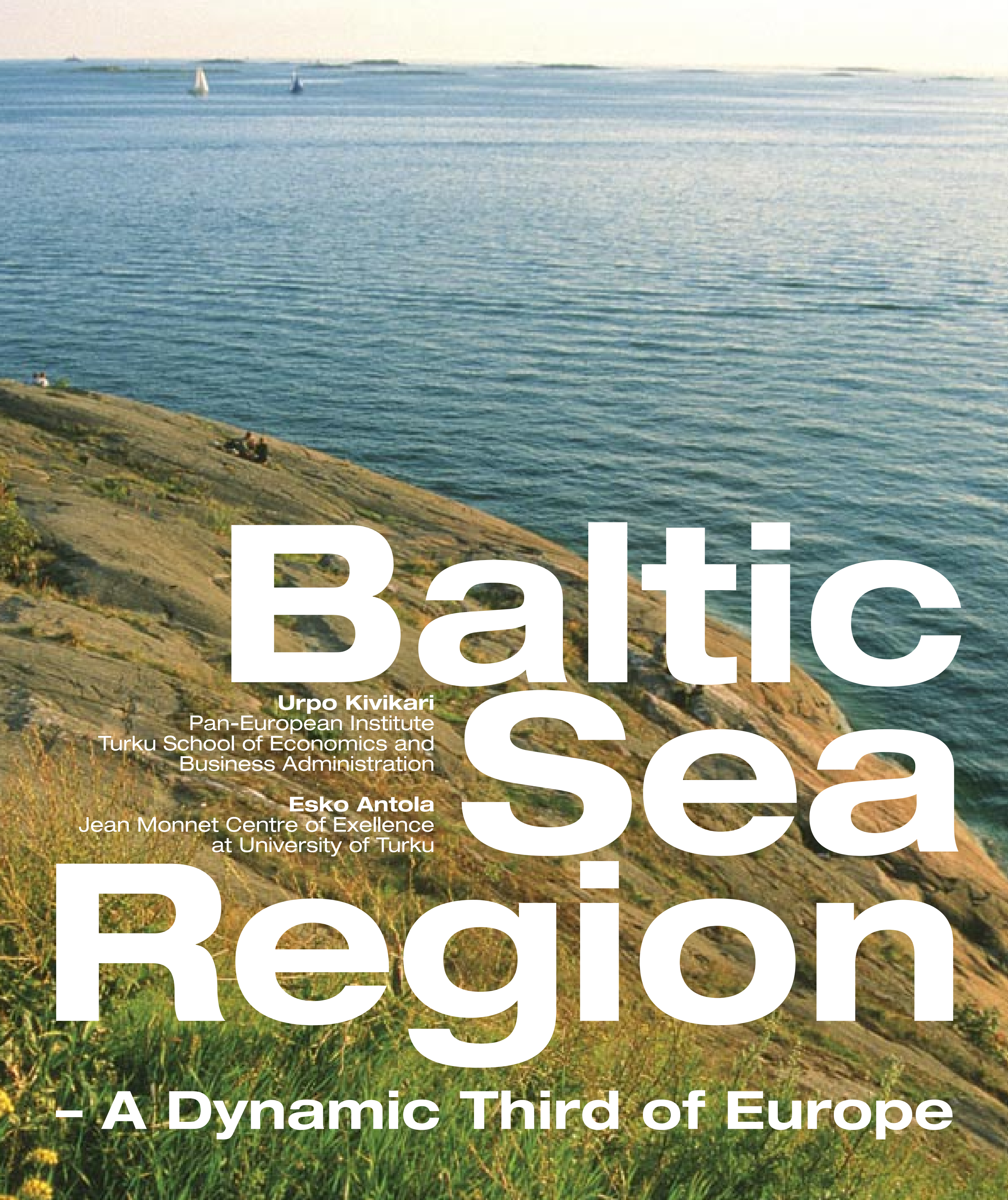

Baltic Sea Region

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– A Dynamic Third of Europe

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To the Reader

This important and timely study is commissioned by the City of Turku as a part of our efforts to promote discussion and networking in the Baltic Sea Region. It is also another testimony about our close cooperation with the three universities in Turku.

The writers, Urpo Kivikari of the Pan-European Institute of the Turku School of Economics and Business Administration, and Esko Antola of the Jean Monnet Centre of Exellence at the University of Turku, are leading Finnish experts with high international reputation.

Turku is celebrating its 775th anniversary this year. We want to develop our city as an international city of culture and a European competence centre, open for cooperation with partners in East and West, North and South. The Baltic Sea Region has been, and will continue to be, our natural context of operation.

This study was commissioned to give food for thought for the Hanseatic Days (June 17-20, 2004), the General Conference of the Union of Baltic Cities (September 29 - October 2, 2005) and many other important events to be organised in Turku.

For the City of Turku, I want to thank the writers for an excellent study. It deserves to be widely read!

Turku, June 8, 2004

Armas Lahoniitty
Mayor of Turku
1st Vice-Chairman, Union of the Baltic Cities (UBC)

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Acknowledgements

This publication is an effort to outline the dimensions of the Baltic Sea Region after the parallel enlargements of NATO and the European Union in 2004. The study was commissioned by the City of Turku in order to facilitate its own activities and strategies in the new Baltic Sea Framework. We are grateful for the City of Turku for its financial support for our effort.

The study is a joint effort of the Jean Monnet Centre of Exellence at the University of Turku and the Pan-European Institute of the Turku School of Economics and Business Administration. Urpo Kivikari has contributed chapters 1-3 while Esko Antola is responsible for chapters 4-6. The authors want to extend their gratitude to the two institutions for providing the framework for the study. We also want to extend our acknowledgements to Terhi Suominen and Peeter Vahtra who performed a valuable and much appreciated support in realising this project.

Turku, May 12, 2004

The Authors

1 The Legacy of History

In the days before the development of land transport and aviation, the sea provided, at times, the only connection, and almost always the best one. For centuries the Baltic Sea has united areas and countries along its coast, and brought them closer to one another and outside world. The Baltic Sea is still - even in terms of speed - an advantageous route, which, together with other forms of transport, constitutes the foundation for relations between the countries around it.

Amber findings of the kind used for sacral purposes in classical Greece prove, that already in times of antiquity, the Baltic Sea region was engaged in trading contacts with outside world. The first truly intra-regional trading network was established in medieval times by the League of Hanseatic towns. It reached its heyday in the 14th and 15th centuries. Lübeck played a leading role in the Hanseatic League. Other important trading towns were e.g. Hamburg, Bremen, Copenhagen, Danzig (Gdansk), Königsberg (Kaliningrad), Riga and Tallinn. Hanseatic towns were not only economically powerful in networking the Baltic Sea region, but the Hanseatic League turned them into a politically important factor in this area, too.

Throughout most of the historical periods of the Baltic Sea region, aspirations to dominate other states and areas instead of friendly cooperation have shadowed political and economic relations. In the years following the Second World War, relations were hampered by East-West antagonism in the Baltic Sea region, as elsewhere. In the East, the Soviet Union, Poland and German Democratic Republic applied a socialist system, whilst other states of the Baltic coast were western democracies and market economies.

In the beginning of the 1990's the political and economic transformation of former socialist countries into democracies and market economies brought the East-West division to an end in the Baltic Sea region (See table 1). There no longer are adversaries along the Baltic coast, just neighbours pursuing common interests and tackling common problems. The dark clouds of war no longer loom on the horizon; today the clouds most feared signal a threat to their common environment. The dismantling of barriers to trade and other two-way measures has increased interaction in various fields of society and economy. The people whose movements are followed most closely are civilians, not soldiers. Instead of differences and competition between systems, interaction is now determined by a desire for cooperation and all-European integration.

In global political and economic geography, the Soviet Union and its allies used to constitute "the East", also called the "Second World". The term was used to emphasise the distance between values and systems and differences between West and East, the First and the Second World. Now the two worlds have merged into a single Europe, the stability of which is no longer guaranteed by two opposing military forces keeping a close watch on each other. The emergence of "a Baltic corner in the European house" is seen as part of the resulting change. Due to the collapse of socialism and EU enlargements, the Baltic Sea region is now a display and laboratory for integration processes in Europe.

Table 1. Aspects of East-West Relations in the Baltic Sea Region

"Two worlds" until about 1990	"One Europe" from about 1991
Adversary	Neighbour
Security threat	Source of pollution
Military	Citizens/ labour force
Different systems	Different stages of development
Competition of systems	Co-operation, integration
"Another world"	"The Baltic Sea region"

Today "Hansa" is a popular historical citation in names of various events, organisations, sites, firms etc. It reminds us about the possibilities of building workable networks in circumstances, in which the transfer of information, people and commodities took weeks and months instead of seconds and hours. In the light of Hansa's legacy we look inefficient, unless we now are able to create a well-functioning integration in the Baltic Sea region.

2 The Baltic Sea Region Today

More than one definition of the Baltic region could be provided with excellent justification, yet none of them would be fully satisfactory. In this publication, it is defined as the nine states that line the Baltic coast: Russia, Estonia, Latvia, Lithuania, Poland, Germany, Denmark, Sweden and Finland. Neither Norway, a Scandinavian country bordering on the Atlantic Ocean, nor Belorussia, a Baltic hinterland, are included here, although both are sometimes considered to be Baltic countries. Russia certainly cannot be classified purely as a Baltic country; neither can Germany or, perhaps, Poland. To be sure, the Baltic Sea is most important to the coastal areas of those countries, which also contain other horizons. Asiatic Russia naturally cannot be considered belonging to the Baltic region. A large proportion of Germany is indubitably outside the Baltic region proper; and much the same applies to Poland. Of course, Russia and Germany, as large countries, carry economic and political weight in the Baltic region.

If seven countries are considered to be fully Baltic and only coastal regions of Russia and Germany are included, the population is some 80 million inhabitants. Here St. Petersburg, the Leningrad region and the Kaliningrad region are included for Russia, while Germany is represented by Mecklenburg-Vorpommern, Schleswig-Holstein, and Hamburg, frequently thought of as a Baltic city. If only the coastal provinces of Poland, which have a population of approximately 5 million, are counted as Baltic, the total population of the region comes to less than 50 million.

Table 2. Basic Facts on Baltic Sea Countries (2003)

Country	Region	Area *1000 km²*	Population *million*	GDP *ppp EUR per capita*	Relative GDP *ppp EUR per capita* EU-25=100
Russia		17 075	143,2	7 833	35
	St. Petersburg	*1.4*	*4,8*	*7 400*	*33*
	Leningrad province	*86*	*1,7*	*6 500*	*29*
	Kaliningrad province	*15*	*0,9*	*4 400*	*20*
Estonia		45	1,3	10 322	46
Latvia		65	2,3	9 219	41
Lithuania		65	3,4	10 287	46
Poland		313	38,6	10 227	46
	Pomerania	*18*	*2,2*	*10 158*	*46*
	West Pomerania	*23*	*1,7*	*10 141*	*46*
	Warmia-Masury	*24*	*1,5*	*7 403*	*33*
Germany		357	82,5	24 113	109
	Macklenburg-Vorpommern	*23*	*1,8*	*16 289*	*73*
	Schleswig-Holstein	*16*	*2,8*	*22 569*	*102*
	Hamburg	*0.8*	*1,7*	*42 880*	*193*
Denmark		43	5,4	27 109	122
Sweden		441	8,9	25 340	114
Finland		338	5,2	24 500	110

Sources: Eurostat 2003, Statistics Finland 2003, Helsinki School of Economics: Economic Monitoring of Northwest Russia 2003, authors' calculations

Map 1. The Baltic Sea Region

1 Russia
- a) St. Petersburg
- b) Leningrad Province
- c) Kalingrad Province

2) Estonia
3) Latvia
4) Lithuania
5) Poland
- a) West Pomerania
- b) Pomerania
- c) Warmia-Masury

6) Germany
- a) Mecklenburg-Vorpommern
- b) Schleswig-Holstein
- c) Hamburg

7 Denmark
8 Sweden
9 Finland

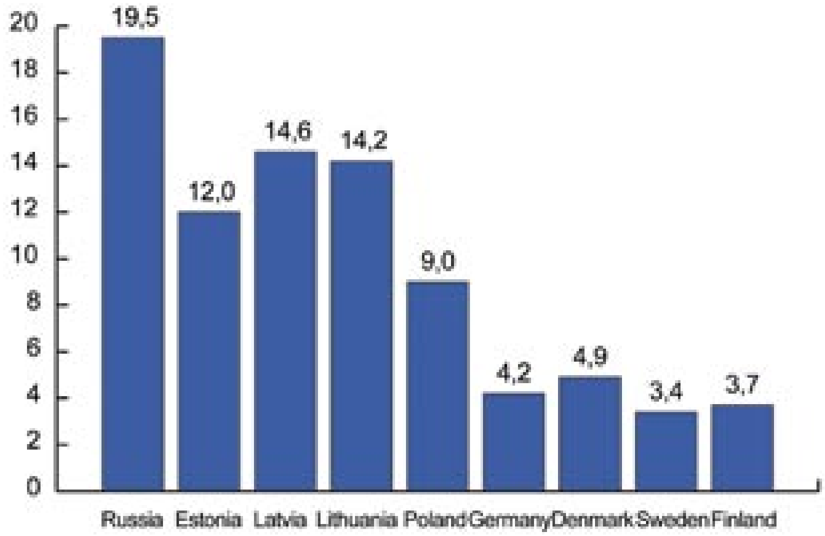
Source: Kivikari, Urpo (1996) The Legacy of the Hansa

Demographic and Economic Overview

After the first difficult years of transition, gross domestic product has grown in former socialist countries much faster than in old market economies. Nevertheless, the gap between income levels still is striking. Old EU-member countries are all above the EU-25 average, while GDP per capita, as well as the purchasing power parity index, show that the former division of the Baltic region into political blocs is still replaced by a gulf in living standards (Table 2).

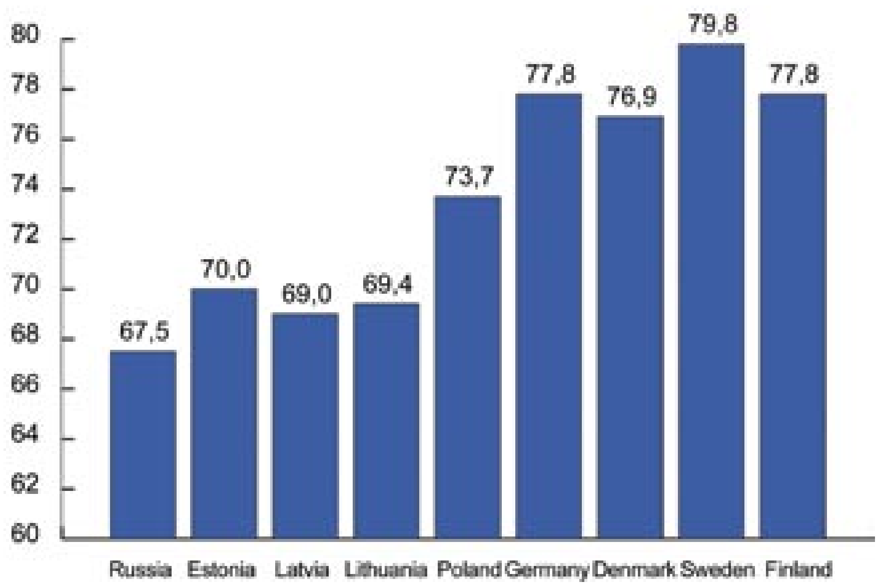
Other statistics on living conditions and standards also reflect a gulf between the former socialist countries and old market economies. The difference is more pronounced in infant mortality than in life expectancy (Figures 1, 2).

Figure 1. **Infant Mortality in the Baltic Sea Region Countries (2003),** *per thousand births*



Source: Statistics Finland 2003

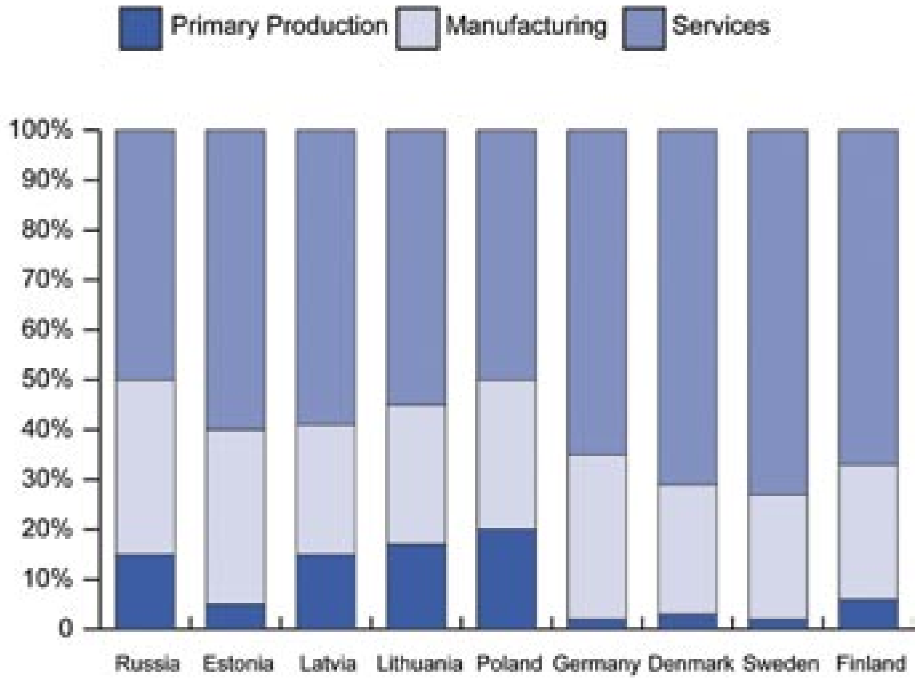
Figure 2. **Life Expectancy in BSR Countries (2002),** *years*



Source: CIA World Factbook 2002

The division of production into main sectors indicates high proportional figures for primary production in former socialist countries and the relative preponderance of services in old market economies. Manufacturing, together with other secondary level production, gives employment to about similar share in labour force in both groups of countries (Figure 3).

Figure 3. **Division of Labour Force in BSR Countries (2001),**
percentage of total



Source: Statistics Finland 2003

The use of workforce in production is based on various factor endowments in national economies. Availability of energy is the essential prerequisite for all kinds of activities. With vast energy resources, Russia differs sharply from the other countries in the region, of which only Poland, Denmark and Germany possess some oil and gas reserves (Table 3). Unlike the other countries in the region, Russia, Poland and Germany have substantial coal deposits.

Table 3. **Oil and Natural Gas Reserves and Production in BSR Countries (2002)**

	Oil Reserves *million tn*	**Oil Production** *million tn*	**Natural Gas Reserves** *trillion m3*	**Natural Gas Production** *billion m3*
Russia	8 200	379,6	47,57	554,9
Estonia	-	-	-	-
Latvia	-	-	-	-
Lithuania	-	-	-	-
Poland	<10	0,8	0,17	4,0
Germany	46	3,2	0,32	17,4
Denmark	200	18,1	0,08	8,4
Sweden	-	-	-	-
Finland	-	-	-	-

Source: BP 2003, International Energy Agency 2003

Electricity production varies greatly between countries. High per capita figures in Sweden and Finland indicate the specific needs of industry, transport and housing in these two countries. The role of nuclear power in the generation of electric energy differs widely from country to country (Table 4).

Table 4. Electricity Production in the BSR (2001)

	Electricity Production, *GWh*	**Production per capita,** *kWh*	**Share of Nuclear Energy,** *%*
Russia	891 284	6 224	15,4
Estonia	8 484	6 285	-
Latvia	4 280	1 860	-
Lithuania	14 737	4 334	77,1
Poland	145 616	3 772	-
Germany	582 540	7 061	29,4
Denmark	37 708	6 983	-
Sweden	161 704	18 169	44,6
Finland	74 451	14 318	30,1

Source: International Energy Agency

Among the factor endowments of national economies in the Baltic region, even more valuable than the natural resources, capital or abundance of labour force are the quality of their human assets and results of R&D inputs. Basic education, vocational training and university education are very competitive throughout the Baltic region, even in global terms. Unfortunately, along with high-quality education new market economies have not yet been able to focus sufficiently on research and development. (Table 5) They should increase collaboration between universities and business life, scientific research and firm-level development. Technology parks arising from a symbiosis of scientific research and business operations are still more common in old market economies than in new ones.

Table 5. Research and Development Expenditures and Education Levels (2001)

Country	**Research & Development Expenditure,** *% of GDP**	**Tertiary Degree Students** *per 100 000 inhabitants*
Russia	1,1	5 003
Estonia	0,7	4 196
Latvia	0,5	4 357
Lithuania	0,6	3 897
Poland	0,7	4 594
Germany	2,5	2 506
Denmark	2,1	3 594
Sweden	3,8	4 053
Finland	3,4	5 374

*figures range from years 1999-2001
Source: Statistics Finland 2003

In former socialist countries the emergence of private firms and entrepreneurship has been an absolute prerequisite for the birth of market economy. Big state enterprises have been privatised to domestic or foreign owners. In addition to acquisition, foreign investors have created new firms by greenfield investments.

The small and medium-sized enterprises (SME) are called upon to play an important role in new market economies. Some former socialist countries already show that SMEs can be a main engine of economic growth. General obstacles in developing small-scale and grass-root entrepreneurship are high administrative barriers, the difficulty in obtaining

bank financing and lack of business knowledge among the population.
The comprehensive World Bank survey "Cost of Doing Business" includes data on various costs and problems the SMEs and other firms face when they begin business in different countries. The indicators presented in Table 6 suggest that it is more costly and complicated to start business in new market economies than in old ones.

Table 6. Costs of Starting a Business in BSR Countries (2003)

Country	Nr of Procedures	Duration *days*	Cost* *% of GNI** per capita*	Min. Capital *% of GNI per capita*
Russia	12	29	9,3	29,8
Estonia	n.a	n.a.	n.a.	n.a.
Latvia	7	11	14,7	93,0
Lithuania	9	26	6,3	74,4
Poland	12	43	20,3	267,0
Germany	9	45	5,9	103,8
Denmark	4	4	0,0	52,3
Sweden	3	16	0,8	41,4
Finland	4	33	3,1	32,0

*Costs connected to the establishment procedure and bureaucracy
**GNI = Gross National Income
Source: World Bank: Cost of Doing Business Database 2003

Formal barriers indicate only partly the actual time and cost associated with starting a new business. Informal barriers often cause big obstacles, too. Corruption may constitute serious distortions to the national economy, serious delays and severe expenses to firms and citizens. Unfortunately, in the incidence of corruption new market economies still clearly lag behind developed market economies. According to the annual survey of the corruption among public officials and politicians, conducted by Transparency International, the Baltic states are relatively less corrupted than the other Eastern European countries, but still, however, are far behind the world's least corrupted nations of Scandinavia. (Table 7) By improving the institutional infrastructure, new market economies might substantially decrease firms' transaction costs and strengthen their competitiveness.

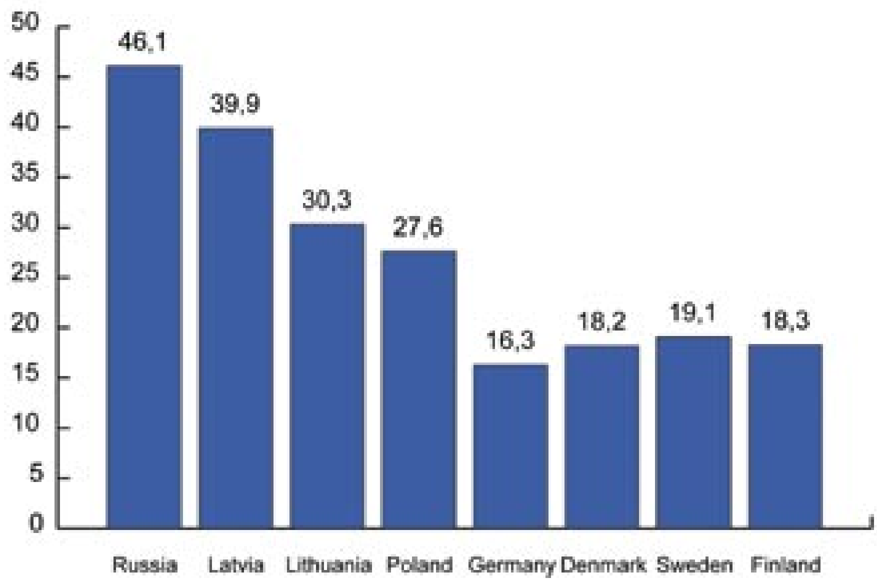
Table 7. Transparency International Corruption Perceptions Index 2002

Ranking among All Countries (102)	Country	CPI 2002 Score (0-10)
1	Finland	9.7
2	Denmark	9.5
5	Sweden	9.3
18	Germany	7.3
29	Estonia	5.6
36	Lithuania	4.8
45	Poland	4.0
52	Latvia	3.7
71	Russia	2.7

Source: Transparency International 2002

One characteristic, common to new market economies, is the large role of the shadow sector in their economies. Of course, the grey and black economy, as such, is not eligible in any market economy. In former socialist countries non-registered incomes and business cause a remarkable leakage in public revenues, which are badly needed for the construction of the physical and social infrastructure. On the other hand, the informal economy might be the only way to escape unbearable living conditions in a society, which is unable to offer social security to its citizens.

Figure 4. Size of Informal Economy in BSR Countries* (2002), *% of GNP*



*Data not available for Estonia
Source: World Bank 2003

In the International Economic Freedom Index, the new member countries, however, rank relatively high with their scores well up to those of developed countries (Table 8). The index measures the factors of e.g. governmental intervention in the economy, freedom of prices and wages, freedom of monetary policy and size of the informal market. From the Baltic Sea region countries, Estonia has ranked among the world's top countries for several years in a row.

Table 8. Economic Freedom Index 2004, *BSR Countries*

Ranking among All Countries	Country	Score (1- free to 5- repressed)
6	Estonia	1.76
8	Denmark	1.80
12	Sweden	1.90
14	Finland	1.95
18	Germany	2.03
22	Lithuania	2.19
29	Latvia	2.36
56	Poland	2.89
114	Russia	3.46

Source: The Heritage Foundation, 2004

Environmental Problems and Challenges

In principle, the environmental problems arising from production, transport and housing should be excluded from a nation's resources. They do have an effect in that resources must be allocated to repairing and preventing environmental damage.

During recent years, the environmental concerns in the Baltic Sea region have nothing but increased, with one of the main reasons being the rapidly increasing Russian oil shipments on the Baltic Sea. The conditions and regulations between the countries still vary, with certain recent improvement, however, having been witnessed along with the tightened conditions for the vessels from the Russian side. Although dominantly only double-hulled vessels are now accepted by the new Russian ports on the Baltic Sea, strong concerns on possible environmental damages remain. From the statistical viewpoint, the estimated amounts of annual oil accidents range from two to three incidents. As the Russian oil companies are constantly increasing their production and the Baltic Sea ports are emerging as major export outlets, a more intense co-operation and the development of common navigation rules, as well as employing common information systems[1] for the shipments, is required.

In April 2004, The International Maritime Organisation gave the Baltic Sea the special sea area status (PSSA), which affords the region greater environmental protection due to its specific vulnerability. The agreement over stricter rules preventing dumping at sea remains, however, voluntary and thus far Russia has refused to agree to any part of the deal, thus exempting itself from setting tighter standards in matters such as ship quality and oil transportation.

Alongside oil shipments, dozens of industrial and agricultural sources of pollution remain in the region, despite the cleaning up of over 50 serious pollution areas during the past 10 years. The Helsinki Commission, HelCom, works to protect the marine environment in the Baltic Sea region from various sources of pollution. In addition to the most serious pollution hot spots comprising several industrial and municipal plants and facilities, the environmental programme further covers the pollution from agricultural and rural areas and facilities, along with the protection of especially sensitive areas such as the coastal lagoons and wetlands.

3 The Baltic Basin as a European Region

Rise of Regionalism and the Baltic Sea Region

Although the sovereign status of states gives them unique authority to handle international relations, they do not have a monopoly on internationalism. Various forms of regional activity are on the rise: regionalism is “in”.

The European Union, now virtually comprising Central and Western Europe, is the most highly integrated of the world’s “macro-regions” and the best example of the voluntary surrender of powers by sovereign states to a larger entity formed by them. On the other hand, “micro-regions” - provinces, the states of federation, or other similar national areas - are seeking to take over some of the traditional functions of the state.

The Baltic Sea region, like other supranational “meso-regions”, is formed as the result of mutual interest and networking among states and sub-regions of several countries. For the Baltic Sea region the period following East-West confrontation has opened the way to develop as one such political meso-region in Europe

It is easy to find explanations for this “neo-regionalist” trend. By no means all problems and phenomena can be contained within national borders. Environmental matters are sub-regional, and yet at the same time, supranational concerns. Pollution spreads through the air and water, ignoring political boundaries. In developing transport links, it is often sensible to combine national projects within the framework of one or more meso-regions. The need to develop international networks for transport, the generation and distribution of energy, communications and economies, is directly connected with neo-regionalism. The complex business of networking is crucial to maintaining and improving the competitiveness of European national economies and companies. Networking is a way to produce “functional regions”. They are different from administrative regions, but they may, of course, develop into administrative units as their functions and interaction increase.

There are several possible ways to look at Europe divided into meso-regions. In three examples presented in Maps 2 and 3 we find one common feature: a meso-region encompassing the Baltic Sea. The Baltic Sea region also has other distinctive features, but the simple geographical fact, an inland sea at its core, may explain its perpetual appearance on the European map since the beginning of 1990’s.

[1] In June 2004, the VTMIS (Vessel Traffic Management and Information Service) System, developed together with Finland, Russia and Estonia will be taken into use.

Map 2. Meso-regions of Europe

Source: Kivikari, Urpo (1996) The Legacy of the Hansa

Map 3. Two Views of European Regions

Source: Kivikari, Urpo (1996) The Legacy of the Hansa

The Baltic Sea certainly is a uniting factor in the Baltic region. Moreover, historical, cultural and ethnic links are important to form and maintain regional identity. The Hansa is proof that the Baltic economic region was once a reality. This, however, is scarcely enough to give rise to solidarity among the present-day inhabitants or countries of the Baltic region, alienated by later events. Although the memory of the Hansa may not be enough to generate a sense of identity, however, it can still be made to serve the development of a functioning Baltic framework.

A long list of preconditions for a meso-region has been posited by R. Cappellin:

a) common values and history;
b) common local "industrial atmosphere"
c) transportation linkages;
d) producer services distribution;
e) common urban-system pattern;
f) single-issue contractual agreements;
g) coordination procedures;
h) common administrative regulations;
i) common public institutions; and
j) common sociopolitical identity.

The Baltic Sea region does not meet these criteria yet. However, with exception of Russia, the enlarged EU now encompasses the whole region, which strongly promotes the fulfilment of the above-mentioned criteria. Hopefully, also Russia will further develop its democracy and market economy in a European spirit.

Although the Baltic region is expected to grow into a functional rather than an administrative region, many new Baltic organisations play an important role in the progress of Baltic identity. The various associations of Baltic cities, chambers of commerce and ports perhaps come closest to the original Hanseatic spirit. These include an organisation for cooperation in the field of tourism, a conference for university principals, and international student and teacher exchange programmes between universities and other educational institutions.

Baltic Integration - Opportunity and Necessity

All national economies that encircle the Baltic Sea region are now market economies, either old or new ones. This means that national demands and supplies have a tendency to become international and united. On the one hand, profit-oriented firms seek new opportunities to market their products in the Baltic region. On the other hand, they look for advantageous inputs and favourable terms for the subcontracting and other operations for relocation of production in this area.

Proximity promotes trade and distance means expense. That is why the firms prefer markets and partners in nearby areas to those located in more distant areas. Naturally, firms are strongest in their home market. An increasing number of firms regard the Baltic Sea region as their home market.

An opportunity often means necessity, too. If the profitability of production could be improved by widening marketing to new areas or utilising new inputs and partners in the Baltic region, the firms might be forced to benefit such possibilities. Otherwise, rivals that utilise those might gain a too strong competitive position.

The modern pattern of international division of labour makes national economies very closely linked to each other. A major part of foreign trade takes place within production processes. This imposes high standards and requirements for infrastructure, quality and logistics on all the countries and companies participating in that kind of international division of labour. Subcontractors or other partners have to meet not only their national qualifications but also those of Mercedes Benz, Nokia or some other multinational partner. Particularly, these terms have been very severe on firms in former socialist countries. So far Russia, whose exports consist mainly of energy and metals, has managed to postpone their response to this challenge.

Foreign direct investments (FDI) have played a decisive role in the adaptation of new market economies to modern foreign trade. In some countries, especially Estonia in the Baltic Sea region, the biggest exporters now are foreign-owned companies. Into all new market economies FDI has also brought, besides capital, new technology, managerial skills and culture, a readiness for risk-taking and marketing channels to external markets. FDI have remarkable spillover effect in the economy of the host country. The investors' main motivation usually is to obtain a new market and/or an advantageous situation for production.

FDI may be an alternative to commodity trade, but often it also increases trade or otherwise has an influence on it. Traditionally, exports and imports between two partners have consisted of different goods. Such trade is called inter-industry trade, which is based on different comparative costs in various countries. Today the majority of trade between developed countries is intra-industry trade, meaning exports and imports of similar goods. Trade statistics indicate that in the Baltic Sea region new market economies' foreign trade is, to a very high degree, still inter-industry trade, while intra EU-trade in this area is mainly intra-industry trade. FDIs are also increasing intra-industry trade between old and new market economies.

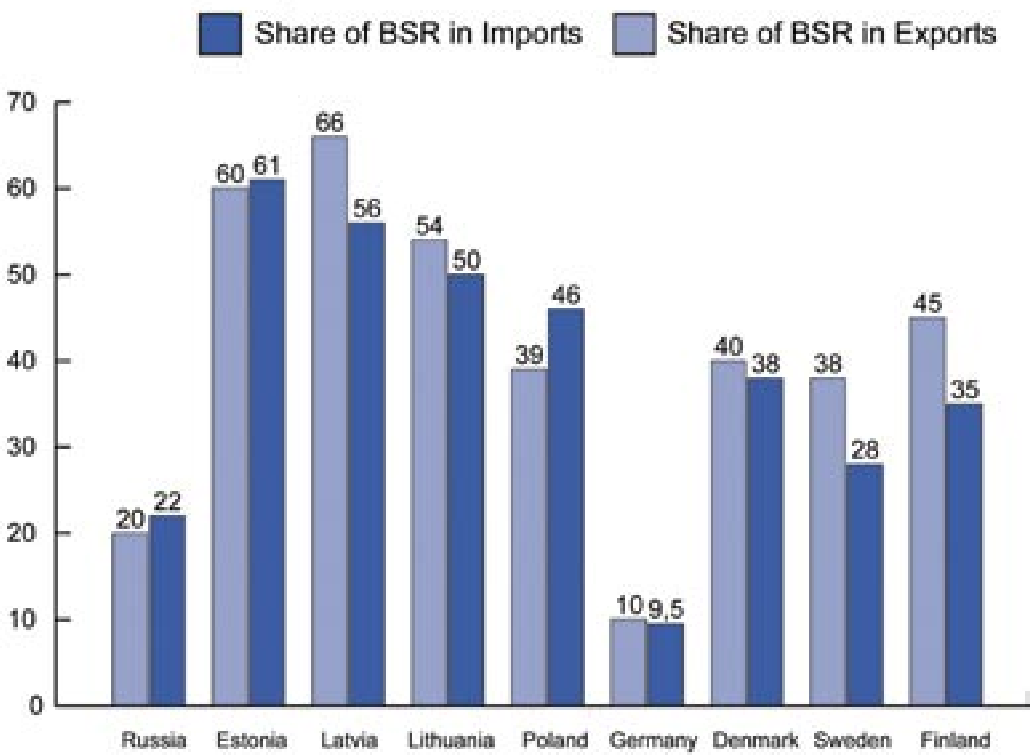
It is important to note that the exit of East-West barriers has given incitement to western firms to also increase their mutual cooperation. Many firms have found it advantageous or even necessary to combine their efforts to carry out operations in former socialist countries and the whole Baltic Sea market.

Trade Flows and Foreign Direct Investments

Naturally, the significance of the Baltic Sea region as a market and partner varies from country to country. For small and medium-size countries the Baltic Sea region is the most important market, whereas for big powers it is not so important. The majority of the foreign trade of Estonia, Latvia and Lithuania is carried out in this area. Also the economies of Poland, Denmark, Finland and Sweden are, to a great extent, dependent on the Baltic Sea region. In Russia one fifth and in Germany only one tenth of all external trade takes place with countries around the Baltic Sea.

The importance of the Baltic Sea region also becomes evident from the fact that for all countries, exclusively Germany, the biggest trading partner, is from this area. As expected, Germany, one of the giants of world trade, is the biggest partner for the most countries. Finland has top place in Estonia's trade statistics. Russia has maintained the leading position in commodity trade with Lithuania. The intensive growth of Polish-German trade has made these countries the biggest partners to each other in the Baltic Sea region.

Figure 5. The Share of BSR in the Countries' Trade Structure (2002), *% of total trade*



Source: National statistics departments, authors' calculations

Table 9. **Share of BSR in Foreign Trade of the Countries in the Region in 2002,** *percent of total FT*

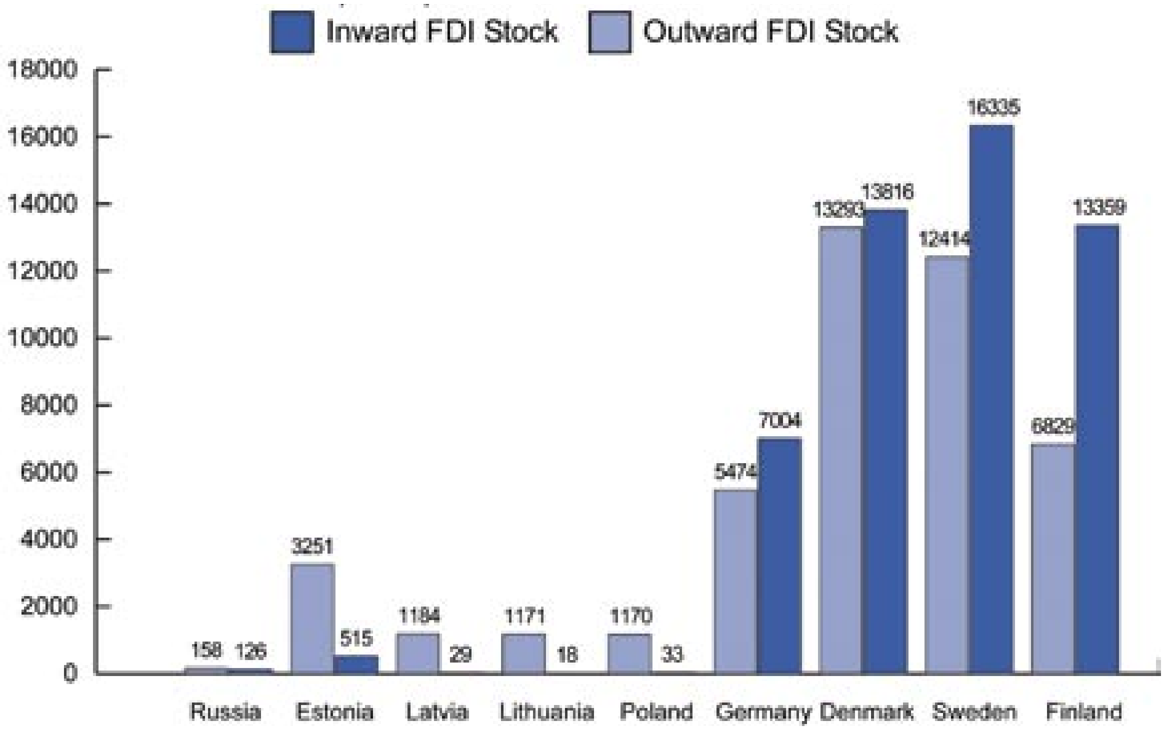
	Rus	Est	Lat	Lit	Pol	Ger	Den	Swe	Fin
Russia	-	5,8	7,7	17,5	6,0	2,1	1,0	1,4	8,1
Estonia	1,2	-	6,3	2,2	0,2	0,1	0,3	0,8	2,6
Latvia	0,6	4,5	-	4,9	0,3	0,1	0,3	0,5	0,5
Lithuania	1,3	3,4	9,5	-	1,2	0,2	0,5	0,4	0,4
Poland	3,3	2,2	3,9	4,3	-	2,6	1,7	1,8	1,4
Germany	9,6	9,2	17,6	14,3	27,7	-	20,6	14,1	13,3
Denmark	0,6	3,3	4,6	3,8	2,2	1,8	-	7,8	3,2
Sweden	1,3	12,0	7,9	3,7	2,9	1,9	11,8	-	9,9
Finland	2,9	20,2	6,0	1,8	1,2	1,1	2,9	5,7	-
BSR Total	**20,8**	**60,6**	**63,5**	**52,5**	**41,6**	**9,8**	**39,1**	**32,5**	**39,4**

Source: National statistics departments, authors' calculations

How "normal" or close to "potential" then are the trade flows presented in Table 9? The so-called "gravity model" is frequently used to answer this kind of question. The model compares the real and "potential" trade flows using, as explanatory variables, such factors as the distance between partners, their populations and income levels. The gravity model proves, for example, that Finland's real trade with Estonia and Russia is very much above the potential level. Yet, the perspectives of trade are also still bright in these cases. More than any model, future development is based on economic growth and integration processes. In the Baltic Sea region, the growth forecast for former socialist countries as well as their EU integration opens promising prospects for trade.

The development of intra-Baltic trade has laid the foundation for an economic region around the Baltic Sea. But commodity trade alone cannot unify a market, let alone furnish it with a distinctive identity. Rather, the intensification of integration is reflected in the increased mobility of factors of production. It is foreign direct investment (FDI) that significantly promotes the formation of new networks and leads to a long-term convergence and integration of the national economies.

Figure 6. **FDI Inward and Outward Stock in BSR Countries,** *USD per capita*



Source: UNCTAD 2003

Figure 6 gives data about the inflow and outflow of FDI that has already taken place. To obtain a comparative picture, the size of the country has been taken into account and, consequently, the figures have been made proportional to the population. In the old market economies, FDI is a conventional operation. In the new market economies of former socialist countries, FDI is still a fairly new phenomenon. In some of the former socialist countries the role of inward FDI is very important, but the outflow of FDI per capita has been remarkable only for Russia and Estonia.

Of the countries that became independent after the break-up of the Soviet Union, Estonia has obviously been most successful recipient of FDIs. Because of its size and natural resources, Poland is considerably more attractive to foreign investors than the Baltic countries. Poland has received more FDI than any other former socialist country in Europe.

Despite rapid economic growth and other positive features in Russia's economy in recent years, the obstacles to FDI have exerted a stronger influence than any encouraging factor. Russia contains the greatest natural resources in the world, a consumer and labour potential of a population of 145 million and limitless investment opportunities, from high technology to agriculture. But the truth is that FDI to Russia does not reflect these opportunities; what they reflect are the barriers, which hinder the utilisation of these resources within the framework of the international division of labour. These persistent inadequacies have delayed the avalanche of foreign investment that had been expected.

Table 10. Three Biggest Foreign Investors in the BSR Countries (as of 1.1.2003)

	Biggest Investor, *per cent of total*		
Target Country	1st	2nd	3rd
Russia	USA *21,0*	Cyprus *19,0*	Germany *12,0*
Estonia	Sweden *39,2*	Finland *27,5*	USA *6,0*
Latvia	Sweden *13,8*	Germany *11,7*	Denmark *9,3*
Lithuania	Denmark *17,2*	Sweden *15,3*	Estonia *11,7*
Poland	France *18,3*	Netherlands *13,0*	USA *12,1*
Germany	Netherlands *21,5*	Luxembourg *21,3*	USA *17,8*
Denmark	USA *25,9*	Sweden *22,6*	UK *10,2*
Sweden*	UK *24,5*	Finland *16,1*	USA *12,1*
Finland	Sweden *54,6*	Netherlands *13,2*	UK *10,6*

**cumulative investments from 1982 - 2003*
Sources: National banks, National statistic departments, authors' calculations

As in matters of trade, in FDI the intra-Baltic flows also play a dominant role (Table 10). The appearance of countries such as Cyprus and Luxembourg as important sources of FDI to Russia and Germany, for example, gives an indication of the use of these countries as transit regions for the capital flows.

EU-Russia relations constitute a special issue of the Baltic Sea region integration process. Although EU enlargement in 2004 indisputably promotes integration between Russia and the EU, many efforts are needed to secure that the "Wider Europe" concept launched by the EU really will work in the Baltic Sea region. Next, Russian coastal areas are viewed as a part of the Baltic meso-region. EU-Russia relations are still inspected in a wider perspective in chapter 4.

Russian Coastal Areas

The Baltic coastal areas of Russia deserve special attention as outposts of EU-Russia integration. Due to EU enlargement in May 2004 the coastal parts of Russia fell into the unique position as the only areas outside the European Union in the Baltic Sea region. Enlargement has brought the union geographically closer to Russia and radically changed the nature of neighbourhood between Russia and the new union member countries. A common challenge to Russia and the EU is to make Russian coastal areas an integral part of the Baltic Sea meso-region.

The importance of the Baltic areas for Russia as both a link with and an outpost against the world outside grew already after the disintegration of the Soviet Union. Russia's Baltic possessions now account for about half a percent of the whole country's territory and about ten times more of its population. This includes the biggest city in the whole Baltic region, St Petersburg. Leningrad in Soviet days, the city took back the name of St Petersburg in the early 1990s as a fitting symbol for the need to redefine its role. St Petersburg and the adjacent Leningrad province, form an entity, which could informally be called the St Petersburg region.

When the Soviet Union ceased to exist, the Kaliningrad region on the southern part of the Baltic coast became a Russian enclave bounded by Lithuania, Poland and the Baltic Sea. Poland's and Lithuania's accession to the EU has further changed the position of this enclave.

Many prominent features of three coastal areas are common to all of them, partly because they reflect the development of the whole Russia, partly due to their common Baltic nature. In the 1990s coastal areas faced exceptional difficulties in adapting their economy, especially industry, to their new situation. But since 2000, the three areas have experienced a much stronger rise in industrial production than Russia as a whole (Table 11).

Table 11. Annual Changes in Industrial Production, %

	2000	2001	2002	2003
Russia	11,9	4,9	3,7	7,0
St. Petersburg	26,2	0,2	31,4	5,8
Leningrad province	26,8	10,7	35,6	20,9
Kaliningrad province	32,4	12,5	8,5	14,5

Source: Goskomstat, Regional Statistics

It is not easy to conclude whether this “Baltic boom” in industry and some other fields of the economy is a trend or a temporary development. In fact, a common regional feature is strong fluctuation in various economic activities, such as production, domestic investment, foreign trade, foreign direct investment, transport etc. Two tenable explanations for these phenomena are the generally unstable situation in Russia and the small scale of many activities in coastal areas. For example, variable rules and practices in taxation substantially influence registered economic activities. In foreign trade a single deal may dominate data, e.g. frigates built for the Indian navy made India the largest export partner of St. Petersburg in the first half of 2003 (share 44 %). Similarly FDI flow has fluctuated strongly, often depending on whether during the year a single big investment has occurred or not.

St. Petersburg is Russia’s second biggest city after Moscow, an important scientific and cultural focus as well as a hub of industry. In the Soviet time of the city’s powerful industry, an estimated 75 % served the military sector. In early 1990s a survey commissioned by the mayor’s office proved the present state and future prospects of St. Petersburg to be particularly difficult, even by comparison with nationwide problems. One of the city’s specific worries turned out to be its shrinking and aging population. In the year 2002 the declining trend of population seemed to stop. Still, the two-fold surplus of the mortality rate over the birth rate is shaping the process of a natural decrease in population, which now seems to be compensated for by migration.

Recent upward turns in total investments and construction were obviously induced by the 300-year anniversary, which, in year 2003, made St. Petersburg the focus of worldwide political and economic attention for a time. In general, the significant support to the city by federal authorities in the year of its tercentenary can serve as a powerful impetus for the further development of the city’s economy. Unexpectedly, the negative trend of foreign investment into St. Petersburg, which first emerged in 2002 continued in 2003. This drop in foreign investments is probably temporary in nature. Presumably, foreign investors will soon focus again on the potentially huge investment opportunities of St. Petersburg, following the city governor’s elections and formation of a new city administration. A new city Governor, Valentina Matvienko, was elected in October 2003.

Simultaneously, with occasional visitors in the group of the biggest trading partners and investors, the USA, Germany and Finland have been permanently, from year to year, in the top five list.

Leningrad province has generated impressive growth figures in recent years. The food industry with a share of 25 % dominates the industrial production of the region. Next come the forest, fuel and power industries with about 15 per cent share each. The general upswing in the province is the reason for the growth of investments into the regional economy. The province benefits from its territorial proximity to the metropolitan area and European Union countries. The province is often considered by investors to be a more favourable target for investment than the city of St. Petersburg. After a decrease in previous years of foreign investments, in 2003 the foreign investments grew again. However, domestic investments exceed foreign investments, which are targeted to infrequent projects, such as Ford Vsevolozhsk, Philip Morris Izhora and Caterpillar Tosno. SMEs are often ignored by foreign investors, and now this niche is occupied by Russian capital.

Finland, Sweden and Germany have maintained their position among the biggest foreign trading partners for the Leningrad province.

Kaliningrad province is a unique case among the revolutionary developments in recent history. Instead of being a part of the Soviet Union it is now part of Russia, albeit detached from the mainland. Its neighbours Lithuania and Poland have become EU member countries since 1st May 2004. In this new situation the Kaliningrad province seeks to strike a balance between its national role as Russia’s sole gateway and military base in the southern Baltic Sea on the one hand, and its own and regional needs for development on the other.

To overcome the difficulties arising from its position as an enclave, the status of Special Economic Zone has been conceded to the province. Due to this privilege it is possible to sell tariff-free to mainland Russia imported commodities on the condition of certain added value in the Kaliningrad province. In addition to Special Economic Zone status there are other sources of attraction for foreign partners. The Kaliningrad province is, for many partners, the nearest part of Russia, the gateway to/from Russia, a part of international transport corridors and a natural part of networks of energy, telecommunications, tourism etc.

In the light of materialised FDI, the attraction of the Kalingrad region still looks very modest: the annual inflow of FDI has remained below ten million US dollars. Commodity trade has developed much more rapidly. Imports (about 2 bln USD) have increased their share in Russian total imports to 2 %. The main items of import are machinery (37 %) and foodstuffs (30%). According to statistics, Germany, Poland and Lithuania are the most important trading partners. Moreover, so-called “shuttle” trading across the borders with Poland and Lithuania is a remarkable economic activity not taken into account by state statistics. In essence, shuttle trading is the small-scale smuggling of some heavily taxed goods (petrol, spirits, tobacco), which are much cheaper in the Kaliningrad region than in neighbouring countries. By different estimates there are from 10.000 to 40.000 people in the Kaliningrad region alone engaged in this trade.

EU enlargement into the neighbourhood of the St. Petersburg area and the Kaliningrad province constitutes a challenge that should be responded to, both by Russian federation and by regional authorities.

EU-Russia relations have come a long way since relations between the EU and Russia were established in the beginning of 1990s. Russia was the first country with which the Partnership and Cooperation Agreement (PCA) was established, the first country with which the EU created A Common Strategy. From very beginning Russia was the principal partner of Northern Dimension policy, which as a result of EU enlargement is now the EU’s neighbourhood policy towards Russia. In energy and many other fields, the EU and Russia have signed agreements and programmes for co-operation. The latest large-scale initiative is Common European Economic Space (CEES), which includes ambitious aims of deepening integration between Russia and the EU.

Paradoxically, EU enlargement, as such, increases EU-Russia integration more than any bilateral plan, agreement or programme between these two partners could increase in foreseeable future. However, in Russia, opinions and discussion about problems have taken precedence over benefits. First, loud protests about the future position of the Kaliningrad region inside the EU were voiced in the Kremlin. Then the costs of enlargement to Russian economy were in the foreground. Still, on the eve of enlargement, Russia denied widening the PCA to cover new EU member countries.

Russian criticism and reservations seem surprising, as Russia - equally with the EU - has constantly emphasised the importance of EU-Russia integration, and even proposed CEES. Of course, Russia is a passive outsider in the enlargement process, but anyway Russia earlier has given its “approval” to enlargement.

Naturally, contradictions in Moscow-Brussels relations cast a shadow over efforts to increase integration on the regional level between Russian coastal areas and their neighbours. This is particularly true in issues rising from the position of the Kaliningrad region, which is now separated from the mainland by a former Soviet republic and a former ally in the socialist era. Kaliningrad is viewed as a laboratory for testing EU-Russia cooperation.

Many programmes, plans and specific instruments have been designed to overcome the imminent isolation of the enclave and to integrate it both with Russia and with neighbouring countries Lithuania and Poland. The internal situation in Kaliningrad and Russia is obviously of major importance in finding a way forward, but it is also important that the Kaliningrad region has become the focus of various political aspirations. The future status of the region is dependent on Moscow’s policy towards the EU, Poland and Lithuania, and vice versa. Moscow’s concept of the role of Kaliningrad as a part of Russia, and the region’s own political will and choices are also crucial. It is not surprising that the Kaliningrad issue has been high on the agenda of integration discussions. The decisive point is whether adequate will and ability to solve the issue of isolation will be forthcoming at high political levels in Moscow and Brussels.

As an outcome of EU enlargement, the St. Petersburg region, now having two EU member countries Finland and Estonia as its neighbours, faces new opportunities and challenges. A new and innovative approach to regional and economical cooperation between southern Finland, Estonia and the St. Petersburg region is the Gulf of Finland Growth Triangle. In this concept, particular attention is given to public-private cooperation, especially to the active participation of the private sector. Regarding cooperation within the Gulf of Finland region, the objective is to utilise different factor endowments and other differences that exist between the three areas.

The concept of a Growth Triangle is approved as an instrument for regional cooperation in Russia, Estonia and Finland by authorities for regional administration. The Gulf of Finland Growth Triangle is an acknowledged and approved part of the Northern Dimension Policy within the EU. According to the new Northern Dimension Action Plan for the years 2004-2006, “The Gulf of Finland Growth Triangle introduces a new concept of regional and economic cooperation. The aim of the concept is to promote public-private cooperation, trade and economic development between Southern Finland, Estonia and the St. Petersburg Area, i.e. across current and future EU borders.”

4. The Baltic Sea Area in the EU

"One Third -Region" of the EU

The European Union opened its third enlargement process in the Baltic Sea region in 1998 by entering into negotiations with Estonia and Poland. In the Helsinki European Council meeting a decision was taken to also invite Latvia and Lithuania into negotiations. The gradual enlargement of the EC/EU to the Baltic Sea region was initiated in 1972 when Denmark joined the European Community. The second wave of enlargement took place in 1995 when Finland and Sweden joined the European Union.

The second Baltic Sea region enlargement brought Northern areas and peculiar northern issues to the agenda of the European Union. The Northeast enlargement strengthened the process that became evident already by the unification of Germany in the early 1990's. Northern considerations have been part of the agenda of the European Union since that time. The accession of Sweden and Finland shifted the centre of gravity of the European Union further towards the Northeast. The idea of the Northern Dimension emerged in 1998 in the agenda of the EU.

The third enlargement of the European Union in the North made the Baltic Sea an internal sea of the Union. Only the western regions of Russia, i.e. the Leningrad Oblast and the Kaliningrad region shall remain outside the EU. The EU enlargement was a parallel process to that of NATO enlargement. Arguments in favour of two parallel enlargements pointed to their mutually reinforcing nature. The EU enlargement shall promote soft security structures in the region by enhancing economic development and stability. The NATO enlargement emphasises traditional hard security issues.

These two processes produced a number of temporary arrangements in the Baltic Sea region. The EU framework operated through the Association Partnership and through a number of pre-accession programmes. The Partnership for Peace arrangement in the NATO framework, for its part, adds a security dimension to the Baltic Sea complex. Temporary arrangements have faded away through the accessions although the Partnership for Peace arrangement shall maintain its relevance for Sweden and Finland for as long as they remain outside NATO. The two enlargements shall gradually change the balance of power in the Baltic Sea region from the North to the East.

The Baltic Sea region is dominated by small and medium-sized powers. In the European Union of 25 the dividing line between large and medium-sized Member States goes between the Netherlands and Poland. The Baltic region includes two large Member States (Germany and Poland), three medium-sized countries (Denmark, Finland and Sweden) and two small states (Estonia and Latvia).

The pattern of powers in the Baltic Sea region is a miniature of the European Union at large. Medium-sized nations constitute the core of the European Union while the small and large Member States are equally represented among the Members. The distribution of powers is most concretely seen in the composition of institutions and in the voting power in the Council of Ministers. As table 12 shows, the Baltic Sea region is "a one-third -region" of the EU.

Table 12. The Share of Baltic Sea Region in Selected Indicators of Power in the European Union

	Votes in the Council	% of votes in the Council	Seats in the EP	Popul. (mill)	% of popul. of the EU	% of GNP of the EU
Germany	29	9,04	99	82,04	18,22	21,89
Poland	27	8,42	54	38,67	8,58	1,9
Sweden	10	3,12	19	8,85	1,96	2,74
Denmark	7	2,18	14	5,31	1,18	1,92
Finland	7	2,18	14	5,16	1,15	1,47
Lithuania	7	2,18	13	3,7	0,83	0,17
Latvia	4	1,25	9	2,44	0,55	0,09
Estonia	4	1,25	6	1,45	0,33	0,08
Baltic Sea region	95	29,62	228	147,62	32,8	30,26
Total	**321**	**29,26**	**734**	**450,45**		

"One third -region" is well justified. Eight EU Member States make one third of the population in the EU-25. Their share of the total GNP in the Union is just over 30 per cent. Representatives elected from these countries occupy 31 per cent of the seats in the European Parliament and together they have just about 30 per cent of the votes in the Council of Europe.

The power and voice of the Baltic Sea region in the European Union is largely based on the weight of Germany. According the population Germany is the largest country in the European Union. It also produces more than one fifth of the GNP of the Union and has the highest number of seats in the European Parliament. But the geographical orientation of the leading country, as well as the other large Member State, Poland, is more to Central Europe than to the Baltic region. At least, the Baltic Sea region is not as important in their priorities than it is for the small and medium-sized Member States. Germany addresses her greatest attention to Franco-German collaboration. It seems that Poland, for her part, looks for common interests with Spain.

Even if Member States from the Baltic Sea region were united in their approach, being a "one third -region" would not ensure too much influence in the Union. The combined voting power of the Baltic Sea region remains far from qualified majority position in a voting situation. According to the Treaty of Nice, effective until the possible entry into force of a new Constitution, a qualified majority requires 232 votes in the Council and the majority of the Member States. The Baltic Sea region falls far behind in these requirements. Together they comprise only 95 votes and one third of the number of the Member States.

A Region of Small States

Being a "One third -region" calls for a careful co-ordination of policies as well as an active search of like-minded partners from the outside of the Baltic Sea region. Small and medium-sized countries have often certain similarities in their approach. They have a more limited area of diplomatic activities than their larger counterparts. Small states have small interests and often also more focused interests.

The diplomatic style of small states is different if compared to the large Member States. Small states often take an active role: they take the initiative as well as draft action plans and proposals for co-operation. The Finnish initiative for the Northern Dimension is a good example. Instead of power-related instruments, small states have to rely on diplomatic behaviour, co-operation and friendliness. Their diplomacy is often issue-specific and mission-oriented, crossing the ideological and regional boundaries. These countries are free from hegemony baggage and therefore are less limited in their actions and able to seek more creative solutions.

But acting alone, small states lack power and influence. Therefore small countries emphasise coalition-building and co-operation as they have been forced to define a strategy to survive. They may be successful in their diplomatic actions additionally because of their societal and technical capabilities. These capabilities can be specified as a mixture of entrepreneurship, diplomatic knowledge and the ability to manage the knowledge of functional issues that are the objects of international co-operation.

An illustrative example of this is the Lisbon process. Measured by almost any indicator, the Baltic Region small states - Denmark, Finland and Sweden - score the best results. They are among the best performing countries in the knowledge-based economy in the EU-15.

The political centralisation of decision-making is usually greater in smaller states than in larger ones and their political arrangements are more closely knit. In small states everybody knows everybody. This can lead to strengths and opportunities which the larger states do not have.

Functions of small and medium-sized powers in world affairs are threefold: to conciliate, to interconnect and to integrate, in other words, to mediate and moderate. This can take place within the institutions, between the institutions or entirely outside them. Because of their more limited resources, they must carefully calculate which topics are important enough to act upon.

Even though seeing small and medium-sized powers as mediators and moderators gives them a more influential role in international politics, their role is still somewhat limited. Small and medium-sized powers suffer from the unrealised power paradox. They under-exercise their potential powers and possibilities to a much greater extent than their position, relative to the major powers, would seem to support. They do not fully exploit their potential possibilities in the international system and can be described as to be acting only in relation to large countries and in harm-reduction. This all calls for a more active role for small states in the Baltic Sea region as well.

A Region of many Dimensions

But the small state – large state divide is not the only partition in the Baltic Sea Region. The small state – large state dilemma is obvious but it manifests itself only in rare occasions as Member States do not vote very often in the Council of Ministers. In the European Parliament party political divides are more important than those between the Member States. However, in the EU of 25 voting may become a much more used method of decision-making. The distribution of voting power according to the Nice solution favours old Member States by figures 53 to 42. Poland and Germany together can collect 56 votes leaving 39 for the small and medium-sized Members out of 95 of the total in the region. The three Nordic Members together represent 24 votes. “New Europe” can collect no more than 15 votes and very small members 8 of the grand total of 345 votes in the Council of Ministers. The Countries are also divided along the line between net contributors and net receivers.

The EU enlargement shall mark deep-going reforms in the structural policy and money flows in general from the Union to the Member States. Both the financing instruments and philosophy behind the instruments shall be redefined in a way which shall leave the three Nordic Member States largely outside the flows. On the other hand the Eastern part of the Baltic Sea region becomes a new target area. This is already seen in the distribution of structural funds during the budget period 2000 - 2006 as Table 13 shows.

Table 13. Structural Funds allocated to the Baltic Sea Member States in 2000 - 2006

	Germany	Denmark	Sweden	Finland	Poland	Latvia	Lithuania	Estonia
Allocation bill. €	29,764	0,828	2,186	2,090	11,369	1,036	1,366	0,618
Popul. coverage	29,80	10,20	18,90	51,70	100,00	100,00	100,00	100,00
per cent of GNP	0,2	0,1	0,1	0,2	3,1	5,2	4,0	4,6

The new EU Member States have a full 100 per cent coverage of their population through the Structural Funds programmes while in Denmark only 10 per cent of population is covered by the funds. The contribution of the funds to the GNP in the old Member States is minimal.

There is another key dimension in the EU which devides the Baltic Sea region as well: the EMU. After the Swedish referendum it is obvious that Finland and Germany are going to be the only two Member States in the Eurogroup for many years. But even these two countries represent the two extremes among the Euro-12. Finland on the one hand has the largest surplus and Germany the largest deficit. There is no Baltic Sea caucus in the most important area of common policy in the EU.

The region is also divided in preferences concerning the finalité politique of the EU. Finland and Germany are, or at least have been, institutional deepeners while Sweden and Denmark are intergovernmentalists. Small institutional deepeners, like Finland, see that supranational institutions secure the influence of small states in a better way than purely inter-governmental structures. Formal structures and rules benefit small states since all members have to follow them - irrespective of their size and power.

Instead of being issue-specific, these countries are institution-specific in their approach. Small states subscribing to institutional deepening are believers in the power of the Commission as “a friend of small Member States”. An extensive use of the qualified majority voting in the Council is an additional element of the approach. For Germany the motivation to be an institutional deepener is different. On one hand successive German governments have pursued federalist ideas and supported institutionalisation. On the other hand the choice has been made to accommodate the fears of the emergence of a too powerful Germany. Germany has demonstrated her loyalty by advocating strong institutions that limit her power as well.

Intergovernmental pragmatists (Denmark and Sweden) believe that the interests of small Member States will be observed in the best way at negotiation tables between the governments. They appreciate national sovereignty and the value of veto in defending their vital interests. Denmark and Sweden are, in their overall strategy, “reluctant” Europeans. They tend to be issue-specific in their approach, meaning that their focus is in promoting issues that are relevant, from their national perspective. They value the veto as the final instrument more than the safety that the institutions could bring to small states.

At this point it is impossible to predict the policy priorities of the new EU Member States. On the basis of the referendum debates one is tempted to conclude that at least Estonia and Latvia are closer to the Danish and Swedish lines while Lithuania might consider the Finnish approach. In reality Estonia and Latvia look for the British approach which may strengthen the British influence in the region. This already is quite strong through the EMU-policy of Denmark and Sweden. After decades, Great Britain may become a meaningful actor in the region.

The Polish approach as a Member State is the most difficult to assess. At first glance Poland looks like another Spain. They have the same size, they are catholic and they have voiced their dissatisfaction about their shares of votes in the Council in the draft constitution. But we cannot exclude the possibility that Poland may wish to take a role of the prime representative of the new Member States of the Baltic Sea region as well. This idea has got at least some support in Estonia. Estonia sees Poland as another American-minded nation which could help to attract the US interests to the region as a counterweight to the German influence.

In the end one has to ask where are the converging elements of the Baltic Sea region Member States in the EU? Common interests could be found in protecting the environment in the region although national preferences are obvious there as well. Development of the transport infrastructure is a common interest. Fighting the illegal trafficking of drugs and illegal immigration might also become a common interest. But is there going to be a common interest in promoting Northern issues as such? And which are the common Northern issues? At first sight it seems that the direction of the new Member States points to a completely different direction than North.

5. Actors in the Baltic Sea region

The Emergence of "New Europe" – An Additional Element of Divergence

”New Europe” emerged as a political slogan during the process of building the coalition against Saddam Hussein. It was originally presented by Donald Rumsfeld as a concept marking a difference between countries that did not want to follow the United States thus representing "Old Europe" (particularly France and Germany) and those that were ready to do so. Rumsfeld pointed directly to the new Members of NATO: if you look at NATO-Europe today, its weight is moving to the East. And there are a great number of new members.

At the heart of New Europe there are countries that in the Prague Summit in 2002 received an invitation to join NATO. They joined the organization in April 2004. The main common denominator of "New Europe" is that it shows loyalty and allegiance to the unilateral leadership of the United States. It does this for at least three reasons. In terms of realpolitik the countries of "New Europe" do this because they wanted to secure the support of the United States for their membership in NATO. The strategy was successful.

The second reason is that the political elite of the countries of "New Europe" see the United States as the ultimate guarantor of their security. For the "New Europe" NATO is primarily an institution which ensures the commitment of the United States to the European and indeed, to their security. The third reason is that for some of them, the United States also is a model of a good society. This is, in particular, the case for Estonia and Latvia, to some extent also for Lithuania and Poland.

The "New Europe" is well represented in the Baltic Sea region. One could argue that the "hard core" of "new Europe" is in the region. The three Baltic countries represent "New Europe" in all aspects: they see the United States more than NATO as the ultimate guarantor of their security but they also follow the neo-liberal paradigm in economic policy.

The economic policy paradigm of the "New Europe" may well emerge as an important element in the Baltic Sea region. It already is such in Finnish-Estonian relations. Low taxation and a flexible regulatory framework is seen in Finland as a remarkable competitive edge for Estonia. The government of Finland has introduced historical deductions in the taxation of alcohol due to the competition posed by the liberal taxation in Estonia. The Baltic countries are following the neo-liberal paradigm to the extent that is now unknown in "Old Europe", Great Britain and Ireland included.

The pressure of the membership in the European Union most likely puts the neo-liberal economic policy under heavy pressure in the future. But Baltic countries are determined to keep their liberal order for as long as possible. They openly look for partners from "like-minded" countries and see Ireland, in particular, as their model. Great Britain is often seen as the best friend of neo-liberals. One should not exclude the possibility that the influence of the United States in the region is channelled through "new Europe" into the Baltic Sea region in a deeper way than through NATO. Baltic countries hope that through Great Britain they could get the United States involved in the Baltic region as well.

In the Baltic Sea region a competition between social models exists. The Nordic Model has dominated the region. Key elements of the Nordic Model include first of all a strong role for the state which is widely accepted by the citizens. The public sector largely represents society and is close both to the market and the citizens. Strong government regulation has contributed to the rise of new industries in social and environmental sectors and developed new type of social capital. The Nordic model also contributed to a high level of social security albeit with a high level of taxation.

A high level of taxation has also contributed to a high level of public investment towards research and development. Finland and Sweden are the top countries by global comparison in public R & D investment. The Nordic Model has contributed to a high level of competitiveness. In 2003 Finland scored as the most competitive economy in the world, Sweden ranking number 2 and Denmark number 4 according to the World Economic Forum Global Competitiveness Report.

New Member States in the region have followed different models. Estonia and Latvia subscribe more to the liberal Anglo-Saxon model. The model presumes that the free markets should dominate the economic and social development and that the states should intervene as little as possible. Low taxation is a key element of the model. Social welfare inputs are targeted to low-income citizens. Social services, beyond health and basic education, are relatively underdeveloped. Public policies are relatively passive providing only minimum standards. This model does not need a strong state. Among the new Member States Latvia and Poland are difficult to categorise. Germany on the other hand follows its own model with strong elements of the Nordic system. The system is, however, more corporatist and rests on a high level of co-ordination of collective bargaining.

Russia as a Baltic Sea Region Actor

Russian regions harbouring the Baltic Sea shall be greatly affected by the EU enlargement. They shall enjoy a unique position as Russian territories are either bordering the EU or becoming even a Russian enclave in the EU in the case of Kaliningrad. On the other hand, the dynamics of the EU integration shall also add considerable problems and new challenges to these parts of the Russian Federation.

The institutional governance of EU-Russia relations has also emerged. The Partnership and Cooperation Agreement sets a comprehensive structure in which at the top of the dialogue is a system of biannual Summit Meetings between the President of Russia, the presidency of the European Union and the President of the European Commission. The Co-operation Council at a ministerial level as well as Co-operation Committees at the level of senior officials are parts of the institutionalisation of the relationship. Nine Sub-Committees cover practical co-ordination. The set-up reflects the particular nature of the conduct of external relations of the cycles of presidencies.

Political and security issues have a special structure in the relationship. Foreign Ministers meet twice a year for political consultations and political directors of the Foreign Ministries four times a year. In the Summit of October 2001 it was further agreed that the Troika[2] of the Political and Security Committee of the EU meets with the Russian Ambassador in the EU on a monthly basis to discuss security matters. The emergence of the political dialogue as a separate topic is largely due to the rapid appearance of the defence policy dimension of the EU.

The main motivation of the European Union to engage in institutionalised collaboration with Russia is the need to enhance stability in Europe. Russia is a great power whose weight in European Affairs is recognised by the EU. The EU therefore looks for a partnership with Russia on a wide range of issues. Of particular importance in the EU approach towards Russia is the issue of energy.

The stability -argument is also a key motivation for the EU in enhancing the Russian Membership of the WTO. The European Union has taken a key position in negotiations between Russia and the WTO Members. The EU sees a rapid accession of Russia to the WTO as an important element in anchoring Russia into the global trading system. The European Union sees Russia as a major trading partner of the future and regards WTO Membership as a major step in consolidating economic relations between the partners.

Politically the key instrument, from the point of view of the European Union, is the Common Strategy towards Russia. The arrangement offers a framework for dialogue between Russia and Western Europe. It offers an overall context for priority areas including the consolidation of democracy, the integration of Russia into the European economic space and the enhancement of stability and security in Europe and in a wider perspective as well.

The Common strategy has its limits. First of all it is not common in a strict sense of the word. It is more like a “Christmas Tree Strategy”: it provides a framework into which Member States can add their own issues and hopes. It has no budget and its relationship to other instruments is unclear. In this the Common Strategy towards Russia resembles the Northern Dimension which also lacks a budget and whose relationship to other programmes is unclear. It has also been argued that the Common Strategy is reactive by nature, not proactive, as it ought to be in order to be a useful instrument. The strategy still has severe Russian reservations. Russia feels that in preparing and reviewing the strategy it is not consulted enough.

Russia has a variety of roles in the Baltic Sea region. First of all, Russia is a great power in the region. This is seen in different ways by different actors. Neighbouring nations of Russia tend to see Russia traditional security policy terms. This has pushed the Baltic countries to seek security guarantees through NATO and encouraged Finland to keep its traditional policy of military non-alignment. The traditional great powers of Europe see Russia increasingly as a partner not only on the European scene but on global issues as well. From the Baltic Sea perspective the German-Russia relationship is of particular relevance.

The second role of Russia is its impact in the energy policy of the European Union as well as Baltic Sea region countries. Currently about 50 per cent of the oil export of Russia goes to the EU and roughly 60 per cent of the natural gas export from Russia is to the EU area. In a similar way 16 per cent of the oil consumption and 20 per cent of the natural gas consumption in the EU derives from Russia. The future of the energy policy of the European Union rests even more on the energy resources of Russia, thus making the North a vital dimension in EU policy making.

Thirdly, Russia is an environmental threat to the Baltic Sea region. The threat has been seen primarily in terms of nuclear power related issues. The operational conditions of the nuclear power reactors in technical terms as well as in management terms have created concern, in particular in the immediate neighbourhood of the reactors. The nuclear waste question has also been voiced.

A new environmental threat element became focal during the exceptionally hard winter of 2003. Oil transportation security has been on the agenda of both public debate and even high-level government people in Finland. Estonia

[2] Troika consists of EU Presidency, the CFSP High Representative and the Commission.

has expressed similar concerns. The issue is potentially getting more important because of Russian plans to increase rather than reduce oil transportation by sea through the Gulf of Finland.

Political instability in Russia also causes concerns in the Baltic Sea region. Voices of concern are expressed for instance on the condition of the federation under the pressure separatist pressures. Extremist political movements are noted as threats in Finland and in the Baltic countries. Business circles point frequently to the problems in instituting the rule of law in Russia and similar concerns are voiced concerning the freedom of the press and the human rights situation. Cross-border criminality is high on the agenda when Russia is evaluated a threat element.

The weight of Russia in the Baltic Sea region shall increase by the two enlargements. The NATO enlargement issue was solved by a multilateral arrangement between NATO and Russia and bilaterally between Russia and the United States. The latter arrangement included a de facto recognition of the great power status to Russia by the Bush Administration in the aftermath of September 11.

The combination of interests and powers puts the European Union into the category of great powers. This means that two great powers meet in the Baltic Sea region. These two great powers, the European Union and Russia, are different and even contradictory in at least one important dimension. They both have a global interest which they want to defend and promote. But the differences are great as well. The European Union is a civilian power that relies on civilian resources. A commonly used argument is that the European Union is an economic great power but a political dwarf.

Russia, on the other hand, is a political great power with nuclear weapons in its possession but is definitely an economic dwarf. This marks a fundamental difference between the two European great powers. The difference also dominates their relationship. They are different actors in many other dimensions as well. An important element is, for instance, that the European Union in its external relations is a highly decentralised actor while Russia, on the other hand, is a highly centralised society.

“Wider Europe”

As the biggest exporting power in world trade, the European Union occupies a central role in international trade relations. Trade policy has been in the competence of the European Community since the Treaty of Rome. In fact, it was the only area of international relations in the legal competence of the European Economic Community. The European Union has its main focus in trade relations and trade-related international agreements. The single market emphasises the power of the European Union in trade matters and expands its scope to new areas such as investments and services.

The introduction of the Euro fundamentally affects the position of the European Union on the world scene. It is bound to have implications which ultimately will push the EU towards an international actor of much greater political weight as well. A comprehensive reform of its institutions is needed before it can assume a more weighted role in political and security dimensions. But the EU is moving in that direction.

The framework of a “Wider Europe” has been launched by the European Commission to meet the challenges of the post-enlargement situation. The concept specifically refers to Ukraine, Belarus and Moldova as well as to the Southern Mediterranean region as new neighbouring areas. In geopolitical terms the aim of the Commission seems to be to surround the EU with a ring of friendly states. The Union is ready to open its markets for products from these markets and to facilitate free movement to a limited extent.

In the past decade the influence of the EU in the Baltic Sea region was based on the promise of membership in the EU. The perspective of Membership forced the candidate countries to initiate economic and political reforms. The enlargement process also demonstrated that the civilian power doctrine worked. The new neighbourhood policy does not promise membership for new partners, even in the longer perspective.

The “Wider Europe” is a problematic issue for Russia. The EU enlargement shall not only extend the common border between Russia and EU from Estonia’s part but shall also bring some of the key CIS countries into an intimate connection with the EU. As a response to the EU enlargement Belarus, Ukraine and Russia have already intensified their cooperation. Russia has intensified the CIS cooperation with the rest of the CIS countries as well. Predicting the return of the zone of interests thinking is not perhaps an overestimation. The new situation implies that the North is not any more a dimension where EU and Russia meet. Soon there will be an Eastern Dimension of the EU which shall eat away the rest of the Northern Dimension.

6. The Role of Local Authorities in the Baltic Sea Region

The Baltic Cities – the Network of Baltic Co-operation

Cities and city regions have become central territories of economic activity. The political map is increasingly redrawn as a consequence of the restructuring of the world economy. Financial and economic centres like London, Paris and Frankfurt in Europe dominate the hierarchy, replacing states as increasingly important sources of power.

The markets have entered the Baltic Sea region as well. Cities and other local authorities in the region perform the functions of providing a home for different segments of mobile and fixed market forces. In providing such a home, the cities have to generate enough co-operation to get things done. Bringing the necessary actors to the table and then moderating differences and negotiating co-operation is a new local government responsibility. Indeed, to perform this function they need ideas, institutions and interests more than reflecting the established aggregation of interests. If a city is not able to shift its established policy-making priorities it is not able to catch the factors that are mobile and fixed at the same time.

In catching these factors the success of cities is in the institutional “thickness” they are able to provide. “Thickness” means a presence and combination of institutions that are capable of supporting each other and facilitate a base for economic development. “Thickness” is created by an active presence of institutions for economic development: firms, business and trade associations, innovation centres, trade unions and voluntary agencies. Institutional “thickness” provides a safe and supportive base for mobile and fixed factors to decide upon a city or a region.

In providing “thickness” the main functions of cities as political institutions are related to their construction of the base. Cities have to secure that there is enough interaction and trust between the institutions. This function calls for innovations and creative policies. Cities also have to speak for the collectivity of institutions, to be able to perform a collective representation of the diverse and sectional interests of individual institutions. Before this collectivity is created, a collective agenda must be formulated. Cultivating “thickness” does not always need a lot of money or investments from the city but it calls for a lot of innovative thinking and the ability to take the initiative at the local level.

The new challenge for local authorities in the Baltic Sea region is the emerging new division of labour between the central Governments, local authorities, the market and indeed the European Union. There is no common model for the division of labour in the Baltic Sea region. Germany is in its own category with its federal organisation. Länder as the main representatives of Local Authorities are in a key position. But on the other hand, Denmark, Finland and Sweden differ from each other. There is no common Scandinavian way of solving the new puzzle. The three Scandinavian Member States have chosen different paths in the European Union. Finland has opted for the core of the European Union advocating deeper and institutionalised co-ordination of economic policies in the Euro-12 group. Denmark and Sweden again have opted out of the core.

Studies in the Nordic countries show, however, that national economic performance and national economic cycles play a significant role in explaining development on a regional level. These notions demonstrate that nation states are still firmly in control of economic dynamics. This is true in the labour market in particular. In all Nordic countries a debate over the priorities of regional policy is active. During the process of globalisation, views that stress the role of cities as poles of economic development have gained more support at the expense of the traditional rural regional policy. In Finland, for instance, the Urban Centre Programme was created to furnish regional economic growth through urban centres.

For the new Member States in the Baltic Sea region the alternatives are still open. They have the chance to observe and to study both different EU strategies in the region as well as different ways of organising the state - city - market - EU -quadrangle in an aquarium. An additional ingredient to their internal debate is that the future of the structural policy arrangement in the European Union is open. What could be done and emphasised in the Baltic Sea region co-operation between local and regional authorities is to establish extensive systems of sharing information, studies and training between the cities on the models of organising and managing the new situation.

Institutionalised co-operation between cities is an increasingly important instrument for adaptation. The main body for co-operation is the Union of the Baltic Cities (UBC), established in 1991. Its membership has grown up to 104 by the year 2003 from 10 countries. The UBC works in ten commissions which represent the key interests in the Baltic Sea cities. Commissions reflect the traditional functions of cities: urban planning, health and social affairs, sport and transportation. But they also reflect the new challenges that cities face as the establishment of commission for business cooperation and information society.

The UBC is also an example of new institutionalisation in the Baltic Sea region. Traditional inter-state organisations such as the Nordic Council and the Nordic Council of Ministers are accompanied by new bodies such as the Council of the Baltic Sea States. The network of organizations in the region covers also a wide range of non-state associations with which the UBC has established permanent working relationships. There has been also a dramatic increase in institutionalised cooperation between various associations of the civil society.

The European Union and Regions

The presence of the European Union opens many possibilities for the cities and local authorities in the region. The question is not that cities should take on a similar function to the central governments in articulating a common interest in the European Union. Ideas, institutions and interests shape their actions.

Constitutional powers delegated to regions and formal channels of influence are critical but not exclusive determinants of the impact of local authorities at the EU level. At the outset, it seems obvious that German Länder have more influence at an EU level because of their constitutional position than, for instance, the region of Turku. However, a skilful bargaining and access to networks can determine the result of influence.

This seems to be important when dealing with the institutions of the European Union. The Committee of Regions is the natural object of influence and formal channels are open for doing that. But a well-known fact is that the Committee does not have a powerful position and its status is unclear among the institutions. It has a consulting role in issues relevant to cities but it only enjoys an advisory status. Furthermore, although representing regions, its members are nominated by Governments, not elected by local authorities or citizens. The members also have a different status depending on which country they come from.

No doubt that the European Commission is in a key position. It is the main institution through which the EU presence in the Baltic Sea region is felt. It has a double function: it is an agenda setter and also has a major role in policy implementation. It already has established links to local authorities through various kinds of partnerships. It has complex networks of European, national, public and private actors. The network is so complex that it is often difficult to manage, both by the Commission itself, and even more so by local authorities.

The Council of Ministers is obviously the most constitutional by its nature. It is the institution of Central Governments and open to influence primarily at a national level. However, some local authorities, and again the example is Germany, have managed to influence the Committee of Permanent Representatives (COREPER) by being able to seat their representatives to a number of Council working groups.

The European Parliament is perhaps the most complicated partner. Obviously the MEPs come from regions and cities and are therefore sensitive to their constituencies. But on the other hand, it is very difficult to assert influence through one Member of Parliament for a regional problem. In addition, in spite of the increased powers, the Parliament must follow the agenda set by the Council. Issues relevant to cities and regions are not necessarily the types of topics where the co-legislative role of the Parliament is seen.

An important lesson is that cities and local authorities must built coalitions rather than act alone in order to influence EU decision-making. Bigger coalitions between units representing similar interests get more interest, more “eartime”. The main reason for this is that the European Commission is open to suggestions with a clear European dimension than simply a local dimension: European Interests are rewarded instead of particular interests. Although the European Commission is a very formal institution whose main partners are the Member States, not local authorities, it is open to informal influence. In its power-struggle with Member States advocating national interests, the Commission is willing to receive information and expertise from local authorities.

The Commission is accessible but the problem is how to access. The Commission has to rely on external actors in the implementation of its policies. The bureaucracy of the Commission is too thin in areas where implementation is mostly needed: in cohesion policy, in structural funds and in agriculture. In addition to the democratic deficit, European Union suffers also from a management deficit. In fact the management deficit can be seen as one of the major reasons for the mismanagement of the Commission.

In providing both information and participating in implementation, local authorities often play a decisive role. City officials as public servants enjoy credibility and trust more than many of the lobbying institutions and consultants now performing these functions. This perspective calls for a reconsideration of the presence and tactics of local authorities.

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