imports has been over ten per cent. The legal framework for foreign trade will change markedly in coming years. Russia will inevitably become a member of the World Trade Organization (WTO) in a few years. A new economic agreement is also being planned for trade relations between Russia and the enlarged EU. This agreement may extend slightly further than a traditional free trade agreement. Business activity will also change as a result of globalisation.

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RUSSIA IS ONE OF FINLAND'S MOST IMPORTANT TRADING PARTNERS

The long common border between Finland and Russia and complementary production structures make these two countries natural trading partners. Russia is indeed a more important export and import country for Finland than for the other EU countries.

Political changes and other institutional factors have over the years shaped the framework, volume and structure of trade. The economic fundamentals have nevertheless remained largely unchanged. Trade is still based to a great extent on comparative advantage. As a resource-rich country, Russia's exports to Finland are comprised mainly of oil, natural gas, metals and other raw materials.

Finland's exports to Russia, on the other hand, consist primarily of electronic industry products, machinery, equipment and other finished goods. The manufacturing of these products requires a high level of education as well as research and product development. The forest industry also exports to Russia, although relatively less than to the Western markets. The structure of Finland's exports to Russia changed in the 1990s more than the corresponding structure of Russian exports to Finland. Finland exports more information-intensive products than previously.

Along with the transition to a market economy, direct investments have increased to a much higher level than prevailed during the Soviet era. Finns have invested in Russia, and Russians are also increasing their investments abroad.

Economic relations are nevertheless not problem-free. Russia's market economy is still in a state of transition. Liberalisation has in some respects been drastic, but the activities of foreigners are subject to numerous restrictions in the country. Legislation is not up-to-date in many respects and sometimes it is enforced arbitrarily. There are also great problems in obeying laws. Foreign trade is hampered by high tariffs and import restrictions on certain products, as well as slow, corrupt and inconsistent customs activities.

Finnish-Russian economic relations will face significant changes and challenges this decade. This transition stems from Russia's own economic, political and social development as well as changes in international agreements and international business. The economic relations of these countries will increasingly be linked within global economic networks.

RUSSIAN ECONOMY INTEGRATING WITH REST OF WORLD

The enlargement of the EU in 2004 will affect customs and other trade barriers so that the competitive situation of companies from different countries will change. Simulations using the GTAP world trade model suggest that the impact of EU enlargement on Russia's total production and foreign trade will be rather modest.

Russia is currently negotiating its membership in the WTO, which is anticipated to take place within the next few years. This will affect trade relations between Finland and Russia in a way that improves the preconditions for exports and investment. On the other hand, import competition will become somewhat keener in the case of labour-intensive products.

Structure of Finland's Merchandise Exports to Russia, %

	Exports to Russia								Share of total
Product group	1992	1994	1996	1998	1999	2000	2001	2002	2002
0 Food and live animals	11.5	21.5	13.7	10.6	8.2	7.0	6.2	5.8	1.7
04 Cereals and cereal preparations	6.3	0.9	2.2	1.5	1.4	1.3	1.3	1.1	0.3
05 Vegetables and fruit	1.1	9.3	1.6	1.0	0.3	0.2	0.2	0.1	0.1
1 Beverages and tobacco	0.5	1.8	1.4	0.8	0.8	0.5	0.4	0.5	0.2
2 Crude materials, except fuels	0.9	1.3	1.7	1.3	1.8	2.2	2.2	2.0	6.6
3 Mineral fuels, electricity	2.3	0.7	3.6	1.9	1.8	1.6	1.6	1.6	3.4
4 Animal and vegetable oils and fats	0.1	0.1	0.2	0.3	0.7	0.3	0.3	0.3	0.1
5 Chemicals and related products, n.e.s	8.0	5.9	9.9	10.1	11.5	12.1	11.4	14.7	7.0
6 Basic manufactures	14.0	18.3	22.7	22.0	23.2	22.4	21.9	20.1	30.9
64 Paper, paperboard and articles thereof	2.9	3.6	8.5	7.0	9.3	9.1	9.2	8.2	18.1
69 Manufactures of metals, n.e.s	4.6	5.1	4.7	4.7	3.7	3.1	2.9	3.2	1.5
7 Machinery, transport equipment	43.6	31.5	29.9	36.6	38.4	40.0	42.8	43.7	43.6
72 Machinery for specialised ind.	13.5	4.9	3.0	3.7	5.8	6.6	5.9	4.9	5.2
74 General industrial machinery, n.e.s	9.7	7.3	5.5	5.4	5.3	5.1	6.0	6.0	3.9
76 Telecommunications and sound recording equipment	2.5	5.3	5.4	6.7	6.6	11.1	12.8	14.9	18.6
77 Electric machinery, n.e.s and parts	3.2	4.3	6.3	9.6	10.3	8.9	8.0	8.6	5.1
78 Road vehicles	7.8	6.5	5.0	5.6	5.7	4.1	4.9	3.3	3.4
8 Miscellaneous manufactured artic.	19.0	18.9	17.0	16.5	13.6	13.9	13.2	11.4	5.7
81 Prefabr. buildings; sanitary, lighting etc. fixtures	6.2	3.7	1.8	1.2	1.2	1.3	1.4	1.5	0.7
89 Miscellaneous manufactured articles, n.e.s	2.8	4.7	8.0	9.7	7.2	7.1	6.5	5.6	1.8

Sources: OECD, ITCS, Board of Customs.

After Russia becomes a member of the WTO, the next step would be the upgrading of economic relations between Russia and the EU. Russia is already engaged in preliminary talks with the EU about an economic agreement, the depth of which is still unclear. Membership in the EU is not deemed possible because of Russia's huge size and superpower status. The agreement nevertheless goes somewhat farther than a mere free trade agreement. On the other hand, it will probably be less ambitious than the European Economic Space, i.e. the EES agreement between the EU and certain EFTA countries. A successful agreement would boost trade and investments between Finland and Russia.

In addition to the framework of agreements, the general globalisation of the international economy will also affect economic relations between the two countries. Developments in transport and information technology as well as production technology have made business increasingly more international in recent decades. Companies establish subsidiaries in different countries and invest in final or intermediate production there. They also make various types of subcontracting and other agreements with companies located abroad.

The effects of globalisation on trade relations between Finland and Russia are still rather modest at present, but Russia's membership in the WTO will accentuate this process. Russia's political and economic stability, legislative changes and adherence to laws as well as internal liberalisation will have a pronounced impact on the global division of labour via investments. Production in Russia and subcontracting activities there are affected, among other things, by the stability of social conditions, the tendency to obey laws, the development of infrastructure, availability of skilled labour, the productivity of labour, the level of wages and other costs, taxation and the development of administrative culture.

RUSSIA'S ECONOMIC GROWTH SWIFT

We examine three scenarios of Russian economic growth. According to the baseline scenario, Russia's GDP will grow in 2004-2010 by an average of 4 per cent per annum, which is faster than output growth in Western industrial countries, but slower than, for example, that in China and India. In this scenario, investment must be raised from its current low level. An increase in the investment ratio will require further economic reforms.

Lower oil prices, the postponement of reforms and weaker investment, among others, may nevertheless lead to slower growth than that mentioned above. If, however, the price of oil rises significantly, reforms continue and both domestic and foreign companies invest heavily in Russia, GDP growth may well exceed that projected above.

EXPORT AND INVESTMENT PROSPECTS GOOD, IMPORTS DOMINATED BY RAW MATERIALS ALSO IN THE FUTURE

Finland's current exports and imports to and from Russia exceed levels forecast by a gravity model. In addition to historical factors, the potential for exports may stem from corporate strategies based more on exports than direct foreign investments, because Russia's investment environment has been uncertain. The high level of imports may be explained by Finland's high energy requirements and greater emphasis on purchasing from a neighbouring energy-rich country rather than from energy producers located further away. Especially in the case of natural gas there are currently no alternatives but to import from Russia because of the lack of a pipeline network connecting Finland to, for example, Norway.

The starting point for assessing the outlook for imports from Russia is that most of the imports still consist of energy and raw materials. For this reason, imports are calculated under various scenarios depending on the price of oil and Russia's share of Finland's oil imports.

Russia's share of Finland's imports is projected to decline from current levels by the year 2010 if the price of oil falls to 20 dollars per barrel, even if Russia's share of Finland's crude oil imports gradually rises to 90 per cent by that time. Even a crude oil price of 30 dollars a barrel would not be able to prevent a decline in the share unless Finland begins to increasingly import oil from Russia. If Russia's share in Finnish oil imports rises to the above-mentioned 90 per cent in the years 2009-2010 and the price of crude oil remains at 30 dollars a barrel, then Russia's share of Finland's merchandise imports will rise from 13 per cent in the first half of 2003 to almost 15 per cent in 2010. Russia's share would then surpass Germany's 14.5 per cent share that prevailed in 2002. Non-oil imports are assumed to grow by slightly over 3.5 per cent a year.

The development of Finland's exports to Russia is evaluated both at an aggregate level and by product groups. Since the mid-1990s, the most important factor explaining variations in Finnish exports to Russia has been the real effective exchange rate (competitiveness). The price of crude oil has also been a key variable.

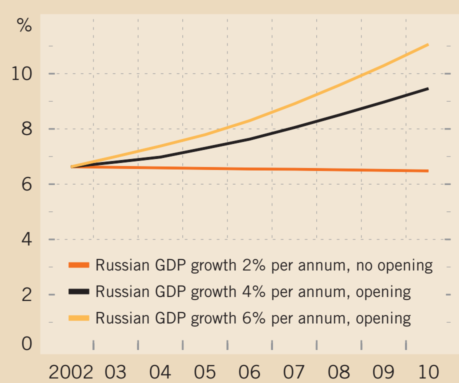
In the long run, Russia's GDP growth is nevertheless a pivotal determinant of Finland's exports. In addition to price competitiveness and the price of oil, economic reforms also have a significant impact on Russia's GDP growth. Export projections in this study are linked to Russia's GDP growth path.

Assuming that Finland's share of Russian imports remains at current levels, the baseline forecast shows Finnish exports to Russia growing by an average of 6 per cent per year in 2004-2010. We must still add the effect of the opening of the Russian economy to this estimate, which will become more visible towards the end of the projection period. In this case, the volume of exports would grow by an average of 7-8 per cent a year, assuming broad-based and rapid liberalisation. Russia's share of Finnish exports would then be about 9-10 per cent in 2010, a level approaching, though not exceeding, Germany's share of Finnish exports.

In an unlikely scenario of sluggish growth and limited trade liberalisation in Russia, the growth of Finnish export volumes would only average three per cent a year. In the scenario of very favourable conditions, Finland's exports to Russia would, in volume terms, increase by an average rate as high as 10 per cent per annum. Thus Russia's share of Finnish exports would surpass Germany's current 11-12 per cent by the year 2010.

Estimating future export developments is complicated by the fact that exports can be replaced by direct investments in Russia. The gravity model calculations made in the study indicate that Finland's current exports to Russia exceed their potential while investments are below their potential. As investment conditions stabilise in Russia, companies operating in various industries will seek to exploit their presence in the Russian market and the country's low labour costs. Direct investments may, on the other hand, also boost exports.

Russia's Share of Finnish Merchandise Exports in Different Scenarios



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When evaluated by product group, many industries in Finland have possibilities to increase their exports appreciably. Russia's swift economic growth will fuel export demand, but Finnish companies will have to maintain their competitiveness in order to benefit from this strengthening in demand.

Russia's low penetration of mobile phones will foster exports of mobile phones and networks as well as create opportunities for phone operators. There are also possibilities to increase exports of other high-tech products.

The forest industry, which currently exports paper to Russia, also enjoys expanding markets for its products in Russia. Direct investments are being directed mostly to the sawmill industry. The amounts invested and risks are lower in the sawmill industry than in the paper industry, where the cost of starting or shutting down operations are high. However, prospects for investment in Russia by the Finnish paper industry will improve as conditions there stabilise.

Several sectors of the Russian economy are still in the midst of being modernised. The profound structural changes will create possibilities for, to mention just a few, distributors of packing materials, high quality foodstuffs and chemical products.

Finnish exports of labour-intensive products face keen price competition due to transition-related pressures. This can in some cases be met by shifting production entirely or partially to Russia or to some other low-cost country. Other ways to safeguard market positions are to specialise in some segment or boost real competitiveness (product quality).

The results of the gravity model indicate that Finnish companies have invested less in Russia than they would have in a corresponding country with more political and economic stability. The pace of investments can be safely assumed to accelerate. The stock of direct investment is forecast to more than double from its current level by the year 2010.

BASELINE SCENARIO POSITIVE, RISKS STILL SIGNIFICANT

The development of the Russian economy in the baseline scenario is relatively positive from the standpoint of Finnish companies. The country will continue to carry out economic reforms and liberalisation, and its society will become more stable. It is likely that Russia will become a member of the WTO in the next few years. After this the EU and Russia will perhaps make an agreement that goes slightly farther than a free trade agreement.

The Finnish economy will benefit from these positive developments. At the enterprise level the benefits can be divided roughly into four groups that are not always mutually exclusive:

1) strong and large international enterprises,
2) small and flexible enterprises,
3) enterprises operating near the border, and
4) enterprises in the tourism sector.

Strong and large Finnish enterprises succeed in finding competitive products that they can produce either in Finland or abroad. The products manufactured in Finland require high technology or Finnish raw materials.

Small and flexible companies specialise in products where they have special know-how. Their market area is often international. Nevertheless enterprises based in the Finnish domestic market can expand to the Russian side of the border by taking advantage of their close proximity and knowledge of the markets.

Companies in different sectors operating close to the border will benefit from the opening of Russian markets and the country's strong economic growth. Companies in the tourism sector (hotels, restaurants, etc.) around Finland will receive more customers along with Russia's favourable economic growth and increased foreign tourism.

Above we have assumed that developments in Russia will be favourable for the most part. This point of departure is nevertheless problematic and progress is slow in many respects. There are also many risks related to these developments. They include the following:

1) political instability and/or rise to power of politicians seeking to curtail reform,
2) social instability and disease (e.g., various lifestyle-related illnesses, HIV/AIDS, tuberculosis),
3) delays in negotiating WTO and EU agreements,
4) dearth of investments,
5) low level of research and development,
6) brain drain,
7) low energy prices (slow economic growth in Russia), and
8) the so-called Dutch disease, i.e. a situation where the success of the energy sector prevents growth of other sectors (weak productivity and employment development).

These factors may curb Russia's economic growth and intermittently destabilise the economy and the entire society. Correspondingly, the business activities of Finnish companies in Russia (exports and investments) would suffer.

Direct investments react very sensitively to uncertainty and slowdowns in the reform process. Exports will be hindered if the price of oil falls or Russia's economic growth slows down for other reasons. Various types of import restrictions are often geared toward products competing with Russia's own production (e.g., foodstuffs) and services (telecommunications, transport, tourism, etc.). Goods can more easily avoid the restrictions if they are in relatively short supply in Russia or if they are not of strategic importance.

Finnish companies should prepare for various types of risks by, for example, diversifying their investment and foreign trade. On the other hand, excessive caution is not good because it can prevent firms from taking advantage of business opportunities.

Finnish authorities and the EU also support Russian development. The instruments include financing from the EU, EBRD (European Bank for Reconstruction and Development) and the EIB (European Investment Bank). Active attempts to promote Russia's integration with Western Europe via intergovernmental agreements are in the interest of Finnish companies.

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APPENDIX
Finnish Investments in Russia

Direct investment

In 2002 the aggregate stock of Finland's direct investment was EUR 61 Bill. Russia accounted for 0.6 per cent of this stock and its share of corresponding employment was 2.9 per cent. While the share in exports was about 7 per cent, direct investment activity is relatively modest. On the other hand, FDI is growing rather fast. In the following, Finnish direct investments in Russia are presented according to the manufactured products. The data are collected from several sources, including company annual reports and from the media, and do not cover all investments.

Telephone, radio, etc. equipment
- Elcoteq has a plant in St Petersburg which produces telecommunications electronics.
- The PKC Group, founded in Kempele near Oulu, has shares in its partners in Russia and production facilities in Kostamus and Viborg (manufacturing electrical harnesses for vehicles and other electronic equipment).

Other electrical machinery
- Helkama Forste Ltd. has a subsidiary, Helkama Forste Viborg, which produces refrigerating machines for retail trade.
- Huurre Ltd. has subsidiaries providing servicing, installation and marketing services in Moscow and St. Petersburg.

Machinery and equipment
- Products of Arctic Machine Ltd. (road maintenance equipment) are manufactured by license in Russia.

Metal products
- Zao Rannila, a subsidiary of Rautaruukki, has a plant producing steel roofings in Jekaterinenburg, a steel service unit in St. Petersburg and a production line near Moscow.
- Kuusakoski Ltd. operates in recycling of metals in Russia (mainly on the Kola Peninsula, Karelia and in the surroundings of St. Petersburg).

Paints
- Tikkurila Paints Ltd. has a paint factory near Moscow.

Plastic goods
- Huhtamäki has a factory producing plastic coverings near Moscow.

Paper and graphical products
- Stora Enso has a paperboard factory in Russia and another one is under construction.

Wood products
- UPM Kymmene has a sawmill and a board factory in Russia.
- Metsä-Botnia the joint pulp company of Metsäliitto and UPM Kymmene, intends to build two saw mills in Russia.
- Stora Enso has several sawmill investments under construction or under planning in Russia.
- Tiivi Ltd. has a joint enterprise OAO Eurotiivi in Murmansk.

Dairy products
- Valio owns the sales and distribution company Valio St. Petersburg.

Fats and Oils
- Raisio has a margarine factory in Russia

Beverages
- Baltic Beverages Holding (BBH) of the Scottish & Newcastle group (which merged with Hartwall) has nine breweries in Russia.
- Sinebrychoff, belonging to the Carlsberg group, has a brewery in St. Petersburg.

Rubber products
- Nokia Tyres intends to build a tyre factory in St. Petersburg in 2004-2005. (The company decided to end joint production of tyres as a partner of the Russian Amtel company in March 2004.)

Construction
- YIT has daughter companies in St. Petersburg and in Moscow.
- Skanska East Europe Ltd. acquired majority ownership in the residential construction firm OAO Peterburgstroi in March 2003.
- NCC has two daughter companies in Russia.

Construction materials
- Parma Betonila has a daughter company, named Parastek, which produces concrete products in Russia.
- Lohja Rudus has a daughter company Betomix, which produces concrete products in St. Petersburg.
- Isover has a thermal insulation material plant in Yegorievsk.
- Tikkurila Paints has a paint factory near Moscow.
- Optiroc is building a plant which will produce dry concrete products near Nizhsni Novgorod.

Electricity
- Fortum owns 20 per cent of Lenenergosta, an electricity company operating near St. Petersburg. The company intends to widen its activity in the electricity sector in Russia.

Trade
- Stockman has a department store and the fashion store Zara in Moscow as well as a store in St. Petersburg.
- Rautakesko has a wholesale warehouse in Moscow.

Banking
- Okobank has a daughter company in St Petersburg.
- Nordea has a 22 per cent share in International Moscow Bank (IMB).

Insurance services
- Pohjola has a minority share in the Russian Principal insurance company.

Communication services
- Telia-Sonera has a share of almost 45 per cent in the telecom operator Megafon. The company has about 20 per cent market share in GSM mobile phone calls in Russia.