

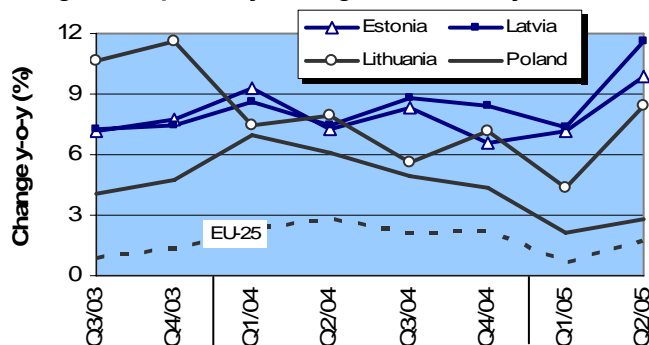
Estonia

GDP expanded almost 10% in the second quarter

The Estonian economy grew by 9.9% in the second quarter of this year compared to the corresponding quarter in 2004. This is the steepest quarterly increase since the second quarter of 2000, when Estonia's GDP expanded by 10.0% y-o-y. Due to this unexpected rapid economic growth within the second quarter, Estonia's economy grew by 8.6% in the first half this year compared to the corresponding period in 2004.

In the second quarter of this year, the main engine behind this economic growth was still rapidly increasing domestic demand, although the growth of exports was also significant. Gross fixed capital formation expanded by almost 8% and private consumption nearly 7% y-o-y. Exports increased strongly by 24% and imports by 7% compared to the second quarter of 2004. Exports of chemical products, machinery and equipment, transport vehicles and metal products all grew around 30-40% y-o-y. When calculated by economic activities, financial intermediation increased sharply by 34% y-o-y over the second quarter. A significant increase was also observed in hotel and restaurant services, up by 16%, and in construction which grew by 14% y-o-y. Rapid growth in the manufacturing sector continued, since its output increased by nearly 13% y-o-y. Retail sales also grew strongly by 12%.

GDP growth quarterly during the last two years



Source: National statistical authorities, Eurostat

According to SEB's Eastern European Outlook, GDP growth in the Baltic economies will remain healthy and stable in 2006-2007. The Baltic States' GDP growth is estimated to be around 6.5-7.5% next year, thus remaining the fastest growing region in the EU-25, as it has been for past five years.

External balance slightly improved in the first half

Estonia's external deficit slightly decreased during the first half of this year. The current account deficit amounted to EEK 8.2 bn (EUR 520 mln), which represents 10.3% of their projected GDP. In the second quarter, the current account deficit was 9.9% of GDP. A reduction in the current account deficit was primarily caused by a decline in their foreign trade deficit. The positive balance of direct investment was a record high – EEK 14.5 bn – as a result of buying up the shares of Hansapank, which was de-listed from the Tallinn bourse.

Due to this change in foreign investment structure, Estonia's foreign direct investment (FDI) stock expanded by almost 60% y-o-y and amounted to EEK 158 bn at the end of June. Correspondingly the stock of foreign-based portfolio investments declined remarkably over the quarter.

Inflation speeds up, EMU entry may be postponed

Estonia's inflation is accelerating again, since the consumer price index stood at 4.9% in September. Therefore Estonia's inflation rate is notably above the Maastricht criteria (2.4% in August) and also the second highest observed in the EU-25, behind Latvia. Within the third quarter of 2005, prices increased by 4.3% y-o-y driven by a 12%-rise in transport prices. The price of housing rose by almost 8% compared to the corresponding quarter of 2004.

The Estonian prime minister recently stated that Estonia will continue its preparations for introducing the euro from the beginning of 2007, although it would be difficult to fulfil the inflation criteria. According to the SEB's recent estimate, this criteria would be around 2.6-2.8% in mid 2006, when Estonia's EMU condition should be evaluated. During recent weeks, there has been increasing doubt if Estonia could meet the EMU inflation criteria using this schedule.

According to recent opinion polls, roughly half of Estonians are supporting and opposing the adoption of the euro. However, a referendum is not needed in the new EU countries, because forthcoming EMU membership was included in their EU membership agreements.

Some business highlights

- Former military systems producer Dvigatel plans to invest more than EEK 8 bn (EUR 500 mln) in an innovation centre Ülemiste City in Suur-Sõjamäe close to Tallinn Airport during the next ten years.
- The logistic company Smarten Logistics plans to build a new distribution centre in Assaku near Tallinn. The centre will have a total area of 39,000 square metres and should be completed by mid-2006.
- The Estonian retailer of IT and electronic household goods, K-Arvutisalong, plans to expand its business to Helsinki.
- Finnish ferry company Viking Line will reregister its passenger ferry M/S Rosella under the Estonian flag as from the beginning of 2006. The company also plans to hire about 200 Estonians to work on the ferry.
- Swedish-based operator Tele2 announced that it has decided to stop any further investments in its fixed line operators in the Baltic States because they have failed to provide conditions for fair competition. The EU Commission has charged nine European countries, including Estonia, Latvia and Poland, for failing to open telecom markets to competition.
- The new Sillamäe Port in Eastern Estonia near the Russian border was opened in October. Currently the port can handle up 10 mln tons of cargo a year.
- Elcoteq Tallinn, A subsidiary of the Finnish-based Elcoteq Network Communications, has received the Foreign Investor 2005 Award from the Enterprise Estonia agency, due to its credits in investments, innovations, exports and job creation. The company was been Estonia's biggest exporter since 1994.
- According to some Finnish and Estonian business magazines, the Estonian ferry company Tallink may acquire Siija Line, the Finnish-origin ferry operator which is currently owned by British Sea Containers. However, both companies have denied such plans. During the last five years, Siija Line's passenger number has decreased by 6%, whilst Tallink's respective number has increased by 87%.

Estonia - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	4.4	0.3	7.9	6.5	7.2	6.7	7.8	8.6	1-6/2005
Industrial production (y-o-y %-growth)	4.1	-3.4	14.6	8.9	8.2	11.0	7.9	9.9	1-8/2005
Inflation (CPI, end of period, y-o-y %-change)	6.5	3.9	5.0	4.2	2.7	1.1	5.0	4.9	9/2005
General government budget balance (% of GDP)	-0.3	-3.7	-0.6	0.3	1.5	2.6	1.7		1-12/2004
Gross wage (period average, EUR)	262	284	314	352	393	430	466	530	Q2/2005
Unemployment (% end of period, LFS data)	10.2	12.9	13.9	11.9	11.3	9.3	8.5	8.1	Q2/2005
Exports (EUR million, current prices)	2 252	2 239	3 445	3 698	3 642	4 003	4 747	3 868	1-8/2005
Imports (EUR million, current prices)	3 529	3 224	4 615	4 798	5 079	5 715	6 738	5 048	1-8/2005
Current account (% of GDP)	-8.7	-4.4	-5.5	-5.6	-10.2	-12.1	-12.7	-10.3	Q1/2005

Source: Statistical Office of Estonia, Bank of Estonia, Eurostat, author's calculations

Latvia

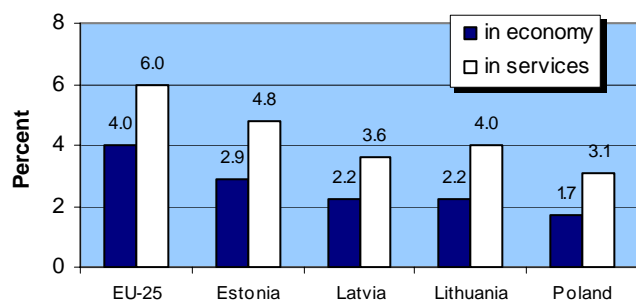
GDP growth reached an all time high

Latvia's economic growth accelerates significantly. In the second quarter of 2005, GDP in real terms increased by 11.6% compared to the corresponding quarter of 2004. This GDP expansion is a record high for Latvia, and also the highest amongst EU countries. During the first half of this year, Latvian economy grew by 9.5% y-o-y. As before, GDP growth has been mainly based on the steep increase in the service sector and construction. In the first six months, domestic trade grew by 17%, construction by 16% and transport and communications by 15% compared to the first half of 2004.

Within the second quarter, domestic trade as well as transport and communications increased by nearly 19% y-o-y. The growth of industrial production accelerated significantly from the previous (weak) quarter, since industrial output expanded by almost 8% y-o-y. Moreover, during recent months, the growth of retail trade and industrial production has accelerated significantly. This indicates that Latvia's economic growth in the third quarter will be also very strong.

However, along with extremely rapid economic growth, Latvia's inflation runs apace. In September, consumer prices were 7.2% higher than in the corresponding month a year earlier. The price increase was mainly influenced by the 19% increase in transport prices, although the prices of hotel and restaurant services and the prices of health care also went up more than 10% y-o-y. Consumer prices rose by 1.5% from August, resulting in the highest month-on-month increase since 1997. Latvia's annual inflation has been the highest amongst EU countries since August 2004.

Share of employment in the HORECA sector in 2004



Source: Eurostat

Despite the great importance of the service sector to the Latvian economy, the share of employment in the hotel and restaurant sector (HORECA) is still quite low, compared to other EU countries. According to Eurostat, only 2.2% of employed Latvian persons worked in this sector in 2004. Poland is the only EU country where the respective number was even lower. In addition, according to Eurostat, the employment structure in the Latvian HORECA sector differs remarkably from the general EU level. In Latvia more than three fourths of the sector's employees were women, whereas the corresponding share in the EU-25 was 54%.

In Latvia, the average income in the HORECA sector is amongst the lowest, about 60% of the country's average wage. In the second quarter this year, the average gross monthly wage in the HORECA sector was only EUR 211. However, unregistered employees and incomes are typical in the HORECA sector, also in old EU member states.

Latvia - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	4.7	3.3	6.9	8.0	6.4	7.2	8.3	9.5	1-6/2005
Industrial production (y-o-y %-growth)	2.0	-8.8	3.2	6.9	5.8	6.5	6.0	4.5	1-8/2005
Inflation (CPI, end of period, y-o-y %-change)	2.8	3.2	1.8	3.2	1.4	3.6	7.3	7.2	9/2005
General government budget balance (% of GDP)	-0.6	-4.9	-2.8	-2.1	-2.3	-1.2	-0.9		1-12/2004
Gross wage (period average, EUR)	202	225	268	282	297	298	314	344	Q2/2005
Unemployment (% end of period, LFS data)	13.7	13.2	13.3	12.9	11.6	10.3	10.3	9.2	Q2/2005
Exports (EUR million, current prices, average exch. rate)		1 613	2 020	2 232	2 416	2 559	3 204	2 579	1-8/2005
Imports (EUR million, current prices, average exch. rate)		2 758	3 453	3 910	4 284	4 634	5 671	4 180	1-8/2005
Current account (% of GDP)	-9.7	-9.0	-4.8	-7.6	-6.7	-8.2	-13.1	-10.8	1-6/2005

Source: Central Statistical Bureau of Latvia, Bank of Latvia, Eurostat, author's calculations

Current account at 10.8% in the first half

During the first eight months this year, Latvia's exports increased by 34% y-o-y, whilst imports grew by 25% in this period. As a result, Latvia's external balance improved in the first half of this year and their current account deficit amounted to 10.8% of GDP. In the corresponding period a year earlier, Latvia's current account deficit reached almost 15% of GDP, but this record-high deficit was influenced by several one-off effects, as the purchase of ships and other investment goods, and by the EU entry-related consumption effect. Thereby this improvement in Latvia's external balance might be temporary, particularly since the growth of imports has been accelerating significantly over the recent months.

Latvia the 26th best location for doing business

The World Bank has ranked Latvia at the 26th place in its "Doing Business in 2006" report. Lithuania was ranked at 15th place and Estonia at 16 in this comparison. Generally speaking, the report praised all the Baltic States for their high rankings and business-friendly policies, recognising that first reforms were implemented in the Baltic States only a decade ago. In the World Bank's study, Latvia was also listed in the "Top reformers 2004" list, as important reforms were implemented concerning the following topics: starting a business, registering property, paying taxes and enforcing contracts.

Latvia may reduce personal income tax to 15%

According to Latvia's minister of finance, Latvia may start reducing personal tax rate from the current 25% rate to 15% since 2007. At present Latvia's corporation tax rate is fixed at 15% of their net profit, thus the tax charge for enterprises is remarkably lower than the current personal income tax rate.

Some business highlights

- TK Development will open a new hypermarket, Galerija AZUR, in Riga next year. The 25,000 square metres project is estimated to cost EUR 35 mln.
- Irish low-cost airline Ryanair opened its fifth route to/from Riga in October, a daily Riga-Liverpool route. From the beginning of November, another Irish air carrier Aer Lingus will open a new Riga-Dublin route, operating three times a week. Norwegian low-costs air carrier Norwegian will start to fly the Oslo-Riga route from November 10. This is the company's first route to the Baltics region. Latvian air carrier airBaltic starts direct flights to Dnepropetrovsk, (Ukraine) at the end of October and plans to start regular flights to Tbilisi (Georgia) next spring.
- Latvian competition authorities have approved TietoEnator's acquisition of a majority stake in SIA IT Alise, the Latvian IT services company.
- SIA NP Properties will build a new industrial park in Ventspils with the total area of 36 hectares. In five years the park should have properties with 50,000m².
- The Latvian government has set the initial price at LVL 73 mln for its 38.62%-share in the Ventspils Nafta (VN) oil transit terminal. The Latvian Privatisation Agency plans to sell the state-owned shares of VN on the Riga Stock Exchange.
- The ferry route between Riga and Stockholm, operated by Rigas Juras Linija's ferry Baltic Kristina, has been stopped since October 15 due to the company's considerable debts. The ship's crew members have refused to leave the ferry until their wages are paid or the insolvency will be announced by the court. The Estonian ferry operator Tallink may open its Riga-Stockholm route in January 2006.
- Norwegian-owned Reval Hotel Latvija has launched an expansion project. The hotel will add 200 hotel rooms and a conference and entertainment facilities.
- Latvian non-financial companies' aggregate net profit made up to LVL 625 mln in 2004. This is 3.2 times more than a year earlier.
- Latvia's minimum monthly wage will increase from LVL 80 to LVL 90 (EUR 128) next year. About 15% of employees are receiving this minimum monthly wage. In Lithuania the minimum wage is set at EUR 145 and in Estonia at EUR 172.

Lithuania

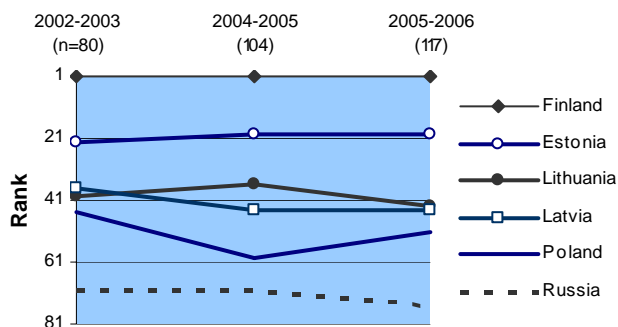
GDP growth 7.6% in the third quarter

Lithuania's economic growth accelerated significantly during the second quarter of 2005, as it did in Estonia and Latvia. In the second quarter, Lithuania's GDP increased by 8.4% y-o-y driven by a notable value added increase in all the main economic sectors. However, the most remarkable expansion was observed in market services, especially in hotel and restaurant services, which increased by 26% y-o-y.

According to the first estimate by Lithuanian statistical authorities, Lithuania's GDP growth slightly decelerated within the third quarter this year. However, their GDP still expanded strongly by 7.6% compared to the corresponding quarter of 2004. Over the third quarter, the most rapid increase was noticed in the service sector, copying the earlier quarters of this year. Therefore Lithuania's economic growth is increasingly based on the rapid growth of the service sector instead of the industrial sector. However, during recent years, the main engine behind Lithuania's rapid economic growth has been rapidly growing industrial production and construction activities.

Lithuanian GDP figures have been recently revised regarding the calculation of financial intermediation services (FISIM). This calculation method will be introduced in all EU countries during the forthcoming months, resulting in an increase of approximately 1.0-1.5% compared to the earlier reported GDP growth rates.

Country ranks in Growth Competitiveness Index



Source: WEF 2005

Lithuania's overall growth competitiveness weakened over the year, according to the World Economic Forum's (WEF) recent Global Competitiveness Report. According to the WEF, the Lithuanian economy is the 43rd most competitive economy in the world. This year the WEF ranked the competitiveness of 117 countries. In the WEF's Growth Competitiveness Index (CGI) a year earlier, Lithuania's was ranked at 36th place. There was no single factor to explain this relative decline, but Lithuania's rank declined over the all sub indices. The CGI consists of the technology index, public institutions index, and macroeconomic environment index, furthermore all of which are divided to several sub categories.

However, Lithuania's business environment was ranked at 15th place in the World Bank's "Doing Business in 2006" report (page 2). Lithuania's rank was the best amongst the Baltic States and the fifth highest in the EU. In Transparency International's recent corruption index, Lithuania's position did not change from the previous year (page 4).

Lithuania - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	7.3	-1.7	3.0	6.4	6.8	10.5	7.0	6.9	1-9/2005
Industrial production in sales (y-o-y %-growth)	8.2	-9.9	2.2	16.0	3.1	16.1	10.8	6.0	1-8/2005
Inflation (CPI, end of period, y-o-y %-change)	2.4	0.3	1.4	2.0	-1.0	-1.3	2.9	2.6	9/2005
General government budget balance (% of GDP)	-3.0	-5.6	-2.5	-2.0	-1.4	-1.2	-1.4		1-12/2004
Gross wage (period average, EUR)	208	231	263	274	293	311	335	386	Q2/2005
Unemployment (% end of period, LFS data)	12.6	15.3	16.9	17.9	13.0	11.6	10.6	8.5	Q2/2005
Exports (EUR million, current prices, average exch. rate)		2 583	3 841	4 778	5 526	6 158	7 478	5 733	1-8/2005
Imports (EUR million, current prices, average exch. rate)		4 340	5 650	6 767	7 943	8 526	9 959	7 462	1-8/2005
Current account (% of GDP)	-12.1	-11.2	-5.9	-4.7	-5.1	-6.8	-7.7	-6.5	1-6/2005

Source: Statistics Lithuania, Bank of Lithuania, Eurostat, author's calculations

Unemployment rate declined sharply to 8.5%

Lithuania's unemployment rate decreased notably in the second quarter of this year. According to the recent labour force survey, the unemployment rate declined by 1.8 percentage points over the year to 8.5% of the country's active labour force. This is the lowest observed rate in ten years. Along with the improvement in unemployment, Lithuania's employment rate rose by 1.3 percentage points y-o-y up to 62.6% of working aged (15-64) people.

During the past four years, Lithuania's unemployment rate has halved from a 16.8%-rate in the second quarter of 2001 to its current level. Correspondingly the number of employed person has increased within this period by 100,000 persons. Currently Lithuania's unemployment rate is slightly lower than the average rate in the EU-25, which stood at 8.7% in June.

Russian FDI in Lithuania expands

Lithuania's foreign direct investment (FDI) stock amounted to LTL 17.5 billion (EUR 5.1 bn) at the end of June 2005. The FDI stock increased by 17% y-o-y. Over the year, direct investments from Russia and Germany increased significantly, since Russia's FDI stock in Lithuania increased by 91% in a year and Germany's by 69% respectively. At the end of June, Sweden held the largest investor status with its 14% share of the total FDI in Lithuania, followed by Denmark (13.5%), Germany (13.3%) and Russia (12.1%).

Government to buy the Yukos stake in MN

The Lithuanian Parliament has approved a bill concerning the acquisition of Yukos' 53.7%-stake in the Mazeikiu Nafta (MN) oil refinery complex. The parliament allows the government to borrow up to LTL 3 bn (EUR 870 mln) for this possible acquisition. According to the law, the acquired shares could be transferred to other investors selected by the government.

Lithuanian government is hopeful about buying MN from the bankrupt Russian oil giant Yukos. The company is asking about a billion dollars for its stake in MN. If the agreement with Yukos comes about, the government has better options to find a suitable strategic investor for the refinery. Either the Russian LUKoil or the Russian-British TNK BP is the most probable new investor in the refinery. The government started negotiations with TNK BP in October with a statement that the door is still open to other potential investors.

Some business highlights

- Rubicon Group will invest LTL 54 mln (EUR 16 mln) in a new aqua park in Vilnius. The aqua park will be the largest in Europe, and it is planned to be opened in the autumn of 2006. The aqua park is a part of the larger Vilnius entertainment park.
- Lithuania was the only Baltic State that was listed in the PricewaterhouseCoopers' "Top 20 list" of the most attractive countries for retailing and consumer investment. Poland and Russia were also included in this list.
- Snoras Banka, the third largest bank in Lithuania, has acquired a 83%-share of the Latvian bank Krajbanka. Snoras is 49%-owned by the Russian Konversbank.
- Kroviniu Terminals, the largest port operator in Klaipeda, plans to invest LTL 110 mln (EUR 32 mln) in a new terminal for petroleum and chemical products.
- Lithuanian property developer Hanner plans to invest USD 500 mln in Ukraine in the next five years and LTL 250 mln (EUR 71 mln) in the Visoriai district (Vilnius) within the next three years.
- Rimi Baltic plans to invest EUR 20 mln to expand its operations in Lithuania. In the first nine months this year, Rimi Baltic's sales in Latvia increased strongly by 32% y-o-y up to EUR 249 mln. Correspondingly the company's sales in Estonia grew by 20% to EUR 237 mln and in Lithuania only by 4% y-o-y to EUR 95 mln.

Poland

GDP growth to be around 3% in 2005

The Ministry of Finance predicts that Poland's economic growth will reach a rate of 3.4% in the third quarter this year, and the whole year's GDP increase will be slightly above 3% compared to 2004. Therefore Poland's GDP growth will be remarkably lower than was forecast. For example, the state budget for 2005 was written according to an expectation of 5% real growth. In 2004, the Polish economy expanded by 5.4%, which was the fifth highest increase amongst EU countries. In 2005, GDP expanded by 2.1% in the first quarter and by 2.8% over the second quarter. Despite the strong zloty, export has been the main engine driving economic growth.

However, as the Ministry of Finance also recognised, economic figures from recent months indicate that GDP growth slightly improved in the third quarter. During the July-September period, industrial production increased by 4.3% y-o-y, thus notably faster than in the first half of this year. In September, manufacturing output increased quite strongly by 6.3%. The growth of construction remained at a high level, up by 10.5% y-o-y, but retail trade increased by only 2.9% compared to September 2004.

Unemployment rate slightly declined

Despite Poland's weaker than expected economic performance in 2005, there is also some good news. Both external balance and unemployment are improving and inflation seems not to be a major problem for Poland, as it currently is for the Baltic States.

Poland's trade deficit decreased notably during the first eight months this year. In euro terms, the trade deficit amounted to EUR 5.9 bn, down by 40% y-o-y. Over the year, exports increased by 19% and imports by 11% when calculated in euros. Although Poland's inflation slightly accelerated in September influenced by the rising fuel prices, Poland recorded the third lowest annual inflation in the EU after Finland and Sweden. In September, the consumer price index stood at 1.8%. The downward trend in unemployment continued in the second quarter. Poland's unemployment rate declined by 1 percentage point y-o-y to 18.1%.

No Polish success in the corruption comparison

Poland did not succeed in the Transparency International's Corruption Perception Index (CPI) for 2005, since Poland's rank was again the weakest amongst the EU-25. Moreover, Poland's rank in this international comparison has been dropping over recent years. Currently Poland's corruption problem is estimated to be close to the level in Croatia, Egypt and Syria, for example. The Corruption Perception Index is based on the several surveys compiled by well known international organisations such as EIU, WEF and IMD.

Country ranks in Corruption Perception Index

Year / Rank (number of countries)	2002 (102)	2003 (133)	2004 (146)	2005 (159)
Finland	1	1	1	2
...
Estonia	29	33	31	27
Lithuania	36	41	44	44
Latvia	52	57	57	51
Poland	45	64	67	70
...
Russia	71	86	90	126

Source: Transparency International 2005

Poland - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	4.8	4.1	4.0	1.0	1.4	3.8	5.4	2.4	1-6/2005
Industrial production (y-o-y %-growth)	3.5	3.6	6.7	0.6	1.1	8.3	11.7	2.5	1-9/2005
Inflation (CPI, end of period, y-o-y %-change)	8.6	9.8	8.5	3.6	0.8	1.7	4.4	1.8	9/2005
General government budget balance (% of GDP)	-2.1	-1.4	-0.7	-3.7	-3.3	-4.8	-3.9		1-12/2004
Gross wage (period average, EUR)	314	401	472	557	544	497	505	561	Q2/2005
Unemployment (% , last survey in the year, LFS data)	10.6	15.3	16.0	18.5	19.7	19.3	18.0	18.1	Q2/2005
Exports (EUR billion, current prices, average exch. rate)	25.1	25.7	34.4	40.4	43.4	47.5	60.0	44.6	1-8/2005
Imports (EUR billion, current prices, average exch. rate)	41.5	43.2	53.1	56.2	58.3	60.3	71.8	50.6	1-8/2005
Current account (% of GDP)	-4.1	-7.6	-6.0	-2.9	-2.6	-2.2	-4.4	-0.9	1-6/2005

Source: Polish Official Statistics, National Bank of Poland, Eurostat, author's calculations

However, in the recent Global Competitiveness Report, published every year by the World Economic Forum (WEF), Poland's position improved significantly, since its rank rose by nine places y-o-y (see page 3). On the other hand, according to the WEF report, Poland's overall growth competitiveness is still the weakest amongst EU countries.

Net budgetary position after EU enlargement

	Estonia	Latvia	Lithuania	Poland	Total New-10
EU payment to new members (New-10)	195.2	259.6	478.9	2 688.4	5 980
Payments made to EU by New-10	55.1	67.1	118.7	1 303.8	3 158
Net balance	140.1	192.5	360.2	1 384.6	2 822

Source: European Commission, September 2005

According to the European Commission's Financial Report 2004, the EU's budgetary balance was significantly positive for all new member states in 2004. Transfers and funds from the EU to the new member states exceeded their payments by EUR 2.8 bn. Poland received nearly 1.4 bn from the EU, almost half of the total net balance for the New-10. However, when measured by GNI, Greece, Portugal and the Baltic States relatively received the biggest money from the EU. It should be noted that the New-10 have benefited from EU funds in full terms only since May. From May 2004 to the end of 2006, the new member states will receive EUR 22 bn from the EU's structural and cohesion funds. By 2006, expenditure on structural activities in these new EU countries will reach 1.75% of their GDP average.

The Commission estimated that the Polish farmers' income increased in 2004 by 74% y-o-y, whereas agricultural income in the new member states increased by an average of 54%.

Some business highlights

- The Nordic Investment Bank (NIB) has signed a loan agreement of EUR 120 with BOT Elekrownia Belchatów S.A., the Polish electricity company, for modernising existing blocks and for a new 833 MW unit. The project's total cost is EUR 1.6 bn.
- Poland's largest ship owner and operator, the state-owned Polska Zegluga Morska (PZM), plans to invest USD 800 mln by 2015 to expand its fleet of ferries.
- According to PAIIZ, the value of foreign direct investments in Poland in 2005 will exceed last year's number and will reach at least USD 10 bn. In 2004, FDI in Poland amounted to USD 7.9 bn.
- French pet food producer Royal Canin will invest EUR 50 mln in a production facility in Niepolomice.
- LG.Philips LCD will build a LCD monitor factory in Kobiercyce near Wroclaw. The company will invest a total of EUR 429 mln by 2011.
- The aggregate net profit of Polish banks increased by 25.7% y-o-y in the first half of 2005 up to PLN 4.7 bn.
- According to the Polish Market Review (PMR), up to 30 companies may debut on the Warsaw bourse by the end of February 2006.
- Four companies are on the short list for acquiring a 47% stake in Jelfa, the Polish drug producer. The bidders are the investor fund Enterprise Investors, the Polish company Adamed, Grindex from Latvia and AS Sanitas from Lithuania.
- German-based Metro plans to invest EUR 100 mln to increase the density of its retail chains in Poland. The company has invested around EUR 1 bn in Poland over ten years and is the fourth biggest foreign investor in Poland.
- The US-based property developer Polimer International plans to invest EUR 55 mln in a new 66,000 square metres shopping centre in Poznan.
- Michelin is to invest more than EUR 250 mln to expand its tire factory in Olsztyn. The project should be completed in 2006 and will create 500 new jobs.

More Than a Decade of Purposeful Economic Policy

by Urmas Paet

Estonia is recognised for its stable and purposefully implemented economic policy. Analysts often praise Estonia's performance figures and various icons of Estonia's success — the prominent e-sector, the creative economic thinking based on liberal attitudes in the society, the combination of conservative fiscal and prudent monetary policies. Deservedly, these aspects of Estonian economy get positive publicity through the press and the international organisations.

The statistics are certainly encouraging: according to the data released by the Statistical Office of Estonia in June, 2005, the last ten years have demonstrated 6.1% and during the last five years even 7.2% average GDP growth. By preliminary estimations the economic growth of Estonia in the 2nd quarter of 2005 compared to the same period a year earlier reached 9.9%. According to the prognosis of the Bank of Estonia, Estonia's GDP growth in 2005 is expected at 8%.

A decade's economic goals have been completed — what next?

Estonia's progress so far has been visible. However, now that many of the policy goals have been fulfilled, we naturally also wish to satisfy our curiosity about the future. For instance, being a member of the EU, can we expect growth to continue? Or, in somewhat greater detail, could we expect the same policy line to be continued now that we are a part of the internal market and follow the *acquis*? The short answer is "yes".

In this brief article I wish to look into what is actually behind what we see happening every day, what are the processes that continue to shape our present reality as well as the future.

The legal tradition — basis for sound policy

The key departure point in any effort to understand Estonia, her past and future, is to bear in mind the respect of its people to the rule of law as well as trust in the historical practice of the Roman civil law tradition of Europe. This shapes the modern Estonian thinking about our economy today and also tomorrow.

In Estonia's constitution of 1992 one should easily find an extensive catalogue of civil liberties — in fact, the most important source of Estonia's liberal and stable economic policy can be traced in the second chapter of the constitution: the fundamental rights, freedoms and duties. The principles therein bear direct links to the implementation of the role of the state in encouraging economic activity — indubitably, these principles continue to constitute a sound basis for any new and innovative legal initiatives designed to improve any filed of activity. Among these principles, the key to achieving economic success in a modern country is the art of separation of the state functions, the domain of administrative law — from the daily business activities, the domain of civil law.

The role of civil law is reflected in the idea that competitiveness should be encouraged between equal parties that are to be given identical starting positions in their pursuit of business related goals. The daily concerns of administrative authorities have to be strictly separable from private business interests. Hence the state authorities should keep their intervention at minimal necessary levels — at those absolutely indispensable. The aim is to achieve the least burdensome state while providing maximum result for the good of the community whereas preserving the initiative and motivation of the people to work and create. Evidently such simple goals

are easier to achieve, if efforts are directed at building a system that is free from exceptions, exemptions, or any other type of irregularities or excuses which, if tolerated, would inevitably blur and damage the relationship of the state authority and business in the society — would make the system less clear and thereby also less easy and more costly to run.

Abundance of state expenses deriving from exceptions is to be avoided. The administration should be easy to implement and understand while affordable to administer and sustain. Whatever state policy has been under discussion in Estonia, these principles have served as the foundation. These principles also broadly define the competitiveness of a country.

Efficient state for less money — any examples?

In Europe, a well known albeit disputed example of such policy-making is Estonia's flat tax system. For instance, as a country of principles we had to create a simple, transparent and efficient tax system based on not making exceptions and having a single tax rate for all taxpayers whether individuals or companies. In order to make the system efficient and less burdensome to administer, we also had to introduce to the thinking on taxation the idea that the businesses should not pay taxes in so far as they keep their money — including their profits, in the work process. It would be an unforgivable mistake to try to associate Estonia with a notion of a tax paradise — Estonia with her clear bookkeeping and taxation laws cannot be considered an easy place to engage in dishonest practice. It is a myth, cultivated by superficial observation, that Estonia has 0% corporate income tax — on the contrary, whenever money is taken out of business or spent on items not related to the companies' purposeful business, it gets taxed without exemption, whatever the excuses may be. Besides, upon taxable events, the level of taxes payable by businesses is not at all the lowest in the neighbourhood.

What could be the result of an efficient system to precisely collect what is due whereas keeping the capital at work? Motivation for the people to work hard, a strong disincentive for the companies to engage in double-bookkeeping. Besides, also the by-product of better and more representative statistics — definitely more reliable figures of economic performance. It also needs to be pointed out here that in Estonia, upon the end of the first half of 2005, in all tax categories the actual revenue had well exceeded the planned 50%, resulting in real budgetary revenue surplus to be spent on societal needs in 2005 as well as to make provisions for the future.

The general belief is that such policies have been useful and need to continue — no quick reforms can rival the economic effect of long-term sound policy.

Reforms and Transition versus Policymaking

In many sources of literature, ratings, etc. we find lots of talk about Estonia and Eastern Europe in terms of reforms. More often than not the process of transition is the focus that serves also as the point of departure for what actually should be regarded just a policy-related discussion between experts. Speaking about transition used to be the proper way to address the necessary economic policy adjustment issues until certain processes of the property reform were still at progress. These processes, privatisation as the most important among them, were largely completed during the second half of the 1990s. On November 1, 2001, the legendary ...

Privatisation Agency of Estonia had reached its very end — law dissolved it because its tasks were completed. Just to remind, the main method for the privatisation in Estonia was open international tender to pick up core investors.

In this conjunction I would also like to point to a representative summary of the reform period experience by the World Bank, published in 2002. In its foreword we find that one of the key messages of this study was to highlight the role of encouraging the entry and growth of new firms as opposed to the concerns over possible postponing of the pain of liquidating and restructuring the 'old sector' to any later time. The main significance of this work to this discussion derives from the practical orientation of this WB publication: we can find therein a representative benchmark for measuring the completion of restructuring as well as to decide whether an economy would cease to belong to the category of a transitional economy.

When is transition over? This question raised in 2002 by the World Bank and also answered in a simple way: "The wide dispersion in the productivity of labour and capital across types of enterprises at the onset of transition and the erosion of those differences between old and new sectors during the reform provide a natural definition of the end of transition." Hence, the very last enterprise sold by the Estonian Privatisation Agency in the end of 1990-ies as well as the decisive switch away from any privileged, exempted, excused way of different classes of property, most powerfully reflected by the vote of the people over 1992 constitution at the very beginning of restoration of the sovereignty of the Republic of Estonia — these would be the important markers to help define the beginning and the end of transitional economy in Estonia. These milestones also set the stage for any discussion over policy.

Stable and purposeful Policy

Although we have made a clear statement by our success in economic policy implementation, it is evident that some of the key areas of our focus nevertheless remain the same and continue to demand our inventive attention. Among them one would have to name first work with our legal framework, especially in the age of continued technical advances — the ability to adjust to changes becomes more and more critical.

Estonia wishes to be in the frontline of excellent policy-making. There is more than ever before in European history a need to focus on making Europe more competitive. The new challenges before Estonia similarly to very many other EU member states are the issues of ageing society, the environmental problems, and the natural limits to the energy supply. To remain competitive in the world of globalised economy all the nations around the Baltic Sea also have to continue to stand for the economic freedom while finding innovative ways to improve the efficiency of governance. The new situation for everybody is the situation of global competitiveness. In the challenges of policy-making under these evolving circumstances Estonia continues to support the flexible and proactive style.

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New Impetus for the Baltic Sea Co-operation

by Ville Itälä

With the enlargement of the European Union to the three Baltic States and Poland in May 2004, the Baltic Sea became an inland sea within the EU. Hence, eight of the nine countries bordering the Baltic Sea are now EU member states.

The Baltic Sea has historically played an important role within the Baltic Sea Region. Already during the Hansaetic times, the Baltic Sea united the countries surrounding it, in that manner bringing prosperity to the region. At present, the countries around the Baltic Sea make up a third of both the population and the GDP of the European Union. In addition to this, the Baltic Sea region is one of the fastest growing in Europe.

However, the Baltic Sea has equally been nominated as the most polluted sea in the world. The sea is shallow, with its average depth being only 58 metres, and its water changing slowly. Furthermore, 85 million people live in the catchment area; the load to this sea is serious.

Many of the causes of the Baltic Sea pollution can be targeted by actions of the EU. Furthermore, the St. Petersburg Southwest Wastewater Treatment Plant, commissioned last September, serves as a good example of co-operation between the EU and Russia. The plant will cut half the sewage flow that St. Petersburg has until now discharged untreated into the Gulf of Finland. The wastewater treatment plant is a step in the right direction. However, major challenges still remain: single-hull vessels increase the risk of oil tanker accidents, while other vessels are unable to withstand the winter conditions. Moreover, the load from agriculture to the Baltic Sea should be reduced.

The European Union has until now financed the Baltic Sea region as a part of its external policy through the Northern Dimension programme. The current programming period ends in 2006. Decisions on the continuation of the programme will most probably be taken during the Finnish presidency of the EU in autumn 2006. The challenge for the Finnish presidency will be to shape the concept of Northern Dimension to answer to the current needs of the region.

In this respect, co-operation with Russia has been an integral element of the Northern Dimension. The EU is currently reshaping its external aid instruments. Hence, co-operation with Russia will in the future be financed through the European Neighbourhood and Partnership Instrument. However, as eight of the nine countries bordering the Baltic Sea are current members of the European Union, the co-operation should not be seen as part of the EU's external but rather its internal policy. The Northern Dimension has ceased to be an interesting concept merely to Poland and the Baltic states. We need new approaches.

The Baltic Sea Intergroup of the European Parliament, with members from all the Baltic Sea states and beyond, has proposed a creation of a European Baltic Sea Strategy. The strategy would concentrate on areas such as environment, economics, culture and education and security. Members of the European Parliament have also suggested that the Baltic Sea Strategy should have budgetary position within the union's budget similar to the one the Mediterranean Strategy currently has.

Interest towards a new kind of Baltic Sea co-operation is clearly shown in Baltic Sea states as new initiatives to enhance the co-operation are taken around the region. City of Turku has defined the Baltic Sea region as one of its most important international operating arenas. A step towards boosting the efficiency of different actors' communication was taken in a study by Professor Dr. Esko Antola, suggesting creating a Baltic Sea Centre to the City of Turku.

I support warmly the proposal of Professor Antola, not only because Turku is my home town, but because I believe that there is a call for coordination of the co-operation. The City of Turku, one of the old Hanseatic cities with long traditions, would be a natural host for such an institute.

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Why a Baltic Sea Economic Region?

by Johnny Åkerholm

The region around the Baltic Sea is among the fastest growing areas in Europe. But this is clearly not good enough from a global perspective, which is an increasingly relevant basis for judgement. The question is, can we do better by working together, and if so, what could we do?

There are many efforts to promote better integration in the Baltic Sea Region. But the truth is, that much of the interest in Northern Germany and Poland is tuned to the South, the Baltic States are concentrating their interest on funds flowing in from the EU, Russia is focusing on the European continent, and Norway looks towards the West. Moreover, many of the countries in the region concentrate their international cooperation efforts to Brussels. So, are the efforts to strengthen cooperation in the Baltic Sea Region illusory and not well placed?

No, they are certainly not. Enhanced cooperation can bring with it clear benefits. With globalisation, it is increasingly difficult to make a mark on the world map. For that, strong competitiveness is a necessary but not a sufficient condition. To be attractive, the area has to be large enough to be interesting from an economic point of view. But, given the divergent interests and the large differences in income levels and economic structures in the Baltic Sea Region, it seems like a highly heterogeneous area and not as one entity. Hence, the region as such does not have much international attractiveness.

As a consequence, while many of the Nordic countries figure high in the international assessments of competitiveness, direct investments to these countries are small, and the Nordic companies invest heavily elsewhere.

This heterogeneity is a weakness, which intensified cooperation could turn into strength, given that the basic level of education is good all over in the region. The differences in income levels provide for large opportunities for the reallocation of productive resources. No doubt, this has taken place in the past years, but the reallocation seems to be increasingly benefiting other regions. Furthermore, by taking a regional approach to infrastructure, in particular energy and transport, integration would be furthered and cost savings would be achieved.

Increased cooperation requires above all a strong political commitment:

- While there are increased efforts to facilitate the transfer of energy across the borders, a pre-requisite for the integration of markets, the generation of energy is totally uncoordinated. In fact, these decisions are figuring high on the national agendas in all the countries, but the solutions are very different. Eventually, integration of the markets might produce a "market solution" to the generation of energy, but it will take time. Costly and misplaced investments will occur in the meantime, and it will be more difficult to attach due attention to environmental questions. Much would be gained by a regional approach. But this does not seem realistic for the time being.
- Well-functioning logistics between the different areas in the region is a prerequisite for well-functioning integration. Cooperation is also essential in order to safeguard effective connections to the markets outside the region. Traditionally, the transport system has been functioning well between the Nordic countries, and new connections

were created in the 1990's between the Nordic and Baltic countries. But many of these were based on the arbitrage arising from the high taxation of alcohol in the Nordic countries. As this taxation is adapted to the free flows of goods and services, the economics of the existing transport links come into new light. This does not reduce the need for transport, but new approaches are needed when the implicit "subsidies" disappear. Again, a regional rather than national approach to solve these new problems would be most efficient.

- Cooperation in education and research and development could also bring substantial benefits to the region as a whole. Again, while the individual countries have many strong spots, the region is not attractive enough from an international perspective.
- It must be accepted that the economic structures will adjust to the differences in economic conditions. In practice, labour intensive production will have a tendency to move to low-cost areas, which cannot be expected to provide all the public services and take all the related costs in the short- to medium-term. The challenge for the more developed areas is to generate new, higher qualified, higher paid jobs instead of those that disappear. This will become easier if the whole area is more integrated and hence more attractive. Integration is no zero-sum game; when income levels in the region increase, also the attractiveness of the region increases, and all benefit. Hence, the movement of jobs into the poorer regions will not only help them but also make it easier for richer regions to find compensating activities.

How could international financial institutions, such as the Nordic Investment Bank, support the integration process? There are a number of opportunities for this, as long as the political support for the process exists.

- IFI's can coordinate the initiatives and put together cross-border projects, both technically and financially. They can also provide the long-term financing, which is needed for the realisation of infrastructure projects that typically have a long digestion period. NIB has experience from these kinds of projects, e.g. Via Baltica. But this typically requires that funds for technical assistance are available, which makes it possible to use the necessary resources needed for the technical and financial structuring.
- IFI's can help to put together innovative financial packages, which on the one hand involve the private sector (and hence reduce the burden on the budget) and on the other hand multiply any infusion of grant funds. The Southwest Wastewater Treatment Plant in St. Petersburg is a good example of such a project. Contrary to a widespread belief, generated by the generous supply of EU funds, these kinds of projects can never be fully financed by grant money, and the challenge is to use the available funds as efficiently as possible.

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Spatial Polarisation of the Baltic Sea Region

by Tomas Hanell

Spatial polarisation in the Baltic Sea Region (BSR) increasingly predominates across virtually all fields of the society as globalisation and structural change have taken a firm grip of both its eastern and western areas alike. The cities and urban areas in the region are the main engines of its development. This does not imply that more peripheral locations would be untouched by economic globalisation, though empirical evidence suggests that its effects do differ, dividing the regions and cities of the BSR into “actors” and “reactors”. Small and peripherally located settlements lacking the necessary levers to actively take part in the international division of labour often suffer most in this respect.

The concentration of economic activity, population, corporate decision-making, labour, foreign direct investment, knowledge, and innovation to the metropolitan areas of the BSR is substantial, much more so than in several countries of continental Europe. For example, more than 90% of the HQ's of the largest BSR enterprises are located in metropolitan areas, primarily in the western BSR. In the eastern BSR the concentration to these cities is not as marked, as 60% of the 40 largest eastern BSR HQ's are located in metropolitan areas, most of the remaining ones are however also in large Polish cities (e.g. Krakow and Wroclaw). Furthermore, of the BSR offices of the 46 most global producer service firms more than 90% are located in only eight metropolitan cities of the region. Thus the nine capital regions of the BSR (plus Hamburg and St Petersburg) account for more than a third of the region's entire production value, although they contain only a fifth of its population on a mere 3% of its land area.

Among those one hundred (NUTS3) regions in the EU with the lowest GDP per capita in 2002 no less than 56 were within the BSR. Additionally all seven Russian BSR regions qualify in the same category as in all likelihood would those from Belarus – were comparable data to be available. Even more alarming however are the most recent development trends. Comparing the total regional disparities between 1995 and 2002 (Norway and the Russian BSR 1995-00) they have increased in all countries save for the Russian parts of the region (table).

Similar concentration patterns are also discernible with regard to employment although in traditional Polish manufacturing cities in particular the decline in the number of jobs has

been colossal. Disregarding the obvious national differences, city size remains an important factor in explaining new job creation. In general, the larger the city, the more favourable has been the development of its employment. To make matters worse, there is an ongoing process of labour reorganisation in the BSR where agricultural jobs lost in peripheral regions and manufacturing ones in industrial regions are being replaced by service sector jobs in metropolitan areas and other large cities. This transition process cannot but help to reinforce the ongoing shifts in the settlement structure of the region. Thus, in countries – such as Poland or Belarus – that have both a large rural population and a relatively underdeveloped service sector, the likelihood of increased future rural-urban migration seems greater. Or will it be a question of emigration?

The demographic magnetism of larger cities in general and metropolitan areas in particular is strong. The migration surplus to the twelve metropolitan cities during the period 1995-2001 was on average 0.2% each year. However, suburbanisation and increased commuting entails that the absolute winners among the cities of the BSR (when taken as a group) are smaller settlements in close proximity to metropolitan cities, for which the corresponding figure was 0.5% per year on average. Imbalances in the demographic structure reinforce migration patterns where small and peripherally located settlements are rapidly ageing whereas young persons flock to larger cities.

Nonetheless, many of the BSR countries are relatively small in economic terms and are thus often simply unable to compete on a par with the major European economies, let alone globally. As such, then the concentration of effort into the promotion of a select few urban centres seems rational. The question however remains whether this type of concentration is sustainable in the long run. Or is it even sustainable today?

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Change in regional disparity of GDP per capita 1995-2000

Country or area (nr of regions)	Standard deviation of GDP/capita		Absolute change (units)	Relative change (%)	Interpretation	
	1995	2002			Disparity at onset	Tendency
Sweden (21)	7.9	11.9	4.0	50.7	Small	Increasing
Denmark (12)	12.8	14.3	1.5	11.8		
Lithuania (10)	13.4	24.1	10.7	80.0		
Poland (16)	15.1	20.2	5.1	34.1		
Norway* (18)	15.2	16.2	1.1	7.0		
Finland (20)	16.6	19.6	3.0	18.2		
Russian BSR* (7)	29.0	14.8	-14.3	-49.1	Large	Decreasing
Latvia (5)	29.3	39.2	9.9	34.0	Large	Increasing
Estonia (5)	34.3	38.9	4.6	13.5		
German BSR (7)	39.2	43.3	4.1	10.5		
BSR total** (121)	18.8	22.4	3.6	18.9	Average	Increasing

Deviation based on indexed values.

* 1995-2000

** Excluding Belarus