

## Finland Benefiting from the Russian Growth Phenomenon

Opportunities for developing Northwest Russia's economy have been examined in a broad-reaching, three-year Finnish-Russian research project, financed by the Finnish National Fund for Research and Development (SITRA) in collaboration with the Finnish Ministry of Trade and Industry and 20 leading Finnish companies. By Northwest Russia, we mean the region bordering Norway, Finland and the Baltic countries on the west, and bordering the Urals industrial region on the east and Central Russia in the south. Northwest Russia includes the city of St. Petersburg and the surrounding Leningrad region, the republics of Karelia and Komi, the regions of Murmansk, Archangel, Vologda, Pskov and Novgorod together with Kaliningrad, which as a result of enlargement will become an enclave within the EU. In terms of geographical area, Northwest Russia is five times larger than Finland with a population of 14.3 million.

The most outstanding clusters of this region extending from the Finnish border to the Urals are in the fields of energy, basic metals, forestry, and information and communications. Northwest Russia has an abundance of raw material resources that can be used by these clusters together with a pool of cheap and skilled labor as well as access to the rapidly growing Russian markets. The Russian growth phenomenon offers an outstanding opportunity for Finnish industrial companies that start operations in Russia. With growing investment the export of technology will also increase. The next stage is for small and medium-sized Finnish subcontractors to begin activity in Russia and for industries to build cross-border networks.

Over the last six years, the Russian economy has grown at a rate three times faster than that



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of the EU. During 1999-2003, Russia's GDP grew by an average of 6.1 percent per annum while in the EU growth averaged only two percent and in Finland three percent. Growth in Northwest Russia has corresponded to that of overall Russia. In the future, the logistically advantageous geographical position of the region between the key markets of Russia and Europe will increase its potential. Of the EU countries, Finland can benefit the most from Russian growth due to its proximity and economic synergy gains. Finnish exports and imports to and from Russia are growing significantly, making Russia one of Finland's leading trading partners alongside Germany. Finland has become an important trade route and logistical centre for high-value goods to Russia. Thirty seven percent of Russia's imports pass through Finland. Finland enjoys a starting-line position with respect to its direct investment in Russia.

### **THE MAINSTAY OF THE ECONOMY – ENERGY, FOREST AND METALS**

The most promising cluster in Northwest Russia is the energy cluster. Komi, Nenetsia and the nearby Yamal-Nenetsia and Hanti-Mantsi

regions produce both oil and coal. The Barents and Kara Seas hold Russia's largest unexploited reserves of natural gas. Because of the strong growth of the region's own manufacturing and transit haulage, goods transport via the Baltic Sea is expected to increase greatly. A new pipeline to Murmansk would reduce ecological risks and open up a channel to the US market. Developing the production of electricity and heat requires that the present monopolies and administrative price systems be dismantled. International companies could provide help in developing this field.

The forest cluster is growing to become the second largest cluster in the region, overtaking basic metals. Northwest Russia's forest reserves are approximately four times larger than those of Finland, but tree-felling is only 60 percent of the corresponding figure for Finland, and a considerable proportion of that is exported to Finland. Currently, the industry manufactures only low value-added products. The Svetogorsk paper mills (now owned by International Paper) and the Syktyvkari pulp and paper mill (Neusiedler) have embarked on a new course of development. Together they manufacture the majority of Russia's needs for copying paper and are strongly oriented towards exporting. Developing the forestry industry will require long-term investment in forest and timber management, infrastructure, technology and environmental care. The fact that they are the only factories in those communities where they operate constitutes a problem in the sense that these communities are highly dependent on them, which in turn makes it difficult to rationalize production operations. A second important problem concerns obtaining sufficiently long-term felling rights. Attempts are being made, however, to solve this problem with new forest legislation. Progress in forest industry development would help raise the standard of living in Northwest Russia.

The basic metal industry in Northwest Russia is based on the ore deposits of Karelia and the

Kola Peninsula and coal resources in the Komi region. Non-ferrous metals are refined in the Murmansk region and St. Petersburg. The non-ferrous metals giant Norilsk Nikkel is a major producer. The processing of iron and steel is in the hands of Severstal in the Vologda region; it is the largest single enterprise in the whole of Northwest Russia. The most promising field within metal refining, however, is the production of aluminium, for which Northwest Russia has both the raw materials and cheap energy. The collapse of the Soviet system revolutionized the metal industry. Domestic markets crashed and the industry had to concentrate on manufacturing basic products and on exporting, where it succeeded well. Domestic demand is now growing as a result of the improved economy. Problems facing the industry include the rising production costs of mines. The region's mines, refineries and blast furnaces are serious polluters compared with their western counterparts.

Information and communications represents a new field of business in the region. This cluster is concentrated in St. Petersburg. Northwest GSM, which is now a part of the nationwide operator MegaFone, is a pioneer in the field of mobile telephony in Russia. Six and a half million mobile telephones are currently sold each year in Russia but the country has no production of its own. A second growth area within information and communications is software development, a field where the region could follow the pattern of India and Israel. Activity in this area is based on entrepreneurship and strong educational inputs. Of the three Russian centers in this field – Moscow, St. Petersburg and Novosibirsk – St. Petersburg is the most oriented towards exporting. The center of Russia's electronics industry is in St. Petersburg and the surrounding area. Of what remains, manufacturers have gained a foothold in production of narrowly defined products. An important new form of production is license manufacturing, which requires a network of subcontractors to support it. However, regula-

tions controlling the import and export of components need to be liberalized before this field can flourish.

### **RUSSIA NEEDS AN INDUSTRIAL POLICY**

It became obvious during the course of the study that Russia lacks industrial policy. Hitherto the central administration has concentrated mostly on reforms that will contribute to more efficient markets. At the same time, monopolies have been left to operate in many industries, such as energy production, transport services and fixed-line telephone communications.

The high wealth tax of 2.2 percent is a factor hindering investment in capital-intensive industries, such as the forest, basic metals and energy industries. This “additional” required rate of return set by the state is too high. It has, however, encouraged finance leasing since the capital goods acquired in this way are not subject to taxation.

The Russian state is attempting to guarantee its own sources of revenue by retaining many key industries as state monopolies. These include, for example, rail transport, gas production, pipeline transport of oil and the fixed-line telephone network. If these branches were opened up to competition, it would result in markedly higher economic growth and a wave of investment. At the same time, administrative prices for gas and electricity, for example, would have to be freed from restrictions. The government is implementing reforms of this nature but only relatively slowly so.

A characteristic feature of Russian industry is the predominance of massive, large-scale companies and the lack of small and medium-sized enterprises. Such companies were not established during the Soviet era nor have they emerged over the last ten years except in trade and services. This creates problems for large foreign investors, for example, since setting up a subcontracting network is a laborious task.

Russian factories also find it difficult to outsource their operations since there is nobody to whom they can outsource. Russia needs an SME policy.

Another structural problem is the lack of a corporate R&D policy and the paucity of R&D activity. During Soviet times, research institutes conducted all the research and development work for new products and production processes, while companies acted merely as production units. Now the research institutes are encountering difficulties, but companies have not yet developed their own R&D activities. No venture-capital system exists to develop new technologies and bring them on stream.

The most pressing matter at present is to get investment moving. Now would be the time for both the state and the different regions to invest in the infrastructure of promising industrial communities, transport channels and information networks. At the same time, other steps to encourage investment need to be taken so that the costs and risks of investing are reduced. The fact that foreign investment per capita is considerably lower in Russia than elsewhere in Eastern Europe is a reflection of the present poor investment environment. Good opportunities for attracting investment would seem to exist because of the availability of raw materials, advantageous transport costs and rapidly expanding domestic markets. Foreign investment is needed to help develop new products and technology, to provide know-how to corporate management, to attract financing and facilitate marketing, and to open up marketing channels to international markets.

The Northwest Russian cluster project was conducted by ETLA in collaboration with Solid Invest, a research body and consultancy based in St Petersburg, whose researchers are from St. Petersburg's leading universities. The Centre for Strategic Research in Moscow, which conducts and commissions strategic studies for Russia's government ministries and presidential administration, acted as a catalyst for research relations and as an initiator of the project.

### The economic importance of Russia for Finland

**Exports and imports:** Exports to Russia increased to EUR 3.5 billion in 2003. Imports from Russia grew to EUR 4.4 billion. In imports Russia is already Finland's second largest and in exports the fifth largest trade partner. Our largest trading partner is Germany. As export destinations Sweden, the U.K. and the USA are still ahead of Russia. It is very likely that Russia will become Finland's most important trading partner together with Germany within the next 5-10 years. Last year the value of trade with the countries of the former Soviet Union exceeded that with Germany. Finland's trade with Russia is almost three times more than with China.

About 80 percent of Finland's imports from Russia are raw materials and energy – timber, oil, gas, coal, coke, electricity, steel scrap and iron ore. Finnish industry refines and exports these commodities to world markets in the form of paper, lumber, steel and energy. In the future Finnish industries, for example the forest industry, will increasingly invest in higher value-added manufacturing in Russia, thereby increasing and diversifying Russia's exports.

Finland exports a significantly broader and more diverse range of goods to Russia than it imports from that country. Today Finland's success products play an important role also in exports to Russia. The most important single export article is mobile telephones, the demand for which has become so great in Russia that it is worth considering production of mobile phones there. Different types of paper are also important export articles. Capital goods such as equipment for mobile phone networks, machinery and equipment for forest harvesting and the forest industry, mining equipment and vehicles are becoming more important in exports. Finland has plenty of production technology that is needed in Russia. Exports of such goods can grow significantly once investment begins to recover following its long slump. Due to its close proximity, Russia is also an important market for Finnish products that typically are not very competitive in international markets, for example food products. Because of Finland's massive imports of raw materials and energy, our trade balance with Russia shows the biggest deficit. In 2003 the deficit amounted to nearly EUR 900 million.

**Transit exports and logistics services:** The value of transit exports going through Finland is about five times more than Finland's own exports to Russia. In 2003 the

value of transit exports amounted to EUR 17.7 billion. Summing up Finland's own exports and the transit exports through Finland to Russia, the total value of goods exports was EUR 21.2 billion. This is equivalent to 32 percent of Russia's total imports of EUR 66.7 billion, based on the Russian central bank's trade figures. These figures differ considerably from those based on customs data, which show a share as high as 42 percent based on total Russian imports estimated at EUR 50.8 billion. Regardless of which data source is used, Finland has unquestionably become a trade route for valuable goods such as electronics and cars to Russia. Important logistics services for transit exports have grown particularly in the cities of Kotka, Hamina, Kouvola and Hanko. The port of Helsinki is also an important transit harbor, although it has not especially invested in transit traffic services. Transit traffic has a great impact on Finland's own foreign trade. Import traffic counterbalances the export-intensive seaborne traffic, so that vessels do not need to return empty. This also enables a higher frequency of transportation, or transport density, than that resulting from Finland's own import and export transport activity. Consequently, our own exports benefit from lower transportation costs and faster transport times.

**Investments in Russia:** Information about how much Finnish industry invests in Russia is very contradictory. The Confederation of Finnish Industry and Employers (TT) provides the most reliable picture of investments on the basis of a survey of its member companies. According to the survey, the total stock of investment made in Russia amounts to EUR 1.4 billion. This figure includes the revenues invested back in the companies, as well as investments through third countries and investments financed with international credit. The survey also covers investments in Russia made by foreign-owned companies operating in Finland. According to the direct investment statistics of the Bank of Finland, the stock of total investment amounts to only about EUR 342 million. According to Russian statistics, 80 percent of Finnish companies' direct investments are made in Northwest Russia and the rest mainly in Moscow and its surroundings.

Among important Finnish investments are, for example, Hartwall's shares of Russia's biggest brewery Baltika, TeliaSonera's shares of MegaFon, the third biggest mobile phone operator in Russia, and Fortum's investments. Fortum has invested in oil production and a gas station chain in St. Petersburg, and it owns more than 20% of Lenenergo. Fazer is the biggest bakery in St. Petersburg. Stockmann has depart-

ment stores and shops in St. Petersburg and Moscow. Elcoteq has an assembly plant in St. Petersburg, Helkama has a refrigerator plant in Vyborg, Rautaruukki has a roofing material production plant in St. Petersburg and Moscow, etc. The forest industry has also now started to invest. StoraEnso and UPM-Kymmene have built three new sawmills and MetsäBotnia plans to build two sawmills. In addition, companies have shares of Russian timber purchasing organizations, cardboard production, and the board and veneer industry.

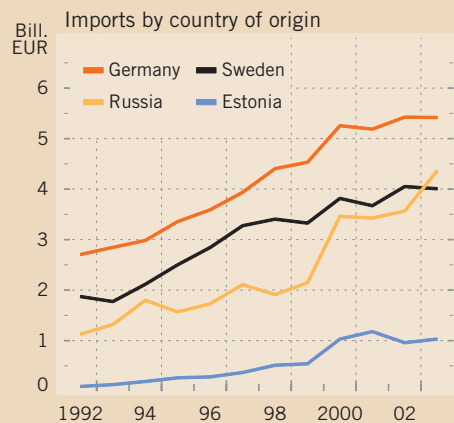
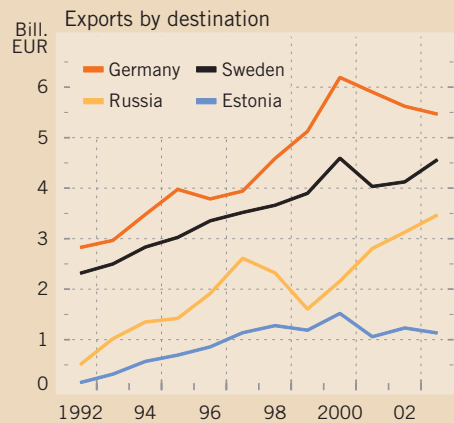
On the whole Finnish companies have been extremely cautious about investing in Russia, with the country accounting for only about 2 percent of total Finnish direct investment. Investors have found the risks associated with Russia to be too high. For example, investing more heavily in the forest industry would require assurances of more reliable raw material supplies. Customs regulations and practices, and the lack of suitable subcontractors have been an obstacle to investing in the electronics industry. Due to a lack of infrastructure, the number of good industrial sites in Russia is very limited. The burden of employment and social obligations, outdated technology and ecological risks do not encourage investors to buy old Russian companies. In addition, attempts to make an investment protection agreement, to guarantee profit repatriation and equal treatment relative to Russian companies, have failed.

Russia's investments in Finland, such as Teboil, Konela and Koneisto, mainly date from the Soviet period. New companies have started operations in the export of electricity and chemical products, for example. It is likely that the biggest Russian exporters are willing to expand operations into down-stream processing and export trade of products in their line of business in Finland.

**Subcontracting:** Finnish subcontracting in Russia has been insignificant, although there are some good examples of this, such as in transportation services and software subcontracting. Since wage, raw material, energy and other costs are low, subcontracting should be very profitable. On the other hand, low productivity levels tend to raise costs. The number of Russian industrial SMEs capable of offering subcontracting services is very small. During Soviet times, large enterprises focused mainly on their own production and there was no room for entrepreneurship. In the Russian period, new companies have been established in trade and services but not in industry.

Subcontracting in Russia comprises a significant future opportunity for Finnish industrial SMEs. The competitiveness of Finnish production relative to that in the Far East could be improved by subcontracting out to Russia. This could be done more efficiently and reliably by Finnish subcontracting SMEs. Another possibility would be to subcontract out to Finnish and foreign companies establishing themselves in Russia. They want to buy subcontracting services, but there is a serious shortage of subcontractors in Russia. From the viewpoint of Finnish companies, the electronics industry, the metal industry and software manufacturing, among others, are promising fields.

### Finnish Exports and Imports



Sources: Board of Customs, Etlatieto Ltd.

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