Baltic Rim Economies

Estonia – Latvia – Lithuania – Poland

28.2.2006 Turku School of Economics and Business Administration

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Estonia

GDP expanded by more than 9% in 2005

Estonia's economic growth was 10.6% y-o-y in the third quarter of 2005. GDP growth was influenced by a rapid increase in domestic demand, which increased 10.8%. By economic activities, the value added grew most in financial intermediation, which went up by 29.5% y-o-y, followed by hotels and restaurants (24.5%), construction (21%), wholesale and retail trade and manufacturing, both up by 13% y-o-y.

According to preliminary data, Estonia's GDP expanded by over 9% in 2005. This would be the steepest increase since 1997, when Estonia' economic growth exceeded 11%. In comparison, GDP growth in the EU-25 is estimated to stand at 1.6% in 2005. Domestic demand will remain as the engine behind Estonia's economic growth, although the positive trend in exports is also expected to continue. Forecasts for GDP growth in 2006 vary between 7% and 8.5%.

Wages increased in the fourth quarter

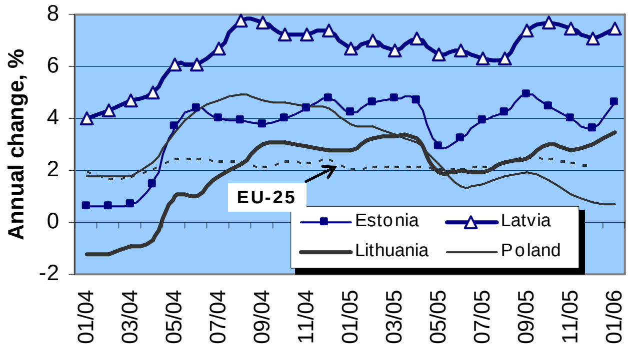
Within the fourth quarter of 2005, Estonia's average gross monthly wage increased by 12.8% compared to the corresponding quarter of 2004. The average monthly wage was EEK 8,690 (EUR 555). This rapid wage increase was influenced by the bonuses paid to the employees at the end of the year due to the companies' increased net profits.

Estonia's unemployment rate declined in the last quarter of 2005. The unemployment rate stood at 7.0%, whilst the respective rate was 8.5% a year earlier. The number of employed persons increased mainly in the service sector.

Estonia's FDI stock EUR 10.4 bn

At the end of the third quarter of 2005, Estonia's foreign direct investment stock amounted to EUR 10.4 bn. FDI stock increased by 58% y-o-y, mainly due to a notable increase in the Swedish capital in the financial intermediation sector. Respectively, Latvia's FDI stock amounted to EUR 3.9 bn, up by 24% y-o-y. Amongst the Baltic States, the weakest increase was noticed in Lithuania, where the FDI stock amounted to EUR 5.3 bn, up by 19% compared to the corresponding quarter of 2004.

Harmonised consumer price index



Source: Eurostat

Average value of real estate contract over 1 mln

Estonia's real estate boom continued over the last year. The number of notarised purchase-sale contracts rose by 30% y-o-y and recorded 63,000 actions. The average value of a real estate contract has doubled in two years. In the fourth quarter of 2005, the average value of a real estate contract was slightly over 1 mln kroons, EUR 66,000. In the corresponding period a year earlier, the average contract price was EUR 43,000, and only EUR 34,000 in the last quarter of 2003.

The Baltics' euro adoption will probably be delayed

According to the World Bank's recent EU8 review, Slovenia is prepared to adopt the euro from January 2007, but this date may slip away for Estonia and Lithuania due to a strict interpretation of the Maastricht inflation criteria. Latvia's plans for adoption of the euro in 2008 may also be difficult to achieve.

However, the forthcoming economic assessment for the EMU candidates might by delayed from June to October 2006. This schedule would be better for Estonia and Lithuania in order to enter the euro area within the planned schedule. The Maastricht inflation criterion was 2.5% in December 2005. The candidates' 12-months inflation is allowed to be not more than 1.5 points over the average of the three lowest rates in the current euro countries. In January, Estonia's inflation rate stood at 4.6% and Lithuania's at 3.5%. Inflation in the euro-zone is expected to slightly accelerate in this year.

Taking into account their continuing record-high GDP growth, the Baltic States EMU entry seems to be delaying. However, this delay is not a catastrophe. Strict inflation control along with rapid GDP growth, rising oil prices, fixed exchange rates and structural factors such as an increasing shortage of a skilled labour force and the lowest overall price level in the EU, is unquestionably a complex equity. Moreover, The Baltic States currently fulfil the other EMU criteria.

Some business highlights

- Hansabank's net profit increased by 26% y-o-y in 2005. The profit amounted to EEK 3.7 bn (EUR 241 mln); SEB Ühisbank, Estonia's second largest bank, made a total profit of EEK 924 mln (EUR 59 mln), up by 25% y-o-y.
- A new passenger and cargo ferry route between Estonia's Sillamäe and Finland's Kotka was opened in February. The route is operated by the Narva Line, a subsidiary of Saaremaa Shipping (SLK).
- Estonian ferry group Tallink and Finnish Viking Line have made an undisclosed offer to buy Silja Line, which is owned by Sea Containers. The possible acquisition, in both cases, would need approval from the competitive authorities.
- In 2005, the Estonian retailer ETK's gross sales increased by 13% y-o-y to EEK 5.2 bn (EUR 330 mln). Swedish-Finnish Rimi's sales in Estonia amounted to EEK 5 bn (EUR 322 mln), up by 15% y-o-y. Estonian Selver's sales amounted to EEK 2.1 bn, Finnish Prisma's sales to EEK 1.3 bn, and Lithuanian VP Market's sales in Estonia to EEK 1.2 bn. All these retail chains plan to expand this year.
- Estonian Infortar, a major owner of Tallink, plans to build a leisure centre in Tallinn Lasnamäe district by 2010. The investment will be worth EEK 4-5 bn.
- The Estonian government is considering a possible re-purchase of a 66%-stake in Estonian Railways from the Baltic Rail Services (BRS) company. The Finnish state-owned railway operator VR and some Russian investors might also be interested in acquiring a majority stake in Estonian Railways. BRS wants EEK 3 bn (EUR 190 mln) for its holding in Estonian Railways.

Estonia - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	0.3	7.9	6.5	7.2	6.7	7.8	9.3		1-9/2005
Industrial production (y-o-y %-growth)	-3.4	14.6	8.9	8.2	11.0	8.0	9.7		1-12/2005
Inflation (CPI, end of period, y-o-y %-change)	3.9	5.0	4.2	2.7	1.1	5.0	3.6	4.6	1/2006
General government budget balance (% of GDP)	-3.7	-0.6	0.3	1.5	2.6	1.7			1-12/2004
Gross wage (period average, EUR)	284	314	352	393	430	466	555		Q4/2005
Unemployment (% end of period, LFS data)	12.9	13.9	11.9	11.3	9.3	8.5	7.0		Q4/2005
Exports (EUR million, current prices)	2 239	3 445	3 698	3 642	4 003	4 770	5 657		1-11/2005
Imports (EUR million, current prices)	3 224	4 615	4 798	5 079	5 715	6 704	7 448		1-11/2005
Current account (% of GDP)	-4.4	-5.5	-5.6	-10.2	-12.1	-12.7	-9.8		1-9/2005

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

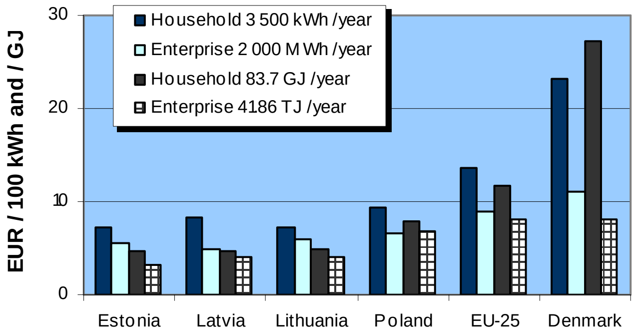
Latvia

GDP growth for 2005 expected to exceed 10%

According to preliminary estimates, Latvia's GDP expanded by more than 10% in 2005. Economic growth was driven by a rapid increase in the service sector, although a remarkable value added increase was observed in all economic sectors. In 2005, domestic trade grew by 21.3% compared to 2004, whilst Latvia's industrial output expanded moderately by 5.6% y-o-y. An extremely rapid increase was noticed in the value of foreign trade.

Latvia's Ministry of Economy, among others, forecasts that Latvia's rapid economic growth will continue throughout this year. The ministry foresees that GDP will increase by 8.5% y-o-y. The central bank's forecast is slightly lower, at 8%, which is in line with the forecasts set by international economic institutions. Latvia's further economic growth will still be based on the rapid increase in private consumption and investment. Moreover, the decline of unemployment will continue, supported with the increasing number of employees working abroad. Latvia's annual inflation rate is expected to be around 5.5% in 2006, thus slightly lower than during the past two years. Latvia's overall price increase has been the steepest amongst the EU-25 countries for almost two years.

Electricity and gas prices on June 1, 2005



Source: Eurostat

Despite a relatively rapid general price increase in the Baltic States since their EU entry, their current price level, as well as their wage level, is the lowest in the EU-25. One good measure is the price of energy products.

According to the comparison compiled by Eurostat, electricity prices in the Baltic countries for both household and industrial consumers are amongst the cheapest in the EU. In general, depending on the level of annual consumption, the price of electricity is around 30-50% below the weighted EU average. The gap is even larger when comparing gas prices – gas costs only 40-50% of the average price in the EU-25. Moreover, The Baltic States had also the lowest petrol prices amongst EU countries in 2005. The lowest price was noticed in Estonia – EUR 0.82, followed by Latvia – EUR 0.83, and Lithuania – EUR 0.86 per litre.

When taking into account relative price differences (purchasing power parity), the Baltic electricity prices are close to the average EU level. However, the cheapest gas price is still found in the Baltic States. How about Poland, currently the poorest EU country? Although energy prices are significantly higher than in the Baltic countries, Poland has the relatively cheapest passenger cars in the EU. Denmark holds the position of the most expensive EU country in these comparisons.

Exports expanded by 34%, imports 27% last year

Latvia's foreign trade turnover increased rapidly over 2005. A significant increase was noticed both in exports, which went up by 34% y-o-y, and in imports, up by 27% compared to 2004. Latvia's trade deficit increased by over LVL 300 million and amounted to almost LVL 2 bn (EUR 2.8 bn).

In 2005, more than a 50%-increase was noticed in exports of machinery and appliances, and in exports of food stuff and beverages. Exports of wood and articles of wood, Latvia's largest export group, increased by only 9% compared to 2004. Exports to the EU-25 covered 77% of the total export value and exports to CIS countries 12% of the total. However, exports to the CIS area grew strongly by 46% y-o-y. In 2005, Lithuania overhauled Germany as Latvia's main export partner by its 11% share. On the import side, Germany remained the largest import country, but Lithuania almost achieved it. Both Germany's and Lithuania's share was almost 14% of Latvia's total import value.

Travelling increased in 2005

Although Estonia remains a leader in incoming tourism in the Baltic States, the Latvian tourism business is developing fast. According to the survey by Latvian statistical authorities, border crossings increased rapidly last year. In the fourth quarter of 2005, the number of border crossings of foreign visitors departing from Latvia grew by 21% y-o-y to 877,000 persons. Correspondingly Latvian residents crossed the border 732,000 times, an increase of 23% compared to the corresponding quarter of 2004. Most of the border crossings were made by the residents of the neighbouring countries; Lithuania, Estonia and Russia. These countries were also the most typical destinations for the Latvian travellers.

Riga International Airport's position as a leading airport in the Baltic area is strengthening. In 2005, Riga Airport served almost 1.9 mln passengers, up by 77% compared to 2004. Respectively, a total of 1.4 mln passengers were served in the Tallinn Airport and 1.3 mln in the Vilnius Airport. Riga's airport expects to serve at least 2.5 mln passengers in 2006.

Some business highlights

- Arena Riga, the multifunctional arena for the next ice Hockey World Championships Games in May, was officially opened in mid-February. The arena was constructed by Merks, a subsidiary of the Estonian Merko Group.
- Latvia's insurance market grew by 20% in 2005. Risk insurance companies made up LVL 138 mln and life insurance companies received LVL 17 mln in premiums. The growth of life insurance was 87% y-o-y and risk insurance 15% respectively.
- In 2005, Latvia's banks aggregate profit increased by 67% y-o-y to LVL 193 mln (EUR 275 mln).Hansabanka's net profit amounted to LVL 41 mln, SEB Unibankas' to LVL 34 mln and Parex Bank's to LVL 26 mln.
- Latvia's credit institutions issued loans for LVL 6.96 bn in 2005. The amount of loans increased by 59%, and the volume of loans to households by 86% y-o-y.
- Latvian airline airBaltic will introduce a low cost ticketing model for its four routes (Bergen, Hamburg, Helsinki and Oslo) from Riga as from March 1. The company also plans to launch 10 new routes this spring, 6 from Riga, and 4 from Vilnius.
- Estonian Tallinn Group and Riga Freeport have finally made a contract to launch a new Riga-Stockholm ferry route in April. Regular passenger traffic between the cities stopped in October 2005 due to the bankruptcy of Riga Juras Linija.
- According to the European Commission, Swedish trade unions were right to act against the Latvian construction company Laval, which refuse to accept Swedish labour arrangements.
- Norwegian-owned Reval Hotels will build a new in Riga by spring 2007. The investment is worth EUR 30 mln. The company already has two hotels in Riga.

Latvia - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	3.3	6.9	8.0	6.5	7.2	8.5	10.1		1-9/2005
Industrial production (y-o-y %-growth)	-8.8	3.2	6.9	5.8	6.5	6.0	5.6		1-12/2005
Inflation (CPI, end of period, y-o-y %-change)	3.2	1.8	3.2	1.4	3.6	7.3	7.0	7.5	1/2006
General government budget balance (% of GDP)	-4.9	-2.8	-2.1	-2.3	-1.2	-0.9			1-12/2004
Gross wage (period average, EUR)	225	268	282	297	298	314	353		Q3/2005
Unemployment (% end of period, LFS data)	13.2	13.3	12.9	11.6	10.3	10.3	8.7		Q3/2005
Exports (EUR million, current prices)	1 613	2 020	2 232	2 416	2 559	3 204	3 323	4 086	1-12/2005
Imports (EUR million, current prices)	2 758	3 453	3 910	4 284	4 634	5 671	5 509	6 879	1-12/2005
Current account (% of GDP)	-9.0	-4.8	-7.6	-6.6	-8.1	-12.9	-11.4		1-9/2005

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

Lithuania

GDP grew by 7.3% in 2005

Lithuania's economic growth accelerated over the last quarter of 2005. According to the estimate by statistical authorities, the whole year's GDP growth amounted to 7.3% compared to the previous year. During the fourth quarter of 2005, GDP growth was 8.2% y-o-y. Although the Estonian and Latvian economies are currently expanding even faster, Lithuania's economic successful growth last year exceeded all forecasts, and was the third highest in the EU-25.

The Lithuanian economy in expected to increase at around 6% pace this year. Domestic demand remains the main engine behind further growth.

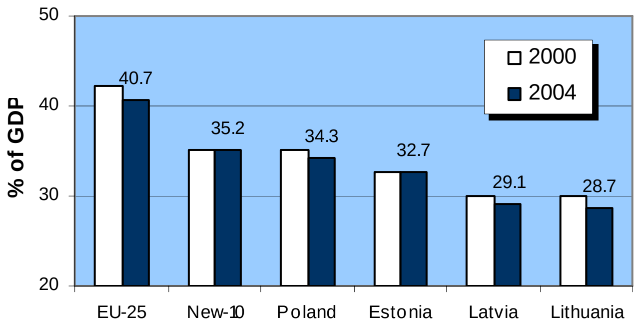
All main sectors expanded strongly in 2005

Lithuania's industrial output increased by 7.3% last year. Although the industrial sector expanded strongly in 2005, the growth rate was notably lower compared to the respective rates in the previous two years. In 2005, the increase by the manufacturing sector reached 8.6% y-o-y, driven by a significant growth in the manufacture of motor vehicles (32%) and other transport equipment (43%) and in the manufacture of non-metallic mineral products (34%). However, the largest export group, the manufacture of refined petroleum products grew by only 4% y-o-y.

In 2005, Lithuanian construction enterprises carried out own-account works for LTL 5.9 bn, up by 11% compared to 2004. The growth in the construction industry was based on the rapid increase in new construction.

The Lithuanian retail trade companies' turnover expanded strongly by 15% in 2005. The growth was mainly based on an increase of the sales of non-food products, which went up by 20% in a year, whilst the sales of food products grew by 7%. In addition, a significant increase was noticed in the turnover of restaurants, bars and catering enterprises, which grew by 24% over the year.

Tax revenue in the EU-25



Source: Eurostat

According to Eurostat, the Baltic States and Ireland have the lowest overall tax burden amongst the EU countries. In 2004, Lithuania's tax revenue was the lowest, at 28.7% of their GDP, followed by Latvia, Slovakia Ireland and Estonia. The highest tax burden was noticed in Sweden, where tax revenues constituted 51.2% of their GDP. In the EU-25, the aggregate tax revenue amounted to 40.7% of GDP.

During recent years, the overall tax burden, which also includes compulsory social contributions, has declined slightly in almost all EU countries.

FDI stock up by 12.5% in the third quarter

Lithuania's foreign direct investment stock totalled LTL 18.2 bn (EUR 5.3 bn) at the end of September 2005. The FDI stock expanded by 12.5% from the beginning of the year, or 19% y-o-y. During the first nine months of 2005, Russia-origin direct investment stock expanded by 71% or by EUR 280 mln. Therefore Russia's share of Lithuania's total FDI stock increased notably to 12.8%. At present Sweden is the largest investor country with its 13.9% share.

Lithuania's FDI abroad increased rapidly during the first three quarters of 2005. Direct investment stock abroad amounted to LTL 1.9 bn (EUR 540 mln), whilst the corresponding stock was below LTL 1.1 bn at the beginning of the year. In this period, Lithuania's investment to CIS countries expanded by 91%. A significant increase was noticed in Lithuania's FDI stock in Ukraine, in the Kaliningrad region, as well as in Russia in general. Moreover, FDI to Latvia and Estonian expanded notably in this period.

Within the first nine months of 2005, Lithuania's current account deficit was 6.9% of GDP. In the third quarter, the deficit slightly broadened to 7.6% of projected GDP.

Exports and imports expanded by one fourth

Rapid increase in Lithuania's foreign trade continued during 2005, driven by high oil prices and strong domestic demand. Comparing with 2004, exports increased by 27% and imports by 25%. Trade deficit widened by 18% y-o-y to LTL 10.1 bn (EUR 2.9 bn).

The growth of exports was mainly based on the strong increase in the export value of mineral products (mineral fuel), which went up by almost 40% y-o-y. Moreover, the export of vehicles increased by 38% and the export of machinery and equipment by 24% y-o-y. The growth of imports was driven by a strong increase in the import of mineral fuel, up by 64% in a year. The import of vehicles also grew strongly by 32%. Currently Russia holds the position of Lithuania's main trade partner, both in exports and imports.

Some business highlights

- Swedish low cost airline FlyMe will acquire Lithuanian Airlines, the formerly state-owned air carrier. Lithuanian Airlines was privatised in 2005 and sold to Lithuanian investors.
- Lithuanian Snoras Bank plans to open a branch office in Prague, Czech Republic. Currently the bank operates in Estonia, Latvia, Russia, Ukraine and Belarus.
- Lietuvos Telekomas' net profit increased rapidly by 250% in 2005 to LTL 84 mln (EUR 24 mln). However, the company's turnover grew by only 1.2% y-o-y.
- Lithuania has awarded 3G licenses to the mobile telephone operators Omnitel, Tele2 and Bite Lietuva. One licence cost LTL 3.5 mln. The companies are expected to start providing UMTS services this year.
- Vilnius will get a new stadium for football and athletics by 2009, when Vilnius will be the capital of European culture.
- SEB Vilnius Bankas group made a net profit of LTL 149 mln (EUR 45 mln) in 2005, up by 25% compared with 2004. Hansabankas' net profit amounted to LTL 137 mln (EUR 40 mln), up by 23% y-o-y. Nord/Lb Bank's profit more than doubled to LTL 41 mln (EUR 12 mln).
- Lithuania's largest retailer's, VP Market, sales amounted to EUR 1.5 bn in 2005, up by 25% y-o-y. Lithuanian retail chain Iki reached turnover of LTL 1.34 bn (EUR 378 mln), up by 13% y-o-y.
- In 2005, there were 536 privatisation deals in Lithuania for the total value of LTL 310 mln (EUR 91 mln). The largest single action was the privatisation of Lithuanian Airlines (LAL) for LTL 25.7 mln.

Lithuania - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	-1.7	3.0	6.4	6.8	10.5	7.0	7.3		1-12/2005
Industrial production in sales (y-o-y %-growth)	-9.9	2.2	16.0	3.1	16.1	10.8	7.3		1-12/2005
Inflation (CPI, end of period, y-o-y %-change)	0.3	1.4	2.0	-1.0	-1.3	2.9	3.0	3.5	1/2006
General government budget balance (% of GDP)	-5.6	-2.5	-2.0	-1.4	-1.2	-1.4			1-12/2004
Gross wage (period average, EUR)	231	263	274	293	311	333	373		1-12/2005
Unemployment (% end of period, LFS data)	15.3	16.9	17.9	13.0	11.6	10.6	7.2		Q3/2005
Exports (EUR million, current prices)	2 583	3 841	4 778	5 526	6 158	7 478	9 502		1-12/2005
Imports (EUR million, current prices)	4 340	5 650	6 767	7 943	8 526	9 959	12 446		1-12/2005
Current account (% of GDP)	-11.2	-5.9	-4.7	-5.1	-6.8	-7.7	-6.9		1-9/2005

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

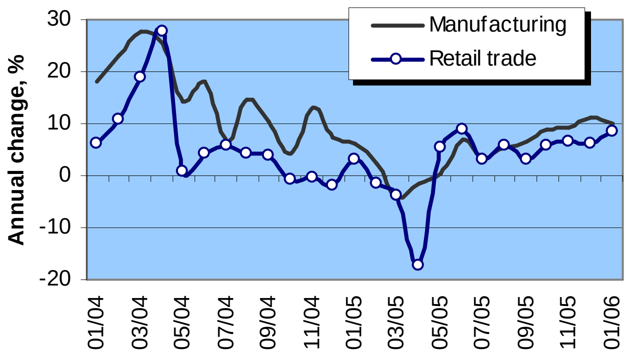
Poland

GDP growth around 3.2% in 2005

Poland's economic growth in 2005 is estimated to reach 3.2% compared to the year 2004. However, in the fourth quarter of 2005, GDP growth accelerated to around 4.5% annual pace. During the fourth quarter, industrial output expanded strongly by 8.4% and retail trade by 5.4% compared to the corresponding period in 2004, both remarkably better results than in the earlier quarters of 2005. Moreover, the growth of gross fixed capital formation increased rapidly, around 10% y-o-y in the last quarter.

Poland's economic performance in 2005 was a disappointment for both politicians and analysts. However, due to a notably better second half of 2005, expectations are quite optimistic for this year. Industrial production and exports are growing with stability despite the strong zloty, the inflation rate is the lowest since more than two years, and a slow decline of unemployment continues. GDP forecasts for this year are around 4.5%. In 2006, Poland's GDP growth is expected to be based on the increase in investments and consumption, although the growth of exports is also expected to remain strong. However, the further strengthening of the zloty might violate the competitiveness of the Polish export sector.

Growth in manufacturing and retail trade



Source: Central Statistical Office of Poland

Poland's industrial output expanded by 4.1% in 2005, and manufacturing slightly faster by 4.3% y-o-y. The growth of industrial output was remarkably lower than in 2004 or 2003, but accelerated during the latter half of the year. In 2005, the most significant increase was noticed in the manufacturing of medical, precision and optical equipment, up by 21% y-o-y. In addition, the manufacturing of machinery and equipment grew strongly by 18% compared to 2004. The manufacture of coke and refined petroleum products went down by 10%.

Despite the extremely weak first half of 2005, Poland's retail trade volume increased by 3.9% last year. The rapid increase was noticed in the sales of furniture and household appliances, which grew by 27% in a year. On the contrary, the sales of motor vehicles dropped more than 10% y-o-y.

In 2005, the Polish construction sector grew by 7.3% y-o-y, constituting the sector's highest increase in this decade.

Inflation at a record-low level

In January 2006, Poland's consumer price index stood at 0.7% y-o-y remaining at the lowest level since mid-2003. Compared to January 2005, housing prices increased by 3.1% and transport by 2.2%. On the contrary, prices in clothing dropped by 6% y-o-y. Poland's inflation is expected to accelerate slightly in 2006, along with faster economic growth, to around 2% annual rate.

In January, Poland's central bank's Monetary Policy Council decided to cut interest rates by 0.25 points bringing them to the lowest level in history. The base reference rate now stands at 4.25%. This impending interest rate cut was due to low inflation and a strong zloty. In 2005, the National Bank of Poland cut the reference interest rate five times from 6.50% to 4.50%.

Foreign investors satisfied with Poland

According to the opinion poll on the investment climate in Poland, conducted by CMB Indicator for the investment agency PAIiIZ, foreign investors are increasingly satisfied with locating their business in Poland. According to the survey, the most important factors for investing in Poland are the size of market, competitive wages, projected GDP growth, qualifications of workers and the availability of human resources.

Budget deficit at PLN 30 bn in 2006

The Polish parliament (Sejm) approved the state budget for 2006 in mid-February. According to the budget, revenues will amount to PLN 194.2 bn whilst spending will reach PLN 224.7 bn. The budget deficit was set at PLN 30.5 bn for this year. The state budget foresees privatisation revenues of PLN 5.5 bn in 2006, of which PLN 4.3 bn will be contributed to the budget. The estimate general government deficit is 3.1% of projected GDP in 2006.

According to preliminary data from the Ministry of Finance, Poland's budget deficit amounted to PLN 28.6 bn or 2.9% of projected GDP last year, whilst the deficit was estimated at PLN 35 bn in the budget for 2005. This better than expected result was influenced by higher tax revenues and dividends paid by state-owned companies. However, privatisation revenues in 2005 amounted to only PLN 3.8 bn, which is almost 2 bn less than the budgeted amount. Poland aims to cut its public deficit below the Maastricht criteria – 3% of GDP – by 2008.

Some business highlights

- Microsoft Corporations plans to establish a software engineering centre in Warsaw. This will be the company's third such centre in the world.
- South Korean LG Electronics plans to invest over EUR 100 mln by 2011 in the new household appliances and LCD television plants in Kobierzyce near Wroclaw. Another Korean electronics manufacturer Samsung plans to expand its R&D centre in Warsaw.
- In 2005, Polish banks' aggregate net profit amounted to PLN 9.2 bn (EUR 2.3 bn), up by 30% y-o-y. Poland's largest bank PKO BP earned a net profit of PLN 1.8 bn.
- French Royal Canin will build a new cat and dog food plant in Niepolomice by mid-2007. The investment is worth EUR 45 mln and creates about 150 new jobs.
- The US-based car components producer Axle Manufacture plans to build a new factory in the Wałbrzych Special Economic Zone. The investment worth EUR 50 mln will be completed by next autumn.
- The largest distribution centre in Central Europe will be constructed in Poland. The companies Europolis and Poland Central plan to built a logistic park of 530,000m² to Piotrków Trybunalski. The investment is worth EUR 172 mln and would create up to 6,000 new jobs. The first phase should be opened this year.
- Cadbury Schweppes will invest EUR 100 mln in the new chewing gum plant in Skarbimierz by 2008. The project will create 500 new jobs.

Poland - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	4.5	4.2	1.1	1.4	3.8	5.3	2.9		1-9/2005
Industrial production (y-o-y %-growth)	3.6	6.7	0.6	1.1	8.3	12.6	4.1		1-12/2005
Inflation (CPI, end of period, y-o-y %-change)	9.8	8.5	3.6	0.8	1.7	4.4	0.7	0.7	1/2006
General government budget balance (% of GDP)	-1.4	-0.7	-3.7	-3.3	-4.8	-3.9			1-12/2004
Gross wage (period average, EUR)	401	472	557	544	497	505	591		1-12/2005
Unemployment (%, last survey in the year, LFS data)	15.3	16.0	18.5	19.7	19.3	18.0	17.4		Q3/2005
Exports (EUR billion, current prices)	25.7	34.4	40.4	43.4	47.5	60.0	71.7		1-12/2005
Imports (EUR billion, current prices)	43.2	53.1	56.2	58.3	60.3	71.8	81.0		1-12/2005
Current account (% of GDP)	-7.6	-6.0	-2.9	-2.6	-2.1	-4.2	-1.4		1-9/2005

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

Riga – the Capital City of Latvia

by Aivars Aksenoks

Riga, the capital of Latvia, is situated in the middle of the Baltic States on the Southern coast of Riga Sea Gulf of the Baltic Sea. Historically the development of Riga city has been largely determined by geographical location. The fact that Riga is situated in the centre of Latvia and the whole Baltic Region, as well as on the crossroads between the markets of European Union and the Eastern regions contributes to the improvement of social and economical situation of the city nowadays. Today Riga has become a well-developed and competitive metropolis with versatile economics and diverse culture in the Baltic Sea Region.

Since the second half of 1990 when the development of Latvia economics restarted, Riga has increased its role in the national economic and social processes at a considerably faster speed than the other regions of Latvia. Nowadays Riga with its stable economical environment and skilled human resources has become the main driving force in the development of Latvia economy. Comparing Riga to other cities in Latvia, GDP has grown slightly faster and reached 58% from the GDP of the country. The rapid development of Riga has created favourable conditions for non-financial and foreign investment increase in the city. The majority of the investment made in Latvia is concentrated in Riga. Now Riga fulfils the economic activities and has business centre function in Latvia. Its favourable geographical location, productive human resources and well-developed infrastructure turn the city into an attractive place for investors from all over the world. Foreign investment stock in the company capital of enterprises registered in Riga exceeds 1 milliard LVL.

At international level Riga city is one of the fastest growing metropolises in the Baltic Sea Region which development impacts further territory than administrative and state borders. The total space of Riga administrative territory is similar to that of other metropolises on the Baltic Sea Eastern coast, but the functional territory of Riga city is considerably larger than its official administrative territory. Riga functional territory or agglomeration occupies 7000 km2 with the population of 1,15 million inhabitants instead of 307 km2 with the population of 0,7 million inhabitants. It serves as a proof that the market is considerably larger from the regional aspect, providing wide opportunities for investors. Moreover, from the planning point of view the perspective development of Riga City should be considered in the context of agglomeration of Riga, Latvia and even the whole Baltic Sea Region.

Riga is a centre of well- developed transport infrastructure that includes Riga Harbour, Riga international airport and railway and road network. Due to this Riga is an important transport centre supporting the link between the Eastern and European Union markets. In perspective Riga could turn into the Eastern gateway city to Europe. Riga is also an important partner in international trade where Riga Harbour plays an important role. Riga Harbour is one of the most rapidly growing harbours in the Baltic Sea region with the turnover of 24 million tons per year. It is essential to note the development of Riga international airport, being the principal gateway to Latvia for the vast majority of visitors. In 2005 the flow of passengers exceeded 1,9 million. Foreign visitors take interest in Riga not only as a business centre but also as an attractive place for tourism activities.

Riga is also well- known cultural, education and tourism center. The attractiveness of the city lies in its diverse culture, socialisation manner and sports. In recent years Riga has been the host in a range of remarkable events. This year in May Riga is welcoming the event of a global significance - the World Hockey Championship 2006. Moreover, in November this year the NATO summit will be held in Riga, being politically significant event at international level. The importance of Riga in global and regional context positively influences the future of Riga development in the Baltic Region.

Riga is developing into dynamic city with its economy being based on knowledge and high added value industries with skilled human resources, investment and new technologies. Since Latvia's accession to European Union, Riga city has acquired new cooperation opportunities with Eastern and Western neighbours. In perspective Riga city looks forward to further development of cooperation with other European metropolises, especially in the Baltic Sea Region, to achieve economic prosperity and well being of society.

Aivars Aksenoks

Chairman

Riga City Council

Kalininingrad and the Baltic Sea Region

by Alexei Ignatiev

The Russian Exclave of Kaliningrad sandwiched between Poland and Lithuania in the Southern Baltic Sea Region is a tiny part of the so-called “Baltic Community”. It has less than 1 million of population and just 15,000 sq km of territory.

What is its current role in the Baltic Sea Region are and what it potentially could or should be?

Kaliningrad has been widely known as the place with the world’s largest amber deposits. Not so many people outside Kaliningrad are aware of the fact that jewelry pieces sold in the airports all over the world are made of raw amber extracted from Kaliningrad’s soil.

Another fact of interest is Kaliningrad’s exports of gas to the European and in particular the Baltic markets. This gas is extracted from Kaliningrad’s land and off-shore.

Among intellectuals, Kaliningrad is well known as the city where the outstanding German philosopher Immanuel Kant lived and worked. Though he lived a long time ago when the city was known under the name of Koenigsberg, Kaliningraders are very much proud of this fact.

Judging from the numerous discussions at various Baltic Sea Region Forums as well as from what one can read or hear in the Baltic mass media, Kaliningrad’s image leaves much to be desired. In the minds of many Western people Kaliningrad is associated with poverty, heavy pollution, organised crime – i.e. a source of potential and real troubles and threats for its immediate neighbors as well as other Baltic countries.

For me – I was born in Kaliningrad and spent almost all my life – it is not easy to admit that this image reflects the reality. Virtually, there is some truth in it (and one should admit it is so difficult to find a place elsewhere in the world with none of the above mentioned problems) but reality is quite different.

Now Kaliningrad is one of the most economically dynamic regions of the Russian Federation. Due to its specific location, market-oriented mentality of the population and the privileges of the Special Economic Zone established 10 years ago, Kaliningrad businesses not only survived but actively developed and expanded mostly to the mainland of Russia. Almost one third of all TV sets and vacuum cleaners in the Russian market are assembled in Kaliningrad. Kaliningrad is also among Russia’s leaders in meat and poultry processing. The numbers of cars and office space per capita are also among highest in the country.

On the other hand, Kaliningrad’s importance for European businesses will be growing, primarily for Poland and Lithuania, which are very active in the Kaliningrad market. Many of European businesses have been using and will use the region as a bridgehead for penetrating the huge Russian market.

As to prospects, I believe that with the new Russian Federal Law on the Special Economic Zone which has been adopted by the Russian Parliament and is to take effect this spring Kaliningrad will become an increasingly interesting location for implementing big business projects targeting both Russian and European markets. The new tax exemptions as well as relatively low land, energy and labor costs seem to be attractive for those enterprises, which are seeking to improve their competitiveness by reducing basic costs.

Definitely, to become a Baltic Tiger Kaliningrad needs to substantially improve its governance: simplified business-related regulations, reduced and ultimately eliminated corruption, developed infrastructure as well as skilled and disciplined labor force are the objectives to this end. To reach these goals the new Kaliningrad Region Government is elaborating new pragmatic policies, which are to be shaped in the Regional Development Program soon.

So the nearest future will show if Kaliningrad managed to obtain and use the advantages and opportunities of its new enclave location within the EU and new business law environment.

Alexei Ignatiev

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The Association of International Experts on the Development of the Kaliningrad Region

Baltic Rim Integration – Opportunity and Necessity

by Urpo Kivikari

All national economies that encircle the Baltic Sea region are now market economies, old or new ones. This means that national demands and supplies have a tendency to get international and united. On the one hand profit-oriented firms search new opportunities to market their products in the Baltic region. On the other hand, they look for advantageous inputs and favourable terms for subcontracting and other operations for relocation of production in this area. It is important to note that the exit of East-West barrier has given incitement to western firms to increase also their mutual cooperation. Many firms have found advantageous or even necessary to combine their efforts to carry out operations in former socialist countries and the Baltic Sea market.

An opportunity often means necessity, too. If the profitability of production could be improved by widening marketing to new areas or utilizing new inputs and partners in the Baltic region, the firms might be forced to benefit such possibilities. Otherwise, rivals that utilize those might get 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 countries and companies participating 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 whatever 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 the response to this challenge.

Traditionally exports and imports between two partners have consisted of different goods. This inter-industry trade which is based on different comparative costs in various countries. Today majority of trade between developed countries is intra-industry trade, that means exports and imports of similar goods. In the Baltic Sea region trade statistics indicate that new market economies' foreign trade is to quite high rate still inter-industry trade.

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

How "normal" or close to "potential" are the current trade flows? 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 like the distance between partners, their populations and income levels. 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 still bright also in these cases. More than any model the future development is based on economic growth and integration processes. Growth forecast for former socialist countries as well as their EU integration opens promising prospects for trade in the Baltic Sea region.

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 alongterm convergence and integration of the national economies.

In old market economies, FDI is a conventional operation. In new market economies of former socialist countries, FDI is still a fairly new phenomenon. Into all new market economies FDI has brought besides capital also new technology, managerial skills and culture, readiness for risk-taking and marketing channels to external market. FDI have remarkable spillover effect in the economy of host country. Investors usually try to obtain new market and/or advantageous situation for production. In some of former socialist countries the role of inward FDI is very important, but the outflow of FDI has been remarkable only for Russia. Likewise in trade also in FDI the intra-Baltic flows play dominant role.

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 encouraging factors. Russia contains the greatest natural resources in the world, a consumer and labor potential of a population of 145 million and limitless investment opportunities from the high technology to agriculture. But yet the truth is that FDI to Russia does not reflect these opportunities.

EU-Russia relations constitute a special issue of the Baltic Sea region integration process. EU-Russia relations have come a long way since relations between the EU and Russia were established in the beginning of 1990s. EU enlargement in May 2004 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. Paradoxically, EU enlargement , as such, increases EU-Russia integration more than any bilateral plan, agreement or programme between these partners could increase in foreseeable future. Although EU enlargement indisputably promotes integration between Russia and EU, many efforts are needed to secure that the integration really will work in the Baltic Sea region. Needed efforts will be deeply discussed in the conference “The Future Competitiveness of the EU and its Eastern Neighbours” hosted by the Pan-European Institute 1-2. September 2006, in Turku. (www.tukkk.fi/peiconference).

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The Baltic Rim Model

by Marcus Svedberg

As a political and economic concept, the Baltic Rim has been in the spotlight for about a decade. Cooperation among the governments of the region has increased rapidly and ambitiously in both scope and degree. The rationale for a closely integrated "Baltic Sea Economic Region" has been the topic of a bountiful supply of reports and conferences. Yet despite all the cooperation and the relatively high levels of integration in terms of trade and investment, the region needs more integration in order to stay competitive in the periphery of Europe. A continued push for economic and financial integration would not only boost regional competitiveness but could also serve as a model and a stimulus for deeper integration EU-wide.

The Baltic Sea region is doing rather well in economic terms, but arguably this is due mainly to the successes of the individual countries. Several analysts point out that more political will from the member states of the region is needed to realize the region's true potential. Their recommendations differ somewhat, but most often include improvements in infrastructure, human capital development and increased economic and financial integration as necessary building blocks for increased regional competitiveness, growth and ultimately, jobs and prosperity. In short, the level of engagement in the regions needs to move from cooperation and partial integration to more ambitious market integration. An alternative, less fortunate but probably more feasible, strategy would be to simply maintain the current level of integration. But this would likely mean that the full potential of the region would remain untapped.

If policymakers in the region do possess the will to push further, now is a particularly good time to demonstrate it. The next stage of integration is as much needed as it is unlikely to materialize elsewhere. The economic benefits associated with EU enlargement have already been exhausted and the EU member states have, at the same time, resisted or seriously weakened the proposals for further economic integration on an EU-wide scale. The failures to agree on the constitution, the service directive, the Lisbon agenda, and the free movement of labor give little hope that market integration will be driven from Brussels in the years to come. EU member states around the Baltic Sea could light the way by introducing a number of important joint policies for the region based on the principle of enhanced cooperation or other mechanisms.

The obvious first step would be to abolish the remaining restrictions on labor mobility within the region. Germany, Denmark and Finland should immediately remove the temporary restrictions on labor migration from the new member states. The countries in the region should jointly establish clear and transparent rules to avoid the labor market frictions that have become one of the most blatant features post-enlargement.

A logical second step would be to open up the labor markets for services as well. After all, one of the most important economic differences between goods and services is that many providers of the latter have been protected from international competition, thereby reducing competitiveness. The countries in the region cannot introduce the EU service directive on their own, but they can take the first steps toward an open market for services that does not discriminate against firms from other member states.

Integrating financial services more ambitiously could be a third initiative. The Baltic Expert Group argues that financial markets in the region are well integrated in terms of ownership but suffer from differences in regulation and supervisory overlap. A well-integrated financial system would have strong and positive effects for the trade and investment flows in the region.

A fourth measure could be to introduce a common corporate taxation policy. The tax reforms that have swept across central and eastern Europe were initiated in Estonia and will certainly reach a critical stage in 2006, when Poland plans to reform its tax system. There are already some effects of the increasing tax competition in the EU, as Finland and Austria have lowered their corporate taxes in response to low tax competition from neighboring Estonia and Slovakia. Many other longtime EU countries have or are planning to reform their taxation policies with at least implicit references to the increasing competition from the new member states. The EU Commission has proposed a common consolidated corporate taxation policy for the internal market, which is unlikely to materialize. It would be very interesting if the countries in the Baltic Sea region would take the lead on this issue by seriously discussing or even implementing a common corporate taxation policy.

These initiatives should not, of course, be viewed as alternatives to domestic policy-making. Reducing the cost of doing business in line with the recommendations of the World Bank Doing Business report and increasing competitiveness along Lisbon agenda lines should both be high on the domestic priority list.

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[1] See Berglöf et al (2005) "Prospering in the Periphery: Competition, innovation and economic integration in the Baltic Sea Region," The Baltic Expert Group, forthcoming.

[2] See for instance, Åkerholm (2005) "Why a Baltic Sea Economic Region? " Expert Article 23 in Baltic Rim Economies; and Svedberg (2005) "Tillväxten gynnas av olikheterna kring Östersjön" ITPS Tillväxtpolitisk Utblick No 8.

[3] Berglöf et al (2005).

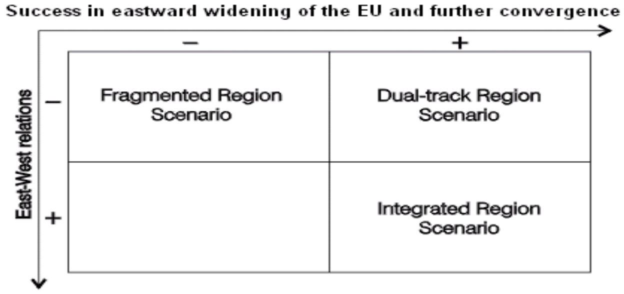
[4] Tervahauta (2005) "Platt skatt skärper konkurrensen om företagens investeringar" ITPS Tillväxtpolitisk utblick, No 9.

Futures Scenarios for the Baltic Sea Economic Space

by Erik Terk

The development of the first packet of scenarios, which was composed about 8 years ago by Erik Terk and Garri Raagmaa, was based on the premises that the development of a common region of cooperation will depend on the success, manner and rate of the EU expansion to the eastern Baltic rim (the accession of Estonia, Latvia, Lithuania and Poland) as well as the context and dynamics of the EU-Russian relations. It was presumed at that time that these two factors were interconnected. This did not refer to Russia's particular ability to prevent the Baltic States' EU accession, but the context of cooperation, which would appear between Russia and the enlarged EU after the accession. The main issue in this context was the role of the metropolis of St. Petersburg and its region in the future East-West cooperation.

Development scenarios of the Baltic Sea region



Regarding the possible events after the EU accession, the scenarios primarily concentrated on the introduction of the euro in the EU member countries, the convergence of the new members and the ways of involving Russia in economic cooperation with the EU.

The matrix depicted in the figure forms four possible development scenarios, three of which were developed in detail. For obvious reasons, the integrated region scenario was considered the most desirable, envisaging the establishment of a customs union between the EU and Russia by the end of the period and visa-free travel of North-west Russian residents in the EU territory.

When viewing the scenarios from the present-day vantage point, it can be stated that the EU enlargement was completed successfully without significant obstructions and approximately at the time forecast in the scenario. Estonia, Latvia, Lithuania and Poland will gradually increasingly integrate with the common economic space.

At the same time, the post-accession period has been characterised by the emergence of various factors obstructing further rapid integration. These were fears, typical of not the Nordic countries, but France, Germany and Austria, concerning the free movement of individuals and services, as well as the so-called social dumping of the new member countries. The scenario text forecast a relatively rapid accession of Sweden with the euro-zone, which has not taken place so far. Latvia has also problems with joining the euro-zone in the next few years due to high inflation rate (it is true that partly caused by the fast economic growth); the same may apply to Estonia. But since the scenarios were not drafted for a medium-length period but until 2015, there are no grounds for claiming that the positive developments depicted by the authors regarding the matrix horizontal axis could not taker place during the period. The developments along the horizontal axis can be generally judged as positive.

A separate issue is the question of the mutual integration of the Baltic States' economies and the geography of the Baltic States' economic relations within the EU. It was only with considerable reservations that the three Baltic States could be viewed as a common economic area. Trade between Latvia and Lithuania was (and still is) relatively voluminous, it is smaller, although still significant, between Estonia and Latvia, but very small between Lithuania and Estonia. Although no qualitative change has occurred in recent years, the trade and other economic cooperation between the Baltic States have become somewhat closer in the last 4-5 years. A tendency can be partially observed here: the decisions regarding integration in the Baltic States' markets are increasingly made in the head offices of the Nordic corporations. Significant differences could be observed in the foreign trade geography of the Baltic States: while Estonia already had very close and Latvia moderately close ties with the Baltic Sea countries and especially the Nordic economic area, Lithuania was a clear outsider in that respect. It has been claimed about Estonia's economy that it has become excessively "Nordic" and it would benefit from closer ties with the other EU countries. Yet the Nordic positions have not weakened in Estonia in the past 4-5 years with the sole exception of some weakening of Finland's role among Estonia's import partners (in other words, Estonia has somewhat diversified its import).

Along the vertical axis, i.e. the EU relations with Russia's and the CIS economic space, the development has been quite contradictory. On the one hand, the Russian economy has significantly (more than predicted) grown due to the devaluation of the rouble and the favourable situation in the world's fuel markets. Obviously, this makes meeting the Russian import demand to the EU highly attractive for the Nordic firms (e.g. Nokia). But even more important for the EU is Russia's role as a source of raw materials and fuel and for the border countries as a source country of the transit. But several tendencies predominating in Russia like certain distancing from the West (one of the indicators being the extremely indefinite state of a basic treaty determining EU-Russian relations in the future), the effective nationalisation of strategic enterprises, negative attitude towards the Western capital in sectors considered strategic, Russia's conflicts with the West regarding political control over the CIS states give reasons for concern. The EU has not succeeded in developing a common energy policy towards Russia, which results in a more vague energy cooperation in the future and in greater risks. The EU and particularly the Nordic firms have to some extent entered the Russian raw materials procurement and processing market (especially timber resources). The EU's Northern Dimension project remains in a rather vague state.

The above sets certain limits to the prospects of the EU-Russian cooperation. While these prospects are most likely positive regarding further trade (the impact of Russia's torturous movement towards WTO), they are unlikely to be encouraging regarding in-depth forms of integration. It is therefore still open, whether the further integration scenario should be sought in the top or bottom half of the figure. Among the EU member countries, this is crucial for Finland, Estonia, Latvia, Lithuania and possible Poland.

The developments in the new EU member countries on the eastern shore of the Baltic Sea depend, besides the background created by more or less favourable geopolitical or geo-economic factors, on these countries' ability to handle the tasks of modernisation and institutional development. The central factors in this process are taking advantage of the new technological opportunities, the development of new contemporary sectors of economy and coping with the inevitable increase of production input cost in the EU environment.

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