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Estonia

Economy halts – GDP -1.4% in Q2

According to a flash estimate by Statistics Estonia, the GDP decreased by 1.4% in the second quarter of 2008 compared to the second quarter of 2007. This was one of the worst figures for several years as the decline of the Estonian economy is getting steeper. Small domestic demand was to blame for the decrease in the value added of the manufacturing, wholesale and retail trades. Major factors influencing the downward trend were the decrease in the production of food, wood and building materials. According to Hansabank Markets, the optimistic scenario for Estonia projects an economic growth of 2.5% this year and 4% in 2009. However, the pessimistic scenario for Estonia projects an economic growth of 2% this year as well as for next year.

Inflation soars high

The increase in the consumer price index was 11% in July y-o-y according to Statistics Estonia. The change of the consumer price index y-o-y has been around 11% for several months now, with a peak value of 11.4% in April and June. The index was mainly influenced by the price increases of food, motor fuels and transport costs and increased prices of housing, mainly due to the rising prices of heat energy and electricity. The increase in the index from June to July was 0.7%. This was mainly influenced, among other things, by price increases in alcoholic beverages and tobacco products proceeding from the change in the excise duty rates and increases in housing expenditure, mainly due to rising electricity costs.

According to the Bank of Estonia, the domestic price rise should be slowing down. Despite the current high price level y-o-y, the domestic inflation rate should follow a steady downward trend in line with general economic cooling. The Bank projects that the month-on-month price growth in August will be one of the lowest of the past couple of years.

Change of the consumer price index in selected commodity groups in July 2008 (y-o-y, %)

Commodity group	y-o-y	Previous month
Food and non-alcoholic beverages	16.8	0.0
Clothing and footwear	1.9	-2.9
Housing	14.1	1.5
Transport	15.0	0.7
Hotels, cafés and restaurants	15.3	0.8
TOTAL	11.1	0.7

Source: Statistics Estonia

Real estate market still in deep trouble

The Estonian real estate market during the second quarter of 2008 is still in serious difficulties just like earlier. According to Statistics Estonia, the total number of notarised purchase-sale contracts decreased by nearly a third compared to the

corresponding quarter of the previous year. The total number of contracts has increased by 10% compared to the previous quarter, but since more contracts is a common real estate market phenomenon for Q2, it should not be taken as a sign of revival in the real estate market. In addition, the total value of the contracts has decreased by 43% compared to the corresponding quarter of the previous year and increased by 6% compared to the previous quarter.

Unemployment for construction sector workers has skyrocketed. Almost 3,000 construction workers were seeking work through the employment offices. This is nearly 60% more than a year before.

Industrial production still on a downward trend

The seasonally adjusted data of Statistics Estonia showed that industrial production did increase by 2% in June compared to May. However, in comparison to June 2007 industrial production decreased by 5%. The decrease was mainly affected by a continuous decrease in electricity production, which fell by 28%. Manufacturing fell by 2%. The decrease in manufacturing was mainly caused by the decrease in the production of food, wood and building materials like in spring earlier this year. According to the Estonian Institute of Economic Research, insufficient demand on the internal market in particular was mentioned as the key factor hindering growth by more than half of the companies studied.

However, some export-oriented industry branches enjoyed growth in their production. Mainly due to an increase in exports, the production of metal products (34%), electrical machinery (9%) and chemicals (3%) grew when compared to June of the previous year.

Some business highlights

- The ministry of the economy is planning the purchase of new trains. The investment would be worth around EUR 200 million, including new rolling stock and upgrading track and infrastructure. A significant part of the financing is expected from the EU cohesion fund.
- The Port of Tallinn received four bids from both domestic and foreign bidders for the construction of a new terminal in Muuga. The bids ranged roughly from EUR 77 million to EUR 92 million.
- The Estonian water company AS Tallinna Vesi has announced a net profit of EUR 7.3 million in the first half of 2008 which is over 4% lower than in the corresponding period last year. In the same time period, the company invested EUR 6.3 million and the company intends to rebuild a total of 16.1 kilometres of old water pipes this year.
- The Estonian energy company Eesti Energia has announced that it intends to capture a third of the energy market in the Baltics and become the energy market leader in the area by 2015. The company has already increased its customer base five times this year in Latvia. The increase is, however, not as impressive as it sounds since the company is now serving only 40 companies in Latvia.
- The Estonian construction company Merko has announced that it might have to close or sell its real estate subsidiary E.L.L. Kinnisvara due to the financial problems of the subsidiary.

Estonia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	7.9	6.5	8.0	7.2	8.3	10.2	11.2	7.1	-1.4	Q2/2008
Industrial production (y-o-y %-growth)	14.6	8.9	8.2	11.0	10.5	11.0	7.3	6.1	-5.0	6/2008
Inflation (CPI, end of period, y-o-y %-change)	5.0	4.2	3.6	1.3	3.0	4.1	4.4	9.6	11.1	7/2008
General government budget balance (% of GDP)	-0.6	0.3	1.5	2.0	2.3	2.3	3.8	2.8	n/a	1-12/2007
Gross wage (period average, EUR)	314	352	393	430	466	555	596	784	788	Q1/2008
Unemployment (% end of period)	13.9	11.9	11.3	9.3	8.5	7.9	5.9	4.7	4.0	Q2/2008
Exports (EUR million, current prices)	3445	3698	3642	4003	4770	6190	7647	8028	4208	1-6/2008
Imports (EUR million, current prices)	4615	4798	5079	5715	6704	8213	10576	11278	5487	1-6/2008
FDI inflow (EUR million, current prices)	425	603	307	822	775	2255	1341	1817	575	Q1/2008
Current account (% of GDP)	-5.5	-5.6	-10.6	-11.6	-12.5	-10.5	-14.8	-17.4	-23.7	Q1/2008

Sources: Statistics Estonia, Bank of Estonia, Eurostat, author's calculations

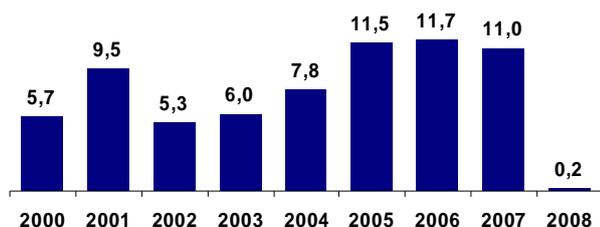
Latvia

GDP growth hits almost zero in Q2

GDP growth in the second quarter was only 0.2 % according to a flash estimate by the Central Statistical Bureau of Latvia. GDP growth was 3.6% in the first quarter and the GDP growth figures for corresponding time periods for the previous three years were over 11% annually. These statistics indicate that the Latvian economy is still suffering from a worsening economic situation. The reason for the slow down is to be found in industrial recession, among other things.

The Bank of Latvia is expecting relatively low growth later this year as well as next year. The development trends in industry and exports will have a key role in turning the economy towards a sufficient growth-rate in the long run. The Bank of Latvia has adjusted its previous growth forecast downwards to 2.5-2.7%. Additionally, consumer surveys in June have pointed to growing consumer pessimism regarding the perceptions and expectations of the Latvian economic development and family income. According to Hansabank Markets, economic growth will stay at a level of 1.3% for 2008 and 2009.

GDP growth in Q2 in 2000-2008 (y-o-y, %)



Source: Central Statistical Bureau of Latvia

Inflation still high but diminishing gradually

The consumer price level in July increased by 16.7% compared to May of the previous year, the Central Statistical Bureau of Latvia reports. Also the June inflation y-o-y was slightly less than in May, so Latvian inflation has, for the time being, seen its highest peak and is diminishing gradually. The rise in the price level in July 2008 compared to the previous month was 0.3%. The price increase of food and transport services had the greatest impact on the inflation level in April. However, the price levels of clothing and footwear and electrical household appliances decreased.

The Bank of Latvia projects that inflation will continue its gradual decrease together with the economic deceleration. However, factors such as higher energy prices in Latvia and abroad, in countries from which Latvia imports are reflected in the prices. Globally rising food prices are also factors preventing inflation from a rapid decrease. The Bank of Latvia forecasts an annual inflation of 13-14% in December.

Exports rose by 3% in June 2008

The value of exports rose by 3.1% in June 2008 compared to June 2007 according to the Central Statistical Bureau of Latvia. The largest increase in commodity exports in June, compared to the corresponding period of the previous year, was in base metals and articles of base metals with a 61.3% increase, in agricultural and food products (up by 15%). Exports in furniture went down by 33.0%, in wood and wood products by 27.1% and in textiles and textile articles by 21.5%. The largest increase in commodity imports in June, compared to the corresponding period of the previous year, was in mineral products, including among other things, oil, natural gas and electricity, with a 37.0% increase, in base metals and articles of base metals (up by 31.0%) and in agricultural goods and food products (up by 7.3%). Imports of wood and articles of wood went down by 57%, furniture by 38% and transport vehicles by 37%.

Compared to the previous month, exports decreased by 3.6% and imports rose by 1.8%. The largest increase in commodity exports in June, compared to May, was in products of chemical and allied industries (up by 8.9%). The largest decrease was in agricultural and food products, which went down by 9.8%. The largest increase in commodity imports in June compared to May was in base metals and articles of base metals (up by 28.6%). The largest decrease was in products of chemical and allied industries, which went down by 9.8%.

Industrial output in decline

The data of the Central Statistical Bureau of Latvia shows that industrial production has decreased by 6.4% in June 2008 compared to June 2007. Mining and quarrying was up by 0.8% but manufacturing decreased by 7.5% and electricity, gas and water supply by 1.8%. The reduction of industrial production volume was mainly due to decreases in the manufacturing of food products and beverages (down by 10.9%) and in the manufacture of wood and products of wood and cork (down by 7.9%).

Some business highlights

- Retail shopping mall operator Linstow Center Management is planning a EUR 400 million investment in building a new retail park near Riga. According to plans, the construction of the 750,000 m² retail park should commence in 2009.
- The Eurotex company is planning a EUR 4.9 million investment in the construction of a new intravenous solution plant in Ogresgals in Central Latvia. The plant's capacity is planned to be 8.5 million 0.5-litre units.
- Lithuanian investment company Invalda has received the permission of the Latvian authorities to purchase a 100% share of the Latvian investment management company Baltikums Asset Management from Akciju Komerbanka Baltikums. The cost of the deal was not made public. Invalda made a net profit of approximately EUR 25 million in 2007.
- Riga International Airport has announced a tender for the construction of a new low-fare airline terminal. The capacity of the new terminal would be 3-4 million passengers annually and the construction ought to be completed in 2009.

Latvia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	6.9	8.0	6.5	7.2	8.5	10.6	12.2	10.3	0.2	Q2/2008
Industrial production (y-o-y %-growth)	3.2	6.9	5.8	6.5	6.0	5.6	4.8	0.5	-6.4	6/2008
Inflation (CPI, end of period, y-o-y %-change)	1.8	3.2	1.4	3.6	7.3	7.0	6.8	14.1	16.7	7/2008
General government budget balance (% of GDP)	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	n/a	1-12/2007
Gross wage (period average, EUR)	268	282	297	298	314	350	430	683	645	Q1/2008
Unemployment (% end of period)	13.3	12.9	11.6	10.3	10.3	8.7	6.8	5.4	6.5	Q1/2008
Exports (EUR million, current prices)	2020	2232	2416	2559	3204	4085	4594	5727	3135	1-6/2008
Imports (EUR million, current prices)	3453	3910	4284	4634	5671	6879	8828	10986	5334	1-6/2008
FDI inflow (EUR million, current prices)	n/a	n/a	223	248	489	568	1324	1797	603	1-6/2008
Current account (% of GDP)	-4.8	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-22.8	-19.4	Q1/2008

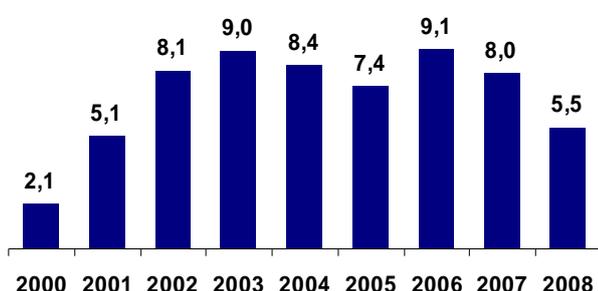
Sources: Central Statistical Bureau of Latvia, Bank of Latvia, Eurostat, author's calculations

Lithuania

More moderate GDP growth figures in Q2

According to Statistics Lithuania, the GDP growth was 5.5% in the second quarter of 2008 compared to the corresponding quarter of the previous year. This was somewhat slower than in the corresponding quarters of 2007 (8.0%) and 2006 (9.1%). Despite the weakening economic growth, Lithuania still enjoys a relatively strong growth which is substantially higher than the GDP growth of its Baltic counterparts in Estonia and Latvia. The Bank of Lithuania has projected in July that they expect the economic growth to continue on a level that is roughly half of the economic growth of the recent years in 2009. This would be a growth of approximately 4.0-4.5%.

GDP growth in Q2 in 2000-2008 (y-o-y, %)



Source: Statistics Lithuania

Inflation soars high

Consumer prices were 12.2% higher in July 2008 compared to July 2007 reports statistics Lithuania. Food products and non-alcoholic beverages (up by 18.1%) and housing, water, electricity, gas and other fuels (up by 17.5%) had the greatest impact on the price rise. The monthly rise in the price level in July 2008 was 1.2% when compared to June. Housing, water, electricity, gas and other fuels (up by 1.1%) as well as transport (up by 1.1%) and food products and non-alcoholic beverages (0.4%) had the greatest impact on the monthly price rise. In addition, the prices of clothes and footwear went down by 4.1%.

The Bank of Lithuania expects a high inflation level for the rest of the year as well. An average annual inflation of slightly below 12% is expected for 2008. The national central bank projects that domestic pressure on consumption prices will ease gradually and inflation is expected to move down gradually in 2009.

FDI in Lithuania decreased in Q1 2008

According to the provisional data of Statistics Lithuania as of 1st of April 2008, foreign direct investment into Lithuania made 9.7 EUR billion or 2.8% less than on 1st January 2008. In Q1 of 2008, the FDI flow was 185 EUR million, which was almost 60% less than in the previous quarter. The decrease was determined by a decrease in share capital and other capital on the borrowing and lending of funds.

Foreign trade grows in the first half of 2008

According to the non-final data of Statistics Lithuania, the value of Lithuanian exports rose in the first half of 2008 by 34% compared to the first half of 2007. The total value of exports in the first half of the year was EUR 7 971 million. Respectively, the value of imports rose by 25% to EUR 10 697 million. The foreign trade deficit was roughly EUR 2.7 billion, 4.8% more than in 2007 y-o-y. The monthly growth in June rose by 9.4% compared to May 2008. At the same time, the value of imports grew by 6.2%.

The decisive impact for the growth of exports in the first half of 2008 was in petroleum oils and oils obtained from bituminous minerals, which rose by 2.6 times and of fertilisers, which rose by 2 times compared to the previous year. The imports of crude oil and natural gas rose by 2.5 times and natural calcium phosphates and crude sulfur rose by 3.1 times compared to the first half of 2007.

The biggest share of exports in the first half of 2008 fell per mineral products (25.7%) while machinery, mechanical appliances and electrical equipment came in second position with a 10.4% share of total exports. The same commodity groups had the biggest shares in imports as well - the biggest share fell per mineral products (29.0%) while machinery, mechanical appliances and electrical equipment came in second place with a 14.4% share of total imports.

Some business highlights

- Polish oil company PKN Orlen has announced that it is interested in buying the remaining 10% of Mazeikiu Nafta from the Lithuanian government. PKN Orlen already owns a 90% share of Mazeikiu Nafta. Should the deal take place, it would be worth around EUR 180-190 million.
- Lithuania's largest retailer chain Maxima LT has tightened their belt. The company has put investments, worth approximately EUR 38 million, on hold and the company might also lay off workers.
- The new nuclear power plant took a step forward when the three Baltic countries and Poland agreed to establish a joint venture for the development of the project. Lithuania's national investment company Leo LT will formally set up the new joint venture in which Lithuania would hold a 51% stake while Estonia, Latvia and Poland would each have a 16.3% stake. The actual project implementation company will be established later.

Lithuania - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	4.1	6.6	6.9	10.3	7.3	7.9	7.7	8.0	5.5	Q2/2008
Industrial production (y-o-y %-growth)	2.2	16.0	3.1	16.1	10.8	7.3	8.9	7.2	3.8	7/2008
Inflation (CPI, end of period, y-o-y %-change)	1.4	2.0	-1.0	-1.3	2.9	3.0	3.8	8.1	12.2	7/2008
General government budget balance (% of GDP)	-2.5	-2.0	-1.4	-1.3	-1.5	-0.5	-0.3	-1.2	n/a	1-12/2007
Gross wage (period average, EUR)	263	274	293	311	335	421	459	594	623	Q1/2008
Unemployment (% end of period)	16.9	17.9	13.0	11.6	10.6	8.3	5.6	4.2	4.9	Q1/2008
Exports (EUR million, current prices)	3841	4778	5526	6158	7478	9502	11250	12522	7971	1-6/2008
Imports (EUR million, current prices)	5650	6767	7943	8526	9959	12446	15384	14341	10697	1-6/2008
FDI inflow (EUR million, current prices)	439	516	772	160	623	826	1448	1645	185	Q1/2008
Current account (% of GDP)	-5.9	-4.7	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7	-17.7	Q1/2008

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

Poland

GDP growth might slow down gradually

According to the National Bank of Poland, the Polish economy might be facing a gradual slowdown. Some members of the Polish Monetary Policy Council have pointed out, that the lower than expected growth of industrial output in June, falling growth in retail sales and deteriorating economic indicators during the summer, among other things, might indicate a slowdown in economic growth. In addition, limited investment and consequently lower GDP growth might also be a result of the likely deterioration of the profit ratios of enterprises.

Inflation up by almost 5%

The Central Statistical Office reports that the prices of consumer goods and services rose by 4.8% in July 2008 when compared to July 2007. Commodity groups with the highest price increases included food, all beverages and tobacco (up by 7.4%) and dwelling (up by 7.8%). The most notable decrease in prices was in clothing and footwear, which was down by 7.1%.

The total price level in July, compared to the previous month, stayed at the same level. The commodity group with the highest price increase was restaurants and hotels (up by 0.6%). The highest price decrease was found in clothing and footwear (down by 1.7%) and in food, all beverages and tobacco (down by 0.7%).

Price changes in selected commodity groups, July 2008 (%)

Commodity group	y-o-y	Previous month
Food, all beverages and tobacco	7.4	-0.7
Clothing and footwear	-7.1	-1.7
Dwelling	7.8	0.4
Transport	5.0	0.5
Restaurants and hotels	6.6	0.6
TOTAL	4.8	0.0

Source: Central Statistical Office

The National Bank of Poland has noted that the high wage growth of Poland represents a major risk factor to inflation in the medium term. In addition, the current heightened inflation, together with adaptive inflation expectations, poses a risk for inflation to stay at a relatively high level. However, it was also noted that despite the increase in the consumer price index, Poland still enjoys one of the lowest inflations of its region.

Foreign trade grows by a fifth in the first quarter

Polish exports rose in value to almost EUR 60 billion in the first half of 2008 which is 16.6% more compared to the corresponding quarter of the previous year, the Central Statistical Office informs. This was slightly less than in the first quarter when exports grew a couple percentage units faster when compared to Q1 in 2007.

Imports rose in value to almost EUR 70 billion in the first half of 2008 which is 18.6% more compared to the corresponding quarter of the previous year. This was also slightly less than in the first quarter when imports grew approximately two percentage units faster when compared to Q1 in 2007. Hence the growth of foreign trade has been somewhat more moderate towards summer than it was earlier in the year.

Industrial output increases by 7% in June y-o-y

Industrial production grew by 7.2% in June 2008 compared to the corresponding period in 2007. The output was up in 19 of the 29 industrial sectors and the highest growth was noted in mining-quarrying which was up by 9.7% and manufacturing which was up by 7.7%. In manufacturing sub sectors, the output of medical and precision equipment rose by a fourth. However, more moderate growth figures were registered in electricity, gas and water supply which were down by 6.9%.

Some business highlights

- Poland's second largest fuel company Lotos has updated its strategy until year 2012. According to company plans, the total corporation investment will amount to almost EUR 4 billion in 2006-2012 instead of the previously planned EUR 2.2 billion. The company is also planning to increase the production capacity of its Gdansk refinery from 6 million tons to 10.5 million tons of products annually.
- German power engineering company RWE plans to invest in the construction of a large coal-fired power plant in Silesia. The investment is worth EUR 1.5 billion and it is expected to be completed in 2015. The plant's output will be 800 MW.
- Poland's largest fuel company PKN Orlen has started the construction of a purified terephthalic acid (PTA) plant in Wloclawek, central Poland. The investment is worth EUR 1.1 billion and is expected to be completed by late 2010. The plant will produce 600,000 metric tons of PTA which is used in the production of plastics.
- Polish chemical producer Zaklady Azotowe Pulawy in Lublin has ordered a feasibility study for a coal gasification system in the plant. Pulawy is the largest industrial consumer of natural gas in Poland and the company acquires annually nearly 900 million cubic metres of Russian gas through the Polish Oil and Gas Company. The value of the system would be around EUR 600 million.
- Air Liquide, the French industrial and medical gas company, is investing EUR 100 million in two industrial gas production projects. First, the company will build and operate two gas extracting plants for Zaklady Azotowe Pulawy starting in 2010. Second, building a similar installation near Gdansk.
- A merger is planned between Fortis Bank and Dominet Bank for the summer of 2009. The new merged bank would be Poland's 11th largest and they are planning on opening at least 200 new outlets until 2012.
- According to an investment appeal report by Ernst & Young, Poland is considered as being the most promising investment destination in Europe, ahead of e.g. Germany and Russia.

Poland - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	4.2	1.1	1.4	3.8	5.3	3.5	6.1	6.5	6.1	Q1/2008
Industrial production (y-o-y %-growth)	6.7	0.6	1.1	8.3	12.6	4.1	5.7	9.7	7.2	6/2008
Inflation (CPI, end of period, y-o-y %-change)	8.5	3.6	0.8	1.7	4.4	0.7	1.4	4.0	4.8	7/2008
General government budget balance (% of GDP)	-0.7	-3.7	-3.3	-2.9	-3.3	-6.1	-3.9	-2.0	n/a	1-12/2007
Gross wage (period average, EUR)	472	557	544	497	505	591	692	825	909	1-6/2008
Unemployment (% end of period)	16.0	18.5	19.7	19.3	18.0	16.7	12.2	11.4	9.6	6/2008
Exports (EUR billion, current prices)	34.4	40.4	43.4	47.5	59.7	71.4	87.5	101.1	57.2	1-6/2008
Imports (EUR billion, current prices)	53.1	56.2	58.3	60.4	71.4	80.6	100.0	118.8	68.1	1-6/2008
FDI inflow (EUR billion, current prices)	10.3	6.4	4.4	3.7	10.0	8.3	15.1	12.8	5.5	1-5/2008
Current account (% of GDP)	-6.0	-2.9	-2.6	-2.1	-3.5	-1.7	-2.3	-3.7	-4.9	Q1/2008

Sources: Central Statistical Office, National Bank of Poland, Eurostat, author's calculations

St. Petersburg

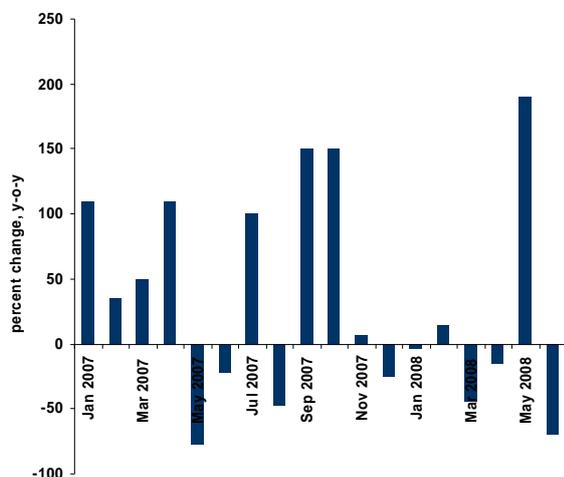
Deceleration persists

Regional economic growth continued to decelerate in April-June 2008, following the cooling of the year's first quarter. Russia, in general, grew fast in the first quarter of 2008: its GDP rose 8.5% y-o-y. But national results for the first half of 2008 are expected to be less impressive. Moreover, in the second quarter of 2008 St. Petersburg region's economic performance appeared to be worse than that of many other Russian regions. St. Petersburg's industry grew 5.2% y-o-y in January-June 2008, proving slower than other sectors of the regional economy, but stable enough. Despite a sharp 42.0% decline in transport machine-building, and stagnation (0.9% increase) by food and tobacco production, several branches achieved prominent growth. For example, in January-June 2008 regional producers of metal works raised their output by 25.4% y-o-y, and manufacturers of electric and optical equipment extended their production by 11.9% y-o-y. Another important leader of St Petersburg's industrial sector were chemicals, with a 10.6% y-o-y output increase in the first half of 2008. Comparatively successful in the first half of 2008 were communication and retail trade, growing 15.4% and 14.8% y-o-y respectively. Impressive 40.3% y-o-y growth of the transport sector was, to a large extent, a result of increasing transport tariffs, while real cargo turnover (in tonnes of cargo per kilometre) rose by 4.7% y-o-y only in the first half of 2008. So tariffs were raised in response to rapid growth in fuel prices: it increased by 22.7% since December 2007 till June 2008. But the most dramatic changes happened in construction.

Construction: recession has started

The construction sector, the source of contemporary financial crisis globally, started to contract in Russia. The volumes of residential construction in the country dropped down by 5.2% in the first half of 2008.

Residential space finalised, (m2, y-o-y % change)



Source: Petrostat, 2008

Moreover, recession covered the four key real estate markets of Russia: Moscow, St. Petersburg, Moscow Province, and Krasnodar Krai (where the state-financed construction of sport infrastructure for Sochi's 2014 Olympics was launched).

Oversaturated markets of real estate in these regions with skyrocketing prices became unable to devour the new supply of apartments and houses offered by construction companies. Therefore, St. Petersburg's construction sector reduced its output in square metres of residential space by 19.6% y-o-y during January-June 2008. A sudden rise of construction volumes in May 2008 did not change the overall picture, as May 2008 gave only 10.5% of the total half-yearly output (2.9% in May 2007 respectively); the month is a seasonal slowdown. Besides exhausted demand, high inflation became an important reason for the recession in the construction sector.

Inflation: a key problem

Inflation became the main economic disease both in Russia in general, and in St. Petersburg in particular. Consumer prices grew 9.2% since December 2007 till June 2008, which meant 14.4% y-o-y. This figure was even higher than CPI increase of 8.7% since December 2007 in Russia on average, which was defined by Prime Minister Vladimir Putin as a national economy target problem. Producer prices in St. Petersburg rose since December 2007 till June 2008 by 11.4%, surpassing regional CPI. Certain important items went up extremely fast: the price for construction concrete during January-June 2008 rose by 44.0% compared to December 2007; respective increase for ceramic brick was 26.8%. The price of one square metre of residential space in St. Petersburg grew 28.0% during the first six months of 2008. Transport and electricity tariffs also rose faster in January-June 2008, than a year ago. The only exception was the regional communication sector, where the prices rose by only 1.5%.

Some business highlights

- The 12th Petersburg International Economic Forum, held in early June, proved to be the top-rank image event of St. Petersburg in 2008. It became an arena for both economic and political discussions and negotiations. The sum of contracts, signed at the 12th PIEF, exceeded that of previous fora, and totalled EUR 9.4 billion.
- A winner of the concession tender for a right to construct and exploit the so-called Western High-Speed Diameter, or ZSD (a road connecting Basil Island with the northern and southern banks of the Finnish Gulf), was defined. It was a consortium of six companies, the biggest of which were Bazel, owned by Russian magnate Oleg Deripaska, Austrian Strabag AG, and German Hochtief. The total cost of the project is presently estimated at EUR 5.75 billion.
- A tender for projecting a new residential district in Juntolovo, a north-western suburb of St. Petersburg, was announced. The district with a residential space of 2.2 million square metres would be constructed by Glavstroy SPb, a big Russian developer. Its investment in the project until 2017 would total EUR 2 billion.
- Russian state holding Atomenergoprom contracted St. Petersburg's large machine-building company Silovye Mashiny to produce equipment for two renovated nuclear plants in Russia, one in Leningrad province, and another in Voronezh. The total sum of these two contracts exceeds EUR 1 billion.
- Construction of the fifth automobile plant in the St. Petersburg region, namely the plant of Hyundai Motor Company, was started in June 2008. The plant would be finalised and launched in 2011. Its annual production capacity is projected to be 100,000 vehicles; planned investment totals EUR 330 million.
- St. Petersburg's largest brewery, i.e. Baltika, continued its expansion to Siberia. The company invested EUR 143 million in its new brewery in Novosibirsk. Baltika plans to become a leader in the Siberian market, and to raise its share in this market from today's 31% up to 41%.

St. Petersburg - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	10.5	4.5	17.7	8.4	7.2	8.4	8.4	9.1	n/a	1-12/2007
Industrial production (y-o-y %-growth)	26.2	0.2	31.4	5.8	14.1	4.2	-7.0	10	5.2	H1/2008
Regional inflation (CPI, y-o-y %-change)	23.5	16.3	16.6	13.0	12.7	12.0	10.0	10.9	14.4	H1/2008
Gross average wage (monthly, EUR)	n/a	n/a	217	209	285	345	407	510	574	5/2008
Unemployment (% average annual)	7.9	4.4	3.5	4.3	2.8	2.4	2.4	2.0	2	H1/2008
Exports (EUR million, current prices)	2736	2134	1839	2429	3210	3954	5499	12978	3553	Q1/2008
Imports (EUR million, current prices)	2693	4423	5158	5123	5560	8081	10299	15093	3596	Q1/2008
FDI inflow (EUR million, current prices)	158.4	126.8	88.9	62.1	90.0	200.5	512.4	566.5	177.8	Q1/2008

Source: Petrostat, Rosstat, Central Bank of Russia, European Central Bank, author's calculations

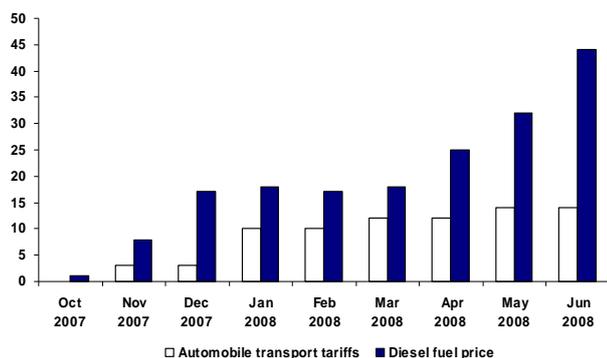
In 2002 and 2004 average wage is for December; in 2003, 2005, 2006 and 2007 wage is for November of corresponding year

Leningrad region

Economic stagnation starts

The first half of 2008 resulted in stagnation and certain decreases in nearly all sectors of the regional economy. This process goes in line with the same trend in St. Petersburg's economy, but has started earlier in Leningrad province. Industrial production, the engine of regional development, stayed at 0.5% y-o-y growth rate in January-June 2008. Industrial sector stagnation was a reflection of the negative results of the leading branches, i.e., the food industry and transport machine-building, which fell by 2.6% and 7.0% y-o-y respectively. Pulp and paper producers experienced a slight 1.3% growth, better defined as stagnation. Nevertheless, the regional forest industry raised its output in January-June 2008 by 15.4% y-o-y. This exception might exist due to an increase of export duties on wood logs, which previously were sold to Finland without any substantial processing on Leningrad province's territory. Another pillar of Leningrad province's economy, namely their transport sector, contracted by 7.9% y-o-y. Automobile carriers ceased their cargo turnover by 1.7% y-o-y, and the turnover of marine transport fell by 22.0% y-o-y in the first half of 2008. Only pipeline transporters, mostly export-oriented, experienced an insignificant 0.7% y-o-y increase of cargo turnover in the reviewed period. The aforementioned decline in automobile transport might have a negative impact on the operations of various businesses, especially in remote locations. The basic source of this contraction was rapid growth in fuel prices, unaffordable for automobile carriers.

Price change in transport, (m-o-m, %, Sept 2007 = 100 %)



Source: Petrostat, 2008

The communication and retail trade sectors, fast growing for the last eight years, decelerated as well. They increased by 6.4% and 9.0% y-o-y in January-June 2008. The rates were much lower than a year ago, when these sectors rose 12.2% and 11.6% respectively. Agriculture kept on growing, with a half-year increase of output equal to 3.5%. Despite its share in regional economy being less than 3%, the sector is very important for preserving employment, social stability, and the traditional lifestyle, especially in distant rural areas.

Construction mysteries

Construction has shown a contradictory performance in the first half of 2008. In the first quarter of 2008 the amount of square metres of residential buildings finalised in the region tripled, compared to January-March 2007. However, in May 2008 output by regional developers fell by 16.8% and in June 2008 by 27.1%. The construction cycle in Leningrad province is normally longer than, e.g., in St. Petersburg. Therefore, the bright results of the first months of 2008 might be the consequence of completing projects launched earlier. Despite housing prices being raised by 19.8%, the regional construction sector's financial outcome in the first half of 2008 fell by 5.7% y-o-y. Developers in Leningrad province, nevertheless, encountered much lower inflation than their St. Petersburg colleagues: in the province prices on construction hardware only went up almost half as fast.

Inflation cutting down incomes

Consumer prices in Leningrad province rose from December 2007 till June 2008 by 9.6%, equal to 15.2% y-o-y. In June 2008 CPI increased by 1.2% compared to the previous month; this growth corresponds to 16.6% per annum. The prices of regional manufacturers grew even higher, 13.9% during the first six months of 2008. And a half-yearly record was set by regional transport companies, who raised their tariffs by 23.6% during January-June 2008. Splitting the state energy producing monopoly RAO UES led to a 20.5% electricity price rise in February 2008, but in the following four months electricity even became slightly cheaper. Prices on cattle and poultry were also 9.6% lower in June 2008 than in December 2007, but this item was almost the only exception. High inflation decreased the real incomes of Leningrad province's residents. Despite the 31.6% y-o-y growth of nominal wages in January-May 2008, the real incomes of residents during the same five months went up by only 2.3% y-o-y.

Some business highlights

- LSR Group, St. Petersburg producer of construction hardware, started to build a new cement plant in Slantsy, Leningrad province. The plant, with an annual capacity of 1.85 million tonnes would be launched in 2010. On the first stage of the project LSR plans to invest EUR 390 million.
- The world's largest aluminium concern, UC Rusal, and OMK, a big Russian producer of metal ware, signed an agreement on constructing a transfer complex for metal cargoes in Ust-Luga, Leningrad province. The joint investment of the partners was estimated to equal EUR 270 million.
- The Agency for Regional development and Finnish company Container Finance Ltd OY agreed to create a techno park in Kirovsk, Leningrad province. The technopark would accommodate regional companies, which co-operate with the Finnish electro-technical cluster. The new structure is expected to employ one thousand local specialists and investments accounted for EUR 40 million.
- The Government of Leningrad province agreed to subsidise loans for constructing new cattle-breeding complexes in the region. The Government would repay 11% of bank's interest, or the Bank of Russia's minimum bid rate. The remaining part of the interest (6-9% on average) would be paid independently by investors.
- The Parliament of Leningrad province adopted a law, which enables permanent residents of the region to obtain land plots almost free of charge. A recipient of the plot should be a resident of the region for not less than five years, and he/she should not have any land property in the region. In case the recipient builds a dwelling house on this plot within 3 years after receiving, he/she gets a right to privatise it.

Leningrad region - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	12.8	8.5	16.3	14.6	8.8	8.3	8.1	8.5	n/a	1-12/2007
Industrial production (y-o-y %-growth)	26.8	10.7	35.6	20.9	10.3	5.9	26.9	2.6	0.5	H1/2008
Regional inflation (CPI, y-o-y %-change)	23.5	19.6	14.8	13.0	14.9	12.0	9.9	9.3	15.2	H1/2008
Gross average wage (monthly, EUR)	106	141	152	173	190	259	324	403	457	5/2008
Unemployment (% average annual)	12.7	10.8	9.6	9.2	7.5	7.8	6.2	3.3	3.1	H1/2008
Exports (EUR million, current prices)	1787	2350	2301	2580	3887	4862	5443	6078	1791	Q1/2008
Imports (EUR million, current prices)	328	810	939	1061	1372	2561	2858	4759	1320	Q1/2008
FDI inflow (EUR million, current prices)	222.5	266.0	121.9	104.5	106.6	178.7	288.0	276.5	88.1	Q1/2008

Source: Petrostat, Rosstat, Central Bank of Russia, European Central Bank, author's calculations

In 2000-2007 average wage is for November of corresponding year

Kaliningrad region

Industrial output growth came almost to a halt

Economic growth in the Kaliningrad region in the first half of 2008 was slower than in 2007 making recent economic trends in the region more similar to the surrounding Baltic states than to mainland Russia. Whilst in Russia, industrial production growth accelerated in 2008, in Kaliningrad it ground almost to a halt: Kaliningrad's industrial output grew by only 2.3% year-on-year (y-on-y) in the first 6 months of 2008. Output in the extractive and utility sectors actually contracted over the same period. Manufacturing still continues to grow but at much slower rate than in 2007. Car production, which was the main driver of last year's manufacturing boom, grew by just 6.5% in June 2008 y-on-y. Recent news suggest that manufacturing growth is unlikely to pick up in the next few months: Avtotor had to cease production of Chinese Chery cars in April and bankruptcy proceedings at the North West Forest Company, which owns one of two remaining pulp and paper plants in Kaliningrad, led to production decreases and significant lay-offs.

Growth rates by sectors (y-o-y, %)

	Jan-Jun, 2008	2007
Industrial production	2.3	40.3
Mining	-0.5	1.0
Manufacturing	14.5	93.7
Utilities	-4.5	0.3
Construction	46.8	9.8
Retail Trade	15.6	17.9

Source: Kaliningradstat (2007, 2008)

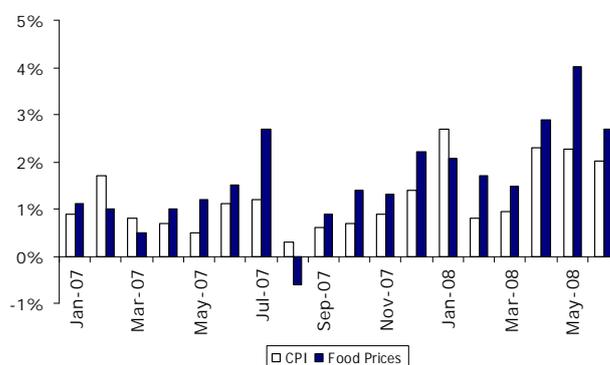
Construction activity remains robust: the volume of contract construction works grew by 46.8% y-o-y in the first half of the year. This year most of the growth came from non-residential construction, the total area of completed dwellings increased by a relatively modest 8.9% in the first six months vs. 68% in the same period last year. Apartment prices have also slowed their growth and increased by just 2.6% in the first half of year (less than CPI).

Private consumption growth in the region is still strong as evidenced by rapidly rising retail sales, which grew by 15.6% in January-June y-o-y. Sales of non-food items increased even more – by 21.3%. Growth in household incomes, as reported by Kaliningradstat, was substantially slower: real per capita income in January-May 2008 increased by 6.2% y-o-y. Consumer financing seems to become more constrained as well: bank loans to individuals (including mortgages) grew at 8% in Q1 (q-o-q) – the lowest rate in the last few years.

Food price growth pushes up CPI

Consumer price growth remains stubbornly high: CPI was up by 2.0% in June (m-o-m) pushed up mainly by food prices, which increased by 2.7%. Annual inflation in June reached 17.3% - the highest level since 2003. Food prices increased even more – by 25% in the year to June.

Consumer price index and food prices in 1/2007 - 6/2008 (%)



Kaliningrad exports fell precipitously

The transit character of the most of Kaliningrad exports was laid bare by recent changes in the customs rules in Russia. Now the export of goods is attributed to the region where these goods were produced. Thus oil exported through Kaliningrad but not produced there does not count as Kaliningrad's export anymore. It made Kaliningrad's exports drop by almost 80% in Q1 y-o-y (in USD) to USD 133 million (EUR 89 million). Now foodstuff, wood and wood products, and machinery account for 60% of Kaliningrad's exports (in Q1). At the same time imports grew rapidly, by 49% to USD 2.05 billion (EUR 1.37 billion).

Some business highlights

- Kaliningrad-based airline, KD Avia, signed a contract with Airbus to buy 25 new A-319s worth USD 1.7 billion in catalogue prices. The aircraft are expected to be delivered in 2014-2016. It is one of the largest orders for new airplanes placed by Russian airlines in recent years.
- Lithuanian ARVI opened a fertiliser plant near Chernyakhovsk. It will produce 250,000 tons of complex granular mineral (inorganic) fertilisers for the Russian and East European markets p.a. Total investment in the plant amounted to about EUR 12 million. ARVI is a resident company of the Kaliningrad special economic zone (SEZ) that provides tax holidays for investors.
- Danish logistics operator DSV has started the construction of 50,000 m² depot near Kaliningrad city. The first phase of the depot represents an investment of EUR 13 million. DSV became the 50th company to set up in the SEZ.
- Kaliningrad company, Fifth Element, will build a brick manufacturing plant with a capacity of 60 million bricks p.a. in the eastern part of the Kaliningrad region. The total project budget is EUR 42.6 million and it will be financed using the company's funds and a EUR 35.6 million loan from NOMOS bank.
- ADG Group will start the construction of a four star hotel in Kaliningrad in the autumn of 2008. Da Vinci CIS Private Sector Growth Fund will be a co-investor in the project, Swedbank will provide project finance and the Rezdor Hotel Group will be the hotel operator. Total investment in the project is expected to be EUR 32 million.
- According to the Russian business daily Vedomosti, the Russian state corporation, Rostekhnologii, bought a 24% stake in Kaliningrad-based shipyard Yantar. The shipyard is building 3 frigates for the Indian Navy under a contract worth more than EUR 1 billion.
- Moscow-based design institute Kurortproekt won a competition to develop a master plan for the Kaliningrad tourist special economic zone that is located on the Curonian Spit.

Kaliningrad region - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	15.2	3.4	9.5	9.3	12.6	3.6	11.6	n/a	n/a	1-12/2006
Industrial production (y-o-y %-growth)	32.4	12.9	4.2	4.7	22.5	27.4	66.6	40.3	2.3	1-6/2007
Inflation (CPI, end of period, y-o-y %-change)	17.5	21.0	9.8	17.5	11.7	11.1	7.9	11.2	17.3	6/2008
Gross wage (period average, EUR)	67	99	125	137	155	193	285	358	410	5/2008
Unemployment (% end of period, LFS data)	15.6	10.6	7.2	7.6	6.5	6.6	4.5	3.4	n/a	Q4/2007
Exports (EUR million, current prices)	514	508	497	507	876	1470	2025	3666	89	Q1/2008
Imports (EUR million, current prices)	947	1169	1701	1894	2419	3283	4275	5714	1370	Q1/2008
Exports (sales) to Russia (EUR million, current prices)	459	691	802	989	1449	1901	2471	3901	n/a	1-12/2007
FDI inflow (EUR million, current prices)	7.1	3.6	6.3	12.4	18.0	15.1	16.9	117.9	25.1	Q1/2008

Source: Kaliningrad Statistical Office, RosStat, Central Bank of Russia, author's calculations

EU-Russia customs cooperation – solving border congestion

By László Kovács

The deepening interdependence between the economies of Russia and the European Union is directly reflected in the growing volumes of our bilateral commercial exchanges. Over the last five years, the EU's trade with Russia has been increasing at an average annual pace of over 24 %. In 2007, its total turnover exceeded € 230 billion. The EU is also Russia's first trading partner, with over 50 % of the value of Russia's total foreign trade.

Our success in developing our bilateral trade relations, however, has come at a price. The ever growing volumes of goods exported or in transit from the EU to Russia have led to an increasing strain on our common border. Finland, Estonia and Latvia have witnessed increasingly long queues of lorries awaiting clearance, sometimes for days on end, with serious consequences not only of a commercial nature and not only limited to the costs imposed on economic operators. Lorry congestion also has an important environmental and social impact on communities near the border.

The EU and Russia are both well aware of this problem, which has been discussed at each of the last four EU-Russia Summits.

At the end of 2006, the Commission took the initiative, in agreement with EU Member States, to propose to Russia a number of structured short-, medium and long-term actions to bring about a sustainable solution, in line with our mutual interests, to congestion at our common border.

The result is that we have agreed with our Russian counterparts a strategy resting on concrete objectives that is in our power to achieve, and which is already becoming a reality. The strategy is based on three interconnected priorities for action:

- Implementation by Russia of legislative, administrative and procedural measures to improve the situation at the border, notably by reducing the number of agencies operating controls at the border;
- Implementation of a pilot project on exchanges of advance information. Consignments for which advance information is sent will benefit from facilitated customs procedures leading to shortened clearance time;
- Implementing and developing border-crossing and customs infrastructure on both sides of the border.

In order to follow up the implementation of these actions, we have set up a working group with the participation of EU Member States on a voluntary basis, the Commission and Russian Customs.

In the framework of this strategy the Community offers to provide advance customs information to Russia on a pilot basis. This gives the Russian authorities an excellent opportunity to streamline and increase the efficiency of procedures at the border. At the same time, the Russian Federation commits itself to using this information so that in return it can offer economic operators real facilitation at the border.

Already 13 EU Member States¹ have subscribed to this project and to sharing this commitment in engaging in exchanges of information. The necessary technical work is being carried out so that the pilot project can become fully operational, as scheduled, in January 2009.

The success of the information exchanges and of the ensuing facilitation from which consignments of goods will benefit depend to a large extent on the results of the ongoing reform of border activities in Russia. If trade continues to expand, the efficiency and processing capacity of customs on both sides of the border will need to increase even faster: should one of the actors in the chain of customs procedures be less efficient than the others, bottlenecks will ensue. This is the reason why we are particularly looking forward to the implementation of Russia's reforms which come under the first priority for action of the strategy we have agreed. The result must be a streamlined, transparent and efficient system of border controls which functions in a predictable manner and eliminates the scope for any arbitrary application of procedures.

The Community has supported Russia's efforts in customs reforms and will continue to do so through commonly agreed and

well-targeted technical cooperation projects. Indeed, the development of bilateral technical cooperation between Russia and the Community is of particular importance in order to achieve the compatibility of our respective customs systems as set out in the current Partnership and Cooperation Agreement.

A € 3 million project on the modernisation of Russia's transit system is already being successfully implemented. The Commission has also proposed another project, funded with € 5 million, which has the twin objectives of reducing the time necessary for the passage of persons and goods through the EU-Russian border, and of improving cooperation among Russian services as well as between them and their counterparts on the other side of the border.

In the longer term, we will also need to ensure that border-crossing and related infrastructure is of sufficient capacity to cope with ever increasing trade volumes. Russia and the EU have already discussed this issue at length, leading to useful exchanges of information on the two sides' infrastructure priorities as well as current and planned projects, including financing possibilities. We need to keep up this discussion so that the development of infrastructure on both sides can take place in a coordinated manner.

In the last meeting of the EU-Russia Sub-Committee on Customs and Cross-Border Cooperation², held in Moscow on 19 June 2008, the EU confirmed its commitment and willingness to proceed along the lines agreed with Russia. The pilot project on exchanges of information will be up and running from the beginning of next year. It is my sincere hope that the reforms of Russian border procedures currently being finalised will also be fully implemented as of that time.

The work that we have achieved so far and that we will accomplish from now on will make an important contribution to the preparation of the new Agreement between Russia and the EU, on which negotiations have just begun and which will eventually replace the current Partnership and Cooperation Agreement. This work will further strengthen our cooperation and help us in harmonizing and simplifying our customs procedures, with the ultimate aim of ensuring the smooth flow of goods in our bilateral trade.

Both Russia and the EU firmly believe that the strategy we have agreed is the right way ahead to solve once and for all the problem of lorry queues at our common border. The EU has shown its commitment to the implementation of this strategy. We expect that Russia will implement the very same commitment and devote all of its efforts to the necessary reforms. Through the parallel and simultaneous implementation of all three priorities of our joint strategy, we will produce a lasting solution to border congestion.

László Kovács

EU Commissioner for
Taxation and Customs Union



¹ Austria, Belgium, Czech Republic, Estonia, Finland, Hungary, Italy, Latvia, Lithuania, Poland, Slovakia, Slovenia and Sweden.

² This Sub-Committee is the main regular, high-level forum for the discussion of bilateral customs issues between the EU and Russia. Its meetings are chaired by the Commission's Director-General of Taxation and Customs Union and by the Head of Russia's Federal Customs Service. Member States may also participate.

Economy of Latvia – on the path to stabilization

By Kaspars Gerhards

Reforms and integration in the EU has made positive impact on economic development of Latvia. In the period of 2004-2007 GDP increased by 10.5% on average annually, which unambiguously reduced Latvia's backwardness in terms of the GDP per capita level compared to the EU-27 average level. High growth was ensured mainly by strong domestic demand, which was fostered by the growth of wages, household crediting and positive expectations of the future, as well as investments and exports.

Economic development in Latvia in the recent years had positive impact on the situation in the labour market. Latvia exceeded the average EU level in terms of employment already in 2006, when employment level in Latvia was 66.3%, but in 2007 it increased to 68.3%. Unemployment level has gradually reduced from 10.4% in 2004 to 6.0% in 2007, which is lower than the EU average. The number of unemployed reduced not only due to the increase of economic activity of the population. Since Latvia's accession to the EU in 2004, labour outflow to the old EU member states, which fully opened their labour markets for the citizens of the new EU member states, has been observed, causing labour shortage in some sectors of the economy.

Alongside with a high growth, economic disproportions developed and deepened since 2004, namely, inflation has increased and the current account deficit has deteriorated.

The imbalances of the Latvian economy are determined mainly by the following factors:

- High GDP growth, which outpaced potential,
- Growth was based mainly on rapid increase of domestic demand, which was fostered by credit expansion,
- Substantial wage growth caused by tight labour market conditions and emigration, and
- Loose fiscal policy in 2004-2006. Only in 2007 budget was balanced.

In order to reduce the overheating threats of Latvian economy, the government adopted *Inflation Reduction Plan* in March 2007. As a result of its implementation as well as cautious crediting policy of banks, domestic demand has slowed down. If during 2006 and the beginning of 2007 the quarterly growth rate of private consumption was about 20%, then in the second half of 2007 we can see that the growth of private consumption slowed down and in the first quarter of 2008 it was only 2.3%.

The decrease of private consumption and external situation, first of all, the instability of the global financial market, affected also GDP growth. Since the second half of 2007 growth rates declined. In the first quarter of 2008 GDP increased only by 3.3% compared to the respective period of the previous year. It means that economic growth started to decline substantially.

The main aim of the government at the current situation is to ensure soft landing of the economy and to create preconditions for increasing productivity and long term competitiveness.

In order to ensure those aims, Latvian government on April 15, 2008 has adopted *Macroeconomic Stabilization Plan for 2008 – 2009*. If Inflation Reduction Plan of 2007 was aimed to decrease domestic demand and crediting, then Macroeconomic Stabilization Plan pays particular attention to stimulating supply side of the economy.

Two key directions of Macroeconomic Stabilization Plan are as follows:

- To continue fiscal consolidation by developing budget with a surplus in 2008 and 2009, as well as increase effectiveness of budget expenditures and
- To implement structural reforms aimed at increasing productivity and long term competitiveness.

It is also foreseen to implement changes in the taxation policy, such as:

- To reduce tax burden on investment, by providing amendments in the Law on Corporate Income Tax and
- To amend the Real Estate Tax.

To increase productivity and long term competitiveness the Macroeconomic Stabilization Plan includes measures and concrete targets for:

- Reduction of administrative burden;
- Strengthening competition;
- Providing availability of finances for SMEs;
- Promotion of flexibility in the labour market;
- Development of knowledge based economy;
- Improvement of energy efficiency.

As regards the reduction of administrative burden, the key measures are aimed to:

- Improve the procedures of enterprise registration and licensing;
- Reduce costs related to employment;
- Optimize regulatory and control institutions in the construction sector.

One of the main tools for improvement of the business conditions is the Action Plan for Improvement of the Business Environment, which is being developed annually. In 2008 – 32 actions are identified in different fields.

Moreover, to ensure better regulation in 2007 the Ministry of Economics started 5 pilot projects to assess administrative burden in such fields, as tax legislation, labour legislation, construction issues and operations with real estate, as well as fuel market to increase bio fuel consumption.

To strengthen competition and anti-trust policy, amendments to the Competition Law are made, which will allow turning against substantial competition infringements more effectively.

In order to provide support for small and medium-sized enterprises of Latvia, the Cabinet of Ministers on May 13, 2008 has approved the *Supporting Programme for Improvement of the Competitiveness of Enterprises*. This programme will be implemented by the Mortgage and Land Bank of Latvia and its goal is to ensure availability of finances for improvement of the competitiveness of SMEs. The total amount of financing is 284.6 million EUR.

On April 8, 2008 the Cabinet of Ministers has adopted decision to establish holding fund with the aim to support export credit insurance/guarantees, risk financing (loans, venture capital), micro credit, portfolio guarantees and holding fund in the amount of more than 214 million EUR.

As it was mentioned before, the Macroeconomic Stabilization Plan includes also measures, which cover labour market, development of knowledge based economy and improvement of energy efficiency.

As concerns the labour market, measures include:

- Support of training and retraining of employees and
- Measures of the State Employment Agency in the area of fostering inclusive labour market.

Development of knowledge based economy foresees measures aimed to:

- Support the development and implementation of new products and technologies;
- Competence centres program;
- Technology transfer program, which is under way since 2007;
- Support to attract highly educated workforce.

Another issue, which is of crucial importance for Latvia is energy policy. I would like to point that there is a well established energy policy framework in Latvia and during the last years particular attention has been paid to the wider use of renewable energy and increase of energy efficiency.

Latvia supports limitations of the greenhouse gas emissions to facilitate achievement of set targets in Kyoto protocol. However, Latvia emphasizes that tightening up of the National Allocation Plan in order to achieve better climate protection should be well balanced with country's development needs. Setting emission allowances too low could detract investment and stem country's industrial development towards meeting the targets. I must say, that under the current emission allocation plan Latvia cannot ensure sustainable development.

Improvement of energy efficiency includes measures aimed to:

- Reduction of the losses in heating networks;
- Fostering introduction of new cogeneration power plants, based on renewable energy resources;
- Reduction of consumption of thermal energy in apartment houses.

In conclusion, it should be stressed that Latvia must work hard in order to develop knowledge economy, increase of competitiveness and improve the welfare of the population. The abovementioned facts witness that we go in the right direction. A lot depends from how efficient Latvia implements structural policy reforms and integrates in the EU.

Kaspars Gerhards

Minister of Economics

Latvia



Lithuanian transport sector – perspectives for development

By Algirdas Butkevičius

Lithuanian transport sector grew strongly in the year 2007, and an overview of the first half of this year also demonstrates a continuing character of this growth, revealing the optimistic patterns of further development.

The turnover of cargo in Klaipėda State Seaport has reached 15,9 million tons in the first half of 2008, showing an increase by 21 % comparing to the same period of 2007. What is more important, Klaipėda seaport continues its leadership among other ports of Baltic states, nearly doubling the handling of TEUs during last three years. In the first six months of this year, almost 182 thousands of TEUs were transported in Klaipėda. State enterprise “Lithuanian Railways” carried 28,6 million tons of cargo, which is by 10% more than during the first half of 2007, and the passenger traffic at the international Lithuanian airports went up by 23,7 %, recording a flow of 1,2 million of passengers.

These figures are important in the light of the whole Lithuanian economy. About 10 per cent of Lithuania's GDP is produced by transport sector. Transport operators are well established in the international markets and transport services account for almost 60 % of export of all services of Lithuania. This shows that a viable transport sector serves as one of the motors of economy and increases Lithuania's competitiveness. Moreover, for the period of 2007-2013, Lithuanian Government will invest 3,5 billion EUR to keep up with the growing demand of transport infrastructure.

Promoting intermodal transport

Intermodality has already become an imperative for a competitive transport system. Lithuanian intermodal approach deals mainly with the promotion of combined transport at Klaipėda and developing adequate logistics skills.

Growing demand for combined transport indicates the need to expand the cargo handling capacity of the port. In the short term, we are aiming at developing better interoperability between different transport modes in Klaipėda by reconstructing and building new rail and road infrastructure until 2010. This plan is an example of successful cooperation of various stakeholders: national and city authorities as well as business. The works will be funded from the national budget and EU funds. State enterprise “Lithuanian Railways” alone will invest more than 17 million EUR into better connections between maritime and inland transport.

A long term project is the construction of a deepwater port (-17 m deep) by reclaiming the land in open sea next to the nowadays port's entrance channel. According to the preliminary calculations in 2004, the costs of the project were 633 million EUR, but they may have doubled due to the inflation. Therefore, various investment strategies are considered, with clear prospects to private capital participation.

Comparing to the Western Europe, Lithuania has stronger experience in freight carriage by rail, which constitutes half of total freight carriage in our country. In order to use this experience and to make it advantageous, Ministry of Transport foresees the development of a network of public logistics centers, which form another part of intermodal approach to transport. As for today, Lithuania plans to build three such centers, near Vilnius, Kaunas and Klaipėda, at the preliminary total cost of nearly 104 million EUR.

Linking East and West

An unprecedented growth of trade and mobility of persons between Europe and Asia creates a great need for adequate transport connections. This determines Lithuanian ambitions to take part in the formation of global and regional transit policy.

Under Lithuanian proposal during the Eight Asia-Europe Meeting (ASEM) Foreign Ministers Summit on 28-29 May 2007 in Hamburg, the Ministers of Transport of Asia and Europe will meet for the first time under the framework of ASEM in Vilnius in 19-20 October 2009. Our initiative was welcomed by the ASEM member states as well as by the European Commission. Our major partner in Asia is China, and such countries as Singapore, Sweden, Vietnam and Germany have already expressed their political support and will to participate in the event.

ASEM Vilnius Ministerial will be a great opportunity to discuss the issues of Asia-Europe trade facilitation, creation of adequate transport systems and climate change. Moreover, the meeting will attract global attention to the Baltic Sea as well, providing the possibility to present transit capabilities of our region in the global transport flows.

Intensive cooperation with our closest neighbours is a necessity for the creation of the effective transport links between Europe and Asia. We have already witnessed the success of the combined transport train Viking, running from Klaipėda to Minsk, Kiev, and then to Odessa/Ilyichevsk, and thus connecting the Black and the Baltic seas. Under the agreement of Ukraine, Belarus and Lithuania, which was signed on 12 May 2008, this transport corridor will be developed further, by means of flexible tariff policy and facilitation of cross-border procedures.

With the implementation of the East-West Transport Corridor (EWTC), we are extending Viking and other transport corridors from the CIS countries to the Western Europe. Lithuania and Sweden recently expressed their support for further EU financial assistance to this project. Bearing in mind the fragile ecosystem of the Baltic Sea, we believe that being a “green corridor”, the EWTC will be a good example of successful sustainable development.

Connecting North and South

Due to the specific historic legacy, the inland transport infrastructure links of three Baltic states with the rest of Europe are insufficient even today. In order enable the mobility of goods and passengers throughout Europe, we have to build adequate infrastructure. One of such projects is the Via Baltica road route, which is being nearly finished on the Lithuanian territory.

Main priority for us as well as for the EU is the Rail Baltica project. The beginning of this year was very successful, as we have seen on 29 February, when the first meeting of the International Coordination Group for the implementation of the Rail Baltica project took place in Vilnius. Parties have agreed on the strategic importance of the project and stressed the need to start construction activities in a few years.

Need for stronger regional cooperation

In large part, many of the initiatives mentioned here concerns the whole region. The success of their implementation depends heavily on the level of cooperation among different countries and other stakeholders of the Baltic Sea Region. Thus, I do believe that common efforts will increase the competitiveness of Baltic Sea Region in the international transport markets.

Algirdas Butkevičius

*Minister of Transport
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Lithuania



Globalisation and the Baltic Sea Region

By Halldór Ásgrímsson

The Top of Europe has become more globalised and interconnected than ever before. But how do we develop welfare and growth further in the age of fast-moving globalisation? This is perhaps one of the most pressing challenges, not only for the Nordic countries but also for the entire Baltic Sea Region.

First of all the new globalisation challenges cannot be solved by a single country. Instead the nature of these challenges requires all countries and regions to take synchronised and coordinated action. Strengthening the region's global competitiveness is not only ambitious and highly demanding in terms of compliance with the Lisbon Agenda; it also requires stronger links between neighbours. One way of achieving welfare and growth is to pool our resources and utilise our expertise and know-how in a more strategic way around the Baltic Sea.

The Baltic Sea Region – the Top of Europe

The Baltic Sea Region has a great potential to become the world's leading region concerning welfare and growth. Almost every Baltic Sea country is growing faster than the EU average. We are a dynamic region that many other regions try to learn from. We must however further develop our regional cooperation and focus on both our strengths and on our weaknesses. Our countries have a very good chance implementing joint policies and thereby coping with the challenges and together turn them into added value and economic progress. In other words seeing the challenges as opportunities instead of treats – acting instead of reacting. Acting together and in partnerships.

Cooperation with partners around the Baltic Sea is not new to the Nordic Council of Ministers (NCM). We have since the beginning of the 1990s had offices in the three Baltic capitals, in St. Petersburg since 1995 and in September 2005, an office in Kaliningrad opened. They are an important part of the Nordic regional cooperation of today and will continue to be so. The forms for cooperation are developing and presently the NCM is working on new guidelines for its cooperation with the three Baltic countries and North-western Russia for the years 2009-2013. The new guidelines are expected to be approved later this year. But, we have also much longer traditions of trade cooperation as historically the Baltic has been a sea of trade. A few hundred years ago many of the Baltic cities belonged to the Hanseatic League, dominating commerce in Northern Europe for centuries as the world's first free trade alliance. We can be proud of this tradition and let it be an inspiration for our modern "Top of Europe" and a reminder that economic protectionism helps no one in the long run.

The Nordic Globalisation Process

Economic development or conditions supporting the economic development of the Nordic region, including the entire Baltic Sea region, stands high on the NCM's political agenda. This is seen clearly when looking at the "globalisation process" kicked off by the Nordic Prime Ministers in the summer of 2007. The objective of this Nordic globalisation process is to enhance a more skilled, visible and thriving Nordic region developing welfare and growth. Some key areas in this process are energy, environment, climate, research and innovation. Presently the NCM is working on a number of concrete projects supporting the Prime Ministers' overall globalisation policy objectives. Innovation offices in Asia, a joint Nordic energy expo, Nordic input into climate negotiations, joint promotions during the World Exhibition in Shanghai in 2010, promotion of higher education in the Nordic Region, greater mobility and freedom of movement, and joint investments in Nordic top-level research are just some of the important "Globalisation Projects".

One of the projects, a Nordic Globalisation Forum has already taken place in Swedish Riksgränsen in April 2008 and the next forum will be held in Iceland in spring 2009. At the forum in Riksgränsen the Nordic Prime Ministers confirmed in a

joint declaration the globalisation process set out in Punkaharju. A Nordic Globalisation Barometer focusing on how the Nordic region is doing in the world was also presented at the forum. The so called "Riksgränsen Declaration" and the Nordic Globalisation Barometer 2008 can be seen on www.norden.org. Another interesting report soon to be ready is the Baltic Development Forum's (BDF) "2008 State of the Region Report". The report, sponsored by the NCM and the Nordic Investment Bank, will give an overview and analysis of the economic situation in the Baltic Sea Region and will be presented this autumn at the BDF Summit in Copenhagen.

EU strategy for the Baltic Sea Region

An EU strategy for the Baltic Sea Region is also an important way of strengthening competitiveness and accelerating economic integration in the region. This strategy serves as one way in which even closer ties can be established between the Nordic and the other Baltic Sea countries, and will create a joint platform from which we can act together in an EU context. It is also important that we with our neighbours continue to work together within the framework of the Northern Dimension not least because Russia is and will continue to be an important partner for the whole region.

Regional cooperation is a necessity if we want our societies to be prosperous and to have economic growth in a sustainable manner in this age of globalisation. The expansion of the EU to 27 member countries has brought new opportunities within the EU, but it also has raised the level of competition and we will perhaps, in the light of the recent EU developments, experience a revival of smaller regional cooperation. We must work closely and efficiently together, both in a broad European framework and in smaller regional frameworks if we want to succeed in the competition for jobs, investment and knowledge.

Halldór Ásgrímsson

Secretary General of
the Nordic Council of
Ministers



The Nordic Council of Ministers

The Nordic Council of Ministers (NCM) is the forum for cooperation among the five Nordic countries and the three autonomous areas Greenland, the Faroe Islands and the Åland Islands. The NCM focuses first and foremost on making added value for the member through cooperation. A lot of this work is about acting jointly in different areas and learning from experiences of different policy approaches between comparable countries. The NCM has traditionally focused its activities on education, research, culture, social health affairs, the labour market, matters to do with economic, environment, foodstuff, forestry, resources of the sea, industrial and energy policy – in other words a continuation of typical domestic affairs within a Nordic framework.

Today the NCM is refining its sphere of activity and priorities within the new international and regional context. The above mentioned policy areas are still on the NCM's agenda, but the perspective is broadening and the actions are more focused. It is fair to say that Nordic cooperation today has four major perspectives; The Nordic region in its own traditional identity, the Nordic region as a part of the Baltic Sea region, the Nordic region as a participant in a larger European cooperation, primarily within the European Union and the Nordic region in a global context.

Baltic Sea as an energy route

By Pekka Haavisto

Baltic Sea has many users. It is a unique Northern biodiversity area, and many species are dependent on its biological condition. Industrialization, urbanization and chemicalization of the agriculture have all increased the pollution of the Baltic Sea. Too many rivers are still used as sewage channels towards the sea.

During the World War II – as well as many earlier wars – the Baltic Sea has also been a war zone. And after the war arms and chemical weapons have been dumped to the bottom of the sea. The military importance of the Baltic Sea has been remaining – despite the fact that the sea is often called the “Sea of Peace”.

For Finland the Baltic Sea is the main route for foreign trade – around 80 percent of our trade goes via the sea route. Even if not according to the maps, economically Finland is an island, dependent on the sea routes. Also the passenger traffic on the Baltic Sea is increasing. Maybe the rising prices of aviation fuel and concern for the changes in the atmosphere will in the future encourage even more people to use ships instead of planes?

In addition to all this, the Baltic Sea is also becoming a more important route for energy transport. I was last summer driving from St. Petersburg to Helsinki via Primorsk, prior to World War II known with its Finnish name Koivisto. It was Sunday, and there was a big outdoor party around an old Finnish church in the town center. When discussing with people, most of them were working in the harbor, which constitutes the new large Russian oil harbor at the geographical bottom of the Gulf of Finland. The capacity of this oil harbor is even increasing in the years to come.

This means more and more oil tankers in the Gulf of Finland and in the Baltic Sea. Everyone can understand what a bigger oil accident in this ecologically vulnerable area could mean. The building of the new harbor in Primorsk was anyhow dominated by economical and political factors, not by environmental ones.

When after the Soviet stagnation new investments in Russia emerged, many countries around introduced themselves as “gates” to Russia. This definition has never impressed Russians. They always remind you that the gate can be either open or closed. The idea of someone controlling their foreign trade or energy export is not very pleasant to Russians.

It goes without saying that guaranteeing the energy routes is nowadays part of the big politics. We all remember the Russia-Ukraine schism over the nature gas supply, and the recent conflict between Russia and Georgia, to take another example.

The Nord Stream nature gas pipeline between Russia and Germany will be a new dimension of using the Baltic Sea as an energy route. Actually the energy cooperation between the Western Europe and Russia is all the time deepening, and EU is becoming more and more dependent on Russian oil and nature gas. When selling the fossil fuels abroad, Russia is at the same time investing in new nuclear power plants. In the future it could increase its role also as an exporter of electricity.

When the Nord Stream pipeline was agreed between Russia and Germany, many EU-enthusiasts in Brussels were a little bit surprised. EU wants to increase its role in energy policy and in energy security, but the Nord Stream case shows clearly that the member states are making their own energy decisions still very independently. When the security policy in EU is deepening, there are also voices saying that

EU should create an energy security network, or something like “energy NATO”, for cases when individual member states are in crisis and need support for their energy supply. While EU is now increasing other collaboration in security and military affairs, it has still a long way ahead when it comes to a common energy security policy.

Countries around the Baltic Sea had different reactions to the Nord Stream project. Estonia took a hard line: it did not accept even any investigation of a southern route through its economic waters. Estonians were not delighted when Russian President Vladimir Putin announced that securing of the nature gas pipeline will be one of the new tasks for the Russian’s Northern Fleet. Estonia looked at the project from the point of view of its own national security, and objected.

The discussion in Sweden was also around the security arguments: The pipeline route is close to Gotland, and according to some voices in Sweden, new espionage technology could be inbuilt to the pipeline. In Russia this kind of thinking was labeled as science fiction, but Sweden has had some negative experiences with the Russians earlier.

When Estonia refused the southern route for the pipeline, in Finland we knew what is left: the northern route via Finnish economic waters. In Finland the pipeline debate has not been around security, but around environmental aspects. It seems that the most risky part is the construction phase, when the sea bottom needs to be made suitable for the pipeline, and also to eliminate mines and dumped chemical weapons on the bottom of the sea.

While the Finnish politicians have concentrated on the environmental impacts of the pipeline, in internet debate there has been also some security concerns expressed by the ordinary citizens. Many Finns remember the beginning of Winter War in 1939: Soviet Union set up an attack in its own territory in Mainila village, and used that then as an excuse to attack Finland. What if a terrorist attack against the pipeline is used as a new Mainila, concerned citizens are asking.

In my mind this kind of speculation is not relevant today, when peace remains all over around the Baltic Sea. But pipelines are long term projects, and for that reason it is good to assess also long term consequences. I think it is clear that also Finland has to invest more to the ecological and security control of the Gulf of Finland, due to the pipeline project. It is always better to be prepared, than to be taken by surprise.

Despite the increased economic use of the Baltic Sea, for many individuals the biggest value of the sea is aesthetic. I am not an exception. One of my favorite places to walk and sit on the coastline are the big cliffs on the Cape Porkkala, close to Helsinki.

What do you think when you stare to the sea? My colleague in the Finnish Parliament, Mr. Jacob Söderman had a good aphorism: “When I watch the sunset in Turku archipelago, I am sure that this is not created by the local social democratic municipal organization.”

Pekka Haavisto

*Member of the Finnish Parliament
and former Minister of Environment*

Finland



Russian politics

By Kimmo Kiljunen

The shift from a monolithic Communist-driven single-party system to a pluralist political system has been painful in Russia. The party political domain is developing. There is still a tendency for power to concentrate in the hands of a single party. Opposition is viewed as criticism of the entire system and, ultimately, criticism of the chief executive — and as such tantamount to treason. In Russia there is no concept of dissent in party politics or, as they put it in Britain, of 'Her Majesty's Loyal Opposition'.

Emerging democracy is characterized by abrupt shifts of opinion and an emphasis on extremities. Parties are highly combative, and politics tends to be fruitlessly confrontational rather than aiming at consensus or compromise.

In a society approaching democracy and pluralism by degrees, politics inevitably initially revolves around strong personalities. Indeed, the Russian party political system is a kaleidoscopic, constantly shifting field where parties rise and fade in tune with individual charismatic leaders. The names of parties, their composition and their alliances change dextrously as the needs of day-to-day politics dictate, and most political movements are better known by the names of their leaders than by their official rubrics.

Since Russian parties do not represent social movements or interest groups, politics is mostly about power rather than about ideologies. This makes it difficult to analyse the party system. Russian parties scarcely have exact counterparts in the European system, and it is extremely difficult to draw parallels.

One party has risen above all others, and the party political field is otherwise fragmented. Former president **Vladimir Putin** has openly declared that the objective is to create a European party structure in Russia, with a strong centre-right party and a centre-left party forming the core of political power.

Leading parties

There is one party that clearly outguns the rest. *United Russia*, Vladimir Putin's party, controls the Duma elected in 2007. It commands the majority required to amend the Constitution. *United Russia* is often described as the 'party of power' (*partija vlasti*), which illustrates the nature of the party well.

It is a centre-right coalition that supports the initiatives of the President/Prime Minister and his administration. True to its name as 'party of power', *United Russia* represents the current political elite and bureaucracy of the country. 'Staying in power' is the only ideology it needs.

The leading opposition party is the *Russian Communist Party*. It is the best organized of all parties.

The Communists are on a nostalgia trip and long to restore the Soviet Union. They have been mercilessly critical of the present powers that be, albeit without being able to offer any alternative responses to Russia's everyday problems. The party is unable to mobilize its widespread support as political capital, a situation which is not helped by its ageing membership and the geriatric party leader **Gennadi Zyuganov**.

The third party in The Duma is the right-wing populist *Liberal Democratic Party* led by the flamboyant **Vladimir Zhirinovskiy** has not challenged the ruling elite. Quite the opposite: the vitriolic demagoguery of the party obscures the fact that for the most part the Liberal Democrats have supported the policies of the President's administration in The Duma. However, their rabid nationalist populism has always guaranteed them success at the polls.

The reformist, West-oriented right-wing parties have not fared so well. Both the *Union of Right Forces* and *Yabloko* have failed to gain seats in the Duma as negotiations on an electoral alliance between them having failed.

The *Union of Right Forces* has been propounding a neo-liberal economic policy, supporting closer ties to the West and calling for reforms. Its supporters are for the most part young, entrepreneurial new-money types.

Yabloko is a Moscow-centred party of the intelligentsia and human-rights activists. It has a social-liberal platform. *Yabloko* has been a member of the Liberal International.

The fourth party in The Duma is a new party called *Just Russia (Spradetlivaja Russia)*. It was established in 2006 just before The Duma elections. It is the most serious effort by the president administration to advance the Russian "managed" or "sovereign" democracy towards bi-party system where both centre-right and centre-left are credibly represented.

The new party comprises three elements: the *Party of Life* led by **Sergei Mironov**, Speaker of the upper house, who is also the leader of the new party; the *Rodina* left-wing populist party; and the *Party of Pensioners*. The last one increased its popularity, in particular, after the government's social-benefits reforms in 2005 which caused major protests by pensioners throughout the country.

Would the *Just Russia* become a real and genuine centre-left force in Russian politics is to be seen. What is clear, the new party is created from the top and it takes time to consolidate its position as a strong and credible political force. The Party became an Observer Party in the Socialist International in 2008.

The matrix of Russian politics

The traditional European division into left-wing and right-wing parties seems ill suited to Russia's present political field. The extreme left — the Communists — are the conservatives. The ultra-liberals on the extreme right are the most radical reformists. They are also the most willing to engage in international interaction.

The quintessentially conservative values of 'home, faith, fatherland' are bread and butter for the extreme left, but they are also the rallying cry of the fundamentalist nationalist pan-Slavists and those portions of the right wing that appeal to traditional Russian nationalism. The community of the Russian people and Russia's superpower history is what they are nostalgic for. Or are they?

How can one analyse the political actors in Russia? Is it still all about a struggle between the market economy and the planned economy, or is it a question of political democracy versus single-party power? It is not that simple. There is no gateway to the past; a return to the old Soviet system is out of the question. Society is inevitably more pluralist and more open.

Today, Russia is steering a course between open international cooperation and isolationist traditional nationalism. At the same time, choices must be made between social responsibility and callous selfishness. The same political trends exist elsewhere in Europe too, but in Russia, the lines of division in the party political field are clearer and the confrontations sharper, due to the immature state of democracy in the country.

Globalization is shaping the domain of politics everywhere. The traditional left-right division is no longer adequate for describing political actors and parties. There is

a new dimension at play, that of global versus local, or open versus closed.

Instead of the traditional linear view, we must now view politics as a matrix. At its simplest, this works out as a four-field matrix. Its horizontal axis is the familiar right-left division, the tension between collective responsibility and individual freedom. The vertical axis is the tension between openness and internationalization on one hand and closed parochialism on the other.



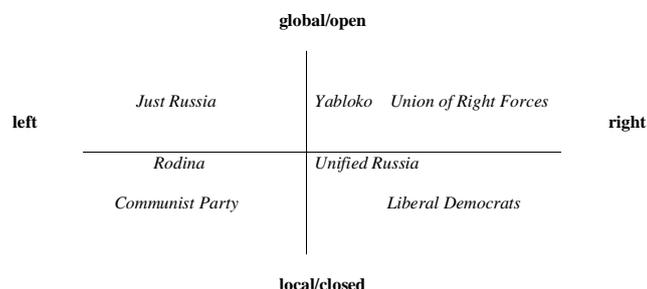
This four-field matrix is the only tool that can explain the curious unholy alliances that are political realities in Europe today, for instance in voting on the EU Constitution. The division between global and local permeates the entire political arena just as thoroughly as the traditional division between left and right. Attitudes to supranational integration constitute only one of its manifestations. The same division is apparent in the opposition of tolerance and rabid xenophobia. An open society is pluralist and democratic; a closed society is narrow-minded and authoritarian.

What about Russia, then? After the centrally led planned economy unravelled, its diametrical opposite emerged, the 'Wild East'. In the days of the Soviet Union, the Communists warned against the treachery of capitalism — and this devious system is exactly what was subsequently born in Russia, thanks in part to the Communists themselves.

Neo-liberal right-wing market-driven policies established themselves with a vengeance as soon as the Soviet Union had collapsed. In Russia, those who have sought to make society more open and more modern have also always sought to dismantle social controls and safety nets. This is most conspicuous in the platform of the *Union of Right Forces*, but the leading party has in practice pursued a similar policy.

As could be expected, there has been a reaction to this. The Communists on the left and the rabid populist Vladimir Zhirinovskiy on the right have widespread popular support for their policies of Russian isolationism, for their hankering back to the Empire that was, to Slavic cultural unity and the Orthodox faith. External influences and foreigners are anathema to both the extreme right and the extreme left. There is a breeding ground for pan-Russian nationalism. Conservative, authoritarian nationalism has a wide audience in Russia. Even the sacramental internationalization of the Communists, 'proletarian internationalism', was by its nature repressive, as open international interaction was forbidden under the Soviet regime.

Agents of tolerance and social responsibility in internationalization are struggling in Russia. One of the main reasons for this is that European-style social democracy is still conspicuous by its absence in the left wing of the political field. Perhaps **Mikhail Gorbachev** has been a modern-day Menshevik, but he is a voice in the wilderness.



There is a stiff challenge. How to create a strong and credible centre-left political power in Russia and to link that force to the international Social Democratic movement? European social democracy today emphasizes not only equality and social responsibility but also tolerance and international cooperation. Solidarity knows no national borders. Democracy and pluralism go hand in hand.

It is surely desirable both in Russia and abroad that an credible centre-left political force emerges in the country. Now there is a new political party, *Just Russia*, to fill this gap. Will this succeed is to be seen.

Kimmo Kiljunen

*Doctor,
Member of Parliament*

Finland



OP-Pohjola Group – appraising expansion opportunities in the Baltic countries

By Reijo Karhinen

OP-Pohjola Group is the leading financial services group in Finland with over 12,500 employees, total assets of EUR 71.5 billion and over 4,100,000 customers at 30 June 2008. The Group has a strong market position in Finland in all its main business areas – 33% of deposits, 32% of loans, 21% of mutual fund savings, 20% of life and pension insurance savings, and 27% of non-life insurance. A key strategic objective is to continue strengthening the Group's market position in Finland by utilising the cross-selling opportunities offered by the vast customer base and unrivalled service offering.

In the Baltic countries, OP-Pohjola Group currently has some 200,000 non-life insurance customers through the Pohjola-owned Seesam companies. Seesam is the 3rd largest non-life insurance company in Estonia with a 15% market share; Latvia's share is 5% and Lithuania's 3%. The Group's banking operations in the Baltic markets are minor, consisting of the operations obtained through the purchase of K-Finance in January 2008 and a representative office in Tallinn.

Baltic insurance market offers tremendous growth potential

The non-life insurance market in the Baltic States is still relatively underdeveloped. Insurance penetration rates are quite low (premiums 1.3-2.0% of GDP in 2007) compared to the European average (3.0%), insurance for private clients centres largely around motor vehicle policies, and insurance for businesses is only beginning to expand beyond compulsory insurance. General awareness of the need for insurance services and professional risk management practices is still at a modest level, and the risk evaluation and pricing methods of many insurance companies are also still inadequate.

That being said, however, it is equally evident that the Baltic insurance market offers abundant growth opportunities and we can expect to see very active product development, rapidly increasing penetration rates, and also substantial structural changes and industry consolidation in the relatively fragmented market during the coming decades. OP-Pohjola Group intends to take active part in these developments and we foresee that a substantial part of the overall growth of our non-life insurance business will emanate from the Baltic region in coming years.

Challenging short-term prospects for the Baltic economies and banking sector

The Baltic economies, particularly Estonia and Latvia, are currently experiencing a severe downturn and it is possible that it will take even 3-4 years or longer for these economies to return to growth rates anywhere near the impressive levels witnessed in 2005-07. Although forecasts vary greatly between experts and depending on the specific assumptions employed, one can safely speak of an economic crisis of considerable magnitude, which will have profound long-term effects on the economies in question. It should also be understood that although the economic difficulties of the region have been accelerated and magnified by the ongoing global financial crisis, the main causes of these difficulties lie elsewhere. Primarily, what the Baltic economies are now experiencing is an abrupt correction of fundamental internal and external imbalances that have accumulated over a number of years.

The substantial fall in property prices and other asset values, and the difficulties facing the construction sector will hit the Baltic banking sector hard. We can expect to see a marked increase in delinquency rates and credit losses, and significantly lower profitability over the next 2-4 years. Banks will also have to review their risk management practices and have already begun to tighten lending, which will slow down economic growth even further. The credit crunch will be lessened by the fact that all major players in the Baltic banking sector are foreign, mostly Nordic banks, which are quite well-capitalised and look set to ride out the financial crisis relatively unscathed. It remains to be

seen, however, how the smaller local players will be able to navigate through the treacherous waters of a simultaneous global financial and domestic macroeconomic crisis.

Long-term development of banking sector linked to developments in the Nordic region

The high levels of concentration and foreign ownership in the Baltic banking sector have been viewed at different times as both beneficial and detrimental factors from the point of view of the long-term development of financial services in the region. In the early days following independence, the entry of foreign banks was both a necessary and inevitable development, as it offered the only realistic solution to setting up an efficient, modern banking system quickly and safely. And overall, looking back across the past decade and a half, the development of the banking sector in Estonia, Latvia and Lithuania can and must be viewed as a great success story.

Looking ahead, the story becomes more complicated. Owing to the dominating presence of five major Nordic banks in the region, the future development of the banking sector in the Baltic countries is inextricably linked to wider developments in Nordic banking. Consolidation in the Nordic banking sector could lead to even higher rates of market concentration in the Baltic states, or it could also pave the way for new entrants and thereby an intensification of competition. In any case, the Baltic banking market will continue to experience large changes, but they will mostly follow as a by-product of external developments.

Expansion opportunities in the Baltic region under review

In June 2007, the policy guidelines concerning OP-Pohjola Group's international business operations were revised, allowing for the expansion of operations in neighbouring regions – more specifically, the Baltic countries and Russia. The decision reflects above all the rapid increase in cross-border economic activities and interdependence between Finland, the Baltic countries and Russia, and the consequent rise in customer needs and expectations regarding services across this region.

OP-Pohjola Group's approach to international expansion and service development can be summarised by saying that we want to evolve alongside our customers, supporting their development in ways that are in line with our own long-term objectives. As the demand among our current Finnish private and corporate customers for banking and insurance services in the Baltics and Russia is clearly growing, we have to respond to this challenge with a credible, financially sound and sustainable concept that satisfies those needs as much as possible. We are currently in the process of reviewing different options for expanding our presence in these markets and are therefore closely monitoring developments particularly in the Baltic economies and financial services sector.

The Baltic countries offer an attractive operating environment for a financial services group in many respects – dynamic, innovative, optimistic, liberal, and open to new ideas. We strongly believe that Estonia, Latvia and Lithuania will emerge out of the current economic malaise energised and rejuvenated and have an exciting, prosperous future ahead of them, and we want to play our own part in their continuing success story.

Reijo Karhinen

Executive Chairman

OP-Pohjola Group

Finland



Challenges facing the higher education in the Baltic countries

By Anders Paalzow

Economic growth, the knowledge society and the role of human capital and higher education are issues high up on the EU agenda as well as on the agendas of the individual member states – the Baltic countries, Estonia, Latvia and Lithuania being no exceptions. On the contrary, their demographic situation further accentuates the need for a higher educational system that provides good graduates whose full potential is unleashed. In the coming years the cohorts of secondary school graduates will be smaller and smaller. In Latvia for example, roughly 42,000 people were born in 1988, ten years later, in 1998, a mere 18,000 people were born.

In this context, the debate on the role of the educational system has in the Baltic countries to a large extent focussed on the secondary schools' ability/inability to provide graduates who are well-prepared for university studies. Nevertheless, in the following I will disregard this issue. The main reason for this is that despite what various rankings tell, I do not believe that the problem lies here. Based on my experience, working with Swedish elite students as well as elite students from the three Baltic countries, the Baltic students without any doubt outperform the Swedish ones. Comparing the students we have at the Stockholm School of Economics in Riga (SSE Riga) with their counterparts at the Stockholm School of Economics (in Stockholm), I would say that we can work at least 1.5 times harder with the Baltic students in comparison with their Swedish counterparts. Although both schools attract top students with high intellectual capacity, the Baltic ones are however better prepared for higher education (in particular they have stronger mathematical and analytical skills) and they are much more motivated than their Swedish ones.

Since there are many more highly talented students in the Baltic countries than the 120 admitted to SSE Riga annually, the question to be considered is how does the higher education system take care of these elite students – students that, if properly nurtured, could play an important role in transforming the Baltic economies into knowledge-based economies. My answer to this question would be "in general not at all". In other words many of the current problems emanates from the higher education system as such and its unwillingness to address issues related to the challenges that come with the knowledge society. In the following I will therefore discuss some of the issues that, to my mind, need to be addressed in order to unleash the potential of the Baltic students and hence of the Baltic economies:

- Full time studies. It is almost 'common practice' to work full time or close to full time while studying full time. This could hardly be optimal and, needless to say, there cannot be full time studies if students manage to work to that extent at the same time. In addition the wide spread acceptance of cheating contributes to making this possible.
- Quantity versus quality. The current funding of higher education puts a premium on quantity rather than quality. Since tuition fees are an important source of income, it is in many cases better for a higher education institution to admit as many students as possible rather than providing a quality education. This leads to a large spread in terms of intellectual ability and motivation within a given class of students, which in turn hampers the learning process. Overall the current system results in maximization of the revenues of the higher education institutions rather than of the social returns to education.
- Central planning. The current system suffers from central planning. There is a belief that the government by allocation tuition free places, so called "budget places", could influence the demand, e.g. have more students studying engineering. In reality this means that many students in let's say an engineering class are not there because they want to study engineering, but because they

could study there free of charge whereas they would have preferred to study law for example. In addition to a misallocation of human capital, the presence of non-motivated students does not contribute positively to the overall learning outcome.

- 'Diploma sickness'. The three Baltic countries still suffer from the Soviet heritage of 'diploma sickness', i.e. what is important is the diploma and the degree as such – not what is behind the diploma in terms of knowledge and skills. This has opened up for many 'academic' programmes that are of poor (or even worse) quality, many of them being offered by private institutions of higher education. This results in a situation where students waste their time and money on programmes of little, if any, value.
- Life-long learning. The current system does not recognize the need for life-long learning and the need to open up to new groups of students. Further contributing to the demand for life-long learning is the fact that a large fraction of the current labour force have a Soviet education that in many cases is obsolete in today's environment.

Failure to address these issues might not only make the route to the knowledge society more difficult, it might also discourage students to study at the higher education institutions in the region. Instead the most talented might leave the region and once they have done that it will be very difficult to lure them back.

A policy addressing these issues has to start with an overall improvement of the higher education programmes increasing the workload of students etc., making the Baltic countries' higher education institutions attractive from a learning point of view. This should be combined with the establishment of elite programmes and/or honours classes where the most talented students can release their full potential. In the light of this, it has to be emphasized that the governments have to recognize that quality costs and should thus be willing to support quality rather than quantity.

The scope of the higher education policy has to be broadened. It has to be part of an overall policy aiming at life-long learning. In this context it is important to keep in mind that a university education should provide the individual with the solid skills that are needed to develop his/her human capital and to adopt in an ever-changing environment, rather than being dictated by the short term needs of the labour market.

The scholarship system should be merit-based and not "subject-based", i.e. good students should get scholarships tied to the individual (giving him/her the freedom of choice) and not to the field of study. Issues such as lack of for example engineers or medical doctors should not be addressed by forcing students to study these fields. They should be addressed by taking a look at the lifetime earnings of graduates in these fields and the overall prestige of these professions. Central planning has never been a good idea, and this applies to education as well.

The current and coming generations of students are too precious assets to be wasted by a higher education system that does not allow them to realise their full potential.

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The EU strategy for the Baltic Sea Region and its links to the Northern Dimension

By Hanna Lehtinen

The idea of the Baltic Sea Region Strategy (BSRS) first came from the European Parliament and was fostered i.a. by the MEP Alexander Stubb, the current Minister for Foreign Affairs of Finland. Following the adoption of the EP report the Swedish Government took on board the initiative and declared the Baltic Sea Region Strategy to be one of the top priorities of the incoming Swedish EU Presidency. In December 2007 the European Council invited the Commission to present an EU Strategy for the Baltic Sea Region at the latest by June 2009.

The preparatory work in the Commission is led by the DG Regional Policy. During the spring, several member states from the region, including Finland, have presented their views and ideas to be included in the future Strategy in the form of various non-papers. On the basis of these contributions, the Commission has outlined four main priorities for the BSRS. These priorities consist of making the region 1) environmentally sustainable, 2) prosperous, 3) accessible and attractive, and 4) safe and secure. The contents of these four pillars will be shaped over the next year, during which the Commission is planning to organise various stakeholder events and thematic round tables around them.

The awareness and priority given to the Baltic Sea Region is also reflected in the Finnish Government's programme of 19 April 2007, which underlines the need to enhance EU-related cooperation in the Baltic Sea Region, to increase the political weight and visibility of our region in the EU, and to streamline regional cooperation networks. Clean Baltic Sea, as defined in the HELCOM Baltic Sea Action Plan, encompassing aspects relating to maritime security is a the key priority of the Finnish Government along with the creation and maintenance of a Dynamic economic region.

The BSRS should be mainly an EU internal strategy drawing on EU *acquis* and the resources and instruments of the Cohesion Policy. However, to reach concrete results, the EU needs to cooperate in many issues with other countries of the region sharing common interests. The December 2007 European Council Conclusions singles out the Northern Dimension framework for providing the basis for the external aspects of cooperation on the Baltic Sea Region.

How can the Northern Dimension framework be used in the Baltic Sea Strategy context?

The Northern Dimension (ND) has been part of the EU's external and cross-border policies since 1999. It covers North-West Russia, the Baltic Sea and the Arctic and subarctic areas, including the Barents region. During the Finnish EU Presidency in 2006, the Northern Dimension was reformed and it is now described as being a common policy of four equal partners, the EU, Iceland, Norway and the Russian Federation. The jointly negotiated Northern Dimension Policy Framework Document and the Political Declaration which define the ND as a regional expression of the so called EU-Russia "Four Common Spaces" guide the Northern Dimension work¹.

On a practical level, one of the main innovations of the Northern Dimension has been the concept of ND partnerships. The two existing ND partnerships, the Environmental Partnership (NDEP) and the Partnership in Public Health and Social Well-being (NDPHS), have produced tangible and concrete results, including the ND flagship project St Petersburg Southwest Wastewater

Treatment Plant. In addition to these, a new partnership on transport and logistics is under preparation with an aim of being approved by the next ND Ministerial Meeting in autumn 2008. Culture is another potential area of future cooperation.

How could the ND framework then be taken advantage of when designing the EU Strategy for the Baltic Sea Region?

Firstly, the various ND structures, particularly the ND Steering Group where the EU is represented by the Presidency and the Commission, can serve as a useful forum for exchange of information among the ND Partners EU, Russia, Norway and Iceland.

Secondly, building on their various achievements, the eventual potential of the ND partnerships for bringing together the internal and external aspects of the cooperation in the Baltic Sea Region should be further explored.

Thirdly, within the ND framework there are several different cooperation organisations in the Baltic Sea Region, and due attention should be paid on how to make better use of these organisations and how to avoid any overlap of work between them.

The four northern regional councils, the Council of the Baltic Sea States (CBSS), the Barents Euro-Arctic Council (BEAC), the Nordic Council of Ministers (NCM) and the Arctic Council (AC), are so called participants to the ND. The CBSS continues to be the forum for political discussions on the Baltic Sea Region, also on the highest level. The decisions of the Riga Baltic Sea Summit in June 2008 on the reform of the CBSS pave the way for the follow-up work aiming at narrowing down and defining the concrete cooperation areas where the CBSS work will offer real added value to the Baltic Sea co-operation. The NCM can also have an important role in supporting the implementation of the BSRS. As to the other northern regional councils, also their work and roles need to be assessed where relevant.

In addition to these "ND participants", there are number of other relevant regional organisations which can play a useful role. For example in the environmental sector, the key structure for the Baltic Sea is the HELCOM, and its Baltic Sea Action Plan adopted by the Ministerial in Warsaw 2007 constitutes a useful framework document for the coming years.

Finally, as to the financing of the EU Strategy for the Baltic Sea Region, the Northern Dimension model consisting of co-financing of several financial sources – the EU budget, national budgets, private sector, IFIs, such as IBRD, EIB, EBRD, NIB – should serve as a model. Setting out clear strategic priorities for the region as such should contribute to better use of the existing financing opportunities. The existing Baltic Sea Regional Programme and the relevant CBC programmes including the ENP CBC programmes at large already provide the countries of the region with a useful tool for regional co-operation and the Strategy should further enhance their implementation.

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¹ http://ec.europa.eu/external_relations/north_dim/

Prospects for EU-Russia relations

By Fraser Cameron and Aaron Matta

With the start of negotiations for a new agreement between the European Union and Russia in July the stage is set for a new chapter in this controversial relationship. But the conflict between Russia and Georgia in mid-August has given many EU member states pause for concern. At an emergency EU foreign ministers meeting on 13 August, which endorsed a French Presidency peace plan, some argued that the EU-Russia talks should be suspended until Russia removed all its troops from Georgia. Others argued that the blame was not entirely on the Russian side and the talks should continue. These divisions between member states have plagued the EU in trying to agree a common approach towards Russia.

The last 20 years have brought momentous changes in Russia which have had an impact on the EU-Russia relationship. When the old Soviet communist system collapsed in 1991, Russia emerged as a reduced nation state with its own system of market economy and democracy. Russia is still struggling to come to terms with the loss of its superpower status based on empire, ideology and missiles and trying to create a new one based on its energy muscle. During this period, the EU has also undergone major changes, some of which such as the 2004 enlargement (and the NATO enlargement) have had a significant effect on EU-Russia relations.

Despite the political souring of relations, economic relations are moving rapidly ahead. Most EU countries have significantly increased their trade with Russia over the past few years. Exports have tripled in some cases, while imports from Russia have doubled; a trend which is due mainly to increased costs for Russian energy supplies. Two way investment has also increased substantially although there are some fears about the Kremlin's interference in business disputes.

The EU-Russia relationship is governed by the 1997 Partnership and Cooperation Agreement (PCA) which reached the end of its initial ten year period in November 2007, but which was automatically prolonged as neither side wished to withdraw. The PCA spawned a considerably network of political and official ties between the EU and Russia which should not be underestimated. While the PCA has worked reasonably well, within its limited parameters, there was a feeling on both sides that ten years on it should be replaced with a broader agreement reflecting the changed political environment. At the 2003 St Petersburg summit the EU and Russia decided to work towards establishing four "Common Spaces" (economic; freedom, security and justice; external security; and research and education) to provide a more detailed framework for mutual cooperation. The Common Spaces were an important move ahead in the relations but since they are not legally binding as the PCA they are incapable of holding the relationship together.

Despite the EU's previous failed attempts to include Russia into a policy addressed to a group of countries, such as the European Neighbourhood Policy (ENP), Russia has on several occasions expressed the desire to be treated as an equal. Therefore, if negotiated, a new PCA would have to be a sui generis type of agreement.

What are the options for the new treaty? The Commission view is that the more issues on the table the easier it will be to reach a comprehensive deal. What is clear, and major challenge, is that the EU has never attempted to negotiate such a comprehensive package with a third country. Some experts have suggested an Association Agreement as the basis for closer integration with the EU, other a reciprocal treatment such as with the US. But this will all mainly depend on the legal approximation approach taken by the sides in the next agreement – which is not favourable to Russia in its present form in the PCA. Therefore, an approach is needed in which Russia will feel respected and not pressured by the EU. Thus hopefully, Russia will eventually make the necessary logical moves towards approximation – possibly inspired by the need to

create a Free Trade Area (FTA) with its proximate biggest economic partner or by the inevitability of having standardised legislation in the WTO framework in order to incorporate its economy into the rest of the world.

No one doubts that any new agreement will involve tough and onerous negotiations. The economic elements to be included in the new agreement, especially the prospect of a free trade area, will directly depend on Russia's accession to the WTO. Given EU dependence on Russian energy, this chapter will be a particularly contested area of the negotiations. It is unlikely that the Russian side will agree on including in the new agreement any reference to Russia's ratification of the Energy Charter Treaty (ETC) and its Transit Protocol, and even if it does, it is doubtful whether Russia will comply with it. However, mentioning of the 'energy dialogue' is important since it is one of the main areas of economic relations and should consequently, at least at a political level, be regulated.

Conditionality will be another difficult area. The EU intends that, the new agreement should, like the PCA, include the commitments to the UN and OSCE and the so-called 'conditionality clause' as an essential element of the agreement, whereby the PCA could be unilaterally suspended if there is any human rights violations. Additionally, the principles of the Council of Europe and the European Court of Human Rights (ECHR) as stressed in the Common Strategy should be included in the PCA. These elements would demonstrate that Russia and the EU have a common international legal basis for the protection of human rights.

A comprehensive new agreement would, besides linking all the aspects of cooperation, reinvigorate economic integration – envisaging practical steps to establish a FTA –, improve cooperation on energy, and add legal weight to the four common spaces. Any new agreement should also have as a very minimum the same standards referring to European values as the old PCA.

The EU has significant but limited leverage on Russia. Its powerful internal market and its consumption of Russian energy resources do give it important bargaining chips. But although its leverage is limited, the EU cannot give up on values as these are in the interests of both sides. An EU-Russia relationship that did not have values at its core would be a relationship not worth having.

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Creative dissent will enhance Baltic business

By Kalle Euro

At the Turku School of Economics' sixth European Day of the Entrepreneur, held in June of 2008, Åbo Akademi University and Royal Institute of Technology (Stockholm) professor Alf Rehn delivered a presentation that challenged positive associations with the current buzzword "creative". Rehn suggested that people coddle creativity like a pet bunny: it is generally regarded as something inherently good and sweet, and there is an emotional unanimity concerning the need to support creativity. However, this is precisely what suffocates it: creativity should incite, challenge, question and change things.

Rehn hit the mark in his critique: creating something new is all about changing things. The creation of the new requires unlearning, which is no easy thing to do. Resistance to change is the opposite of making new things, otherwise known as creativity. When creativity is reduced to little more than a common slogan, creativity itself is in danger of being forgotten for fear of causing irritation.

Creativity requires the identification and recognition of problems

Creativity is a prerequisite for not only art and culture, but also innovations, inventions and product development. Reshaping things demands the ability to come with ideas as to how things as they are right now can be improved as well as the identification and recognition of problems therein. Merely parroting common slogans does nothing to support this kind of thinking. On the contrary, it removes critical thinking from the equation entirely.

When creativity is discussed throughout the European Union and new meanings are assigned to it, these meanings should absolutely be questioned. What does creativity mean anyway? How does one act creatively in the workplace and what kinds of incentives or regulations are required to establish a creative operating approach? How does creativity really support European business or government? Is it because the Union and its member states initiate creativity programmes and open calls for proposals, in which funds are granted to events and citizen activities? I suspect that the benefit to business would be rather lacking in a large percentage of these calls for proposals. What about how civil society and the third sector can advantage creativity or promote the development of creative operating and thinking approaches in Europe?

There are many decisive issues to address in establishing a creative Europe.

Creativity needs conflicts and cross-thinking

Calling things into question forces one to seek new problem-solving models. Things that are considered good can also be improved upon, which is why questioning, rethinking, is beneficial, even if there are no actual problems. When creativity and creative economics are considered the goal, we must be able to dissect that goal in the manner described above: what exactly do we mean by creative economics and creativity as an operating approach?

On one hand, business development cannot be the only objective of creative thinking. The human mind is not only set loose during business hours. On the other hand, ideas generated exclusively at the workplace results in very one-sided, work-related thinking. Human thought evolves comprehensively. Ideas and experiences originating from an array of sources reinforce a person's ability to question and develop things related to their work. It is also for this reason

that contacts formed between various fields have been shown to have a positive influence on development.

The merging of different fields forces one to approach things in a different way. Engineers and humanists usually look at things differently. When these two groups approach something together—with an open mind and no prejudice toward one another—a third perspective is formed. This perspective might prove ideal in terms of development of the matter as a whole. Likewise, there is also room for creative thinking between various fields. What do shipbuilding and architecture have in common and what are the differences? Although these fields certainly learn things from one another, could the new thinking and operating approaches they create be used in other fields. The co-operation of the ICT sector with other fields is an excellent example of how intersectoral co-operation generates creativity. The development of ICT applications for different fields has made the IT sector and other fields more efficient and user-friendly.

Is the Baltic region capable of critical thinking?

The Baltic region is undergoing a period of rapid development. The Baltic countries, Poland and Russia are enjoying fast growth. In the Nordic countries, which have remained stable for a long time, there is pressure to enhance efficiency, enterprise and the ability to advantage their strong expertise base in order to achieve success on the international playing field. Whereas the eastern coastal areas of the Baltic are willing and able to change, the western areas are more resistant to it. The need for change, however, is also recognised in the West.

The Nordic countries have a political tradition of being the pioneer, at least in their own view. The welfare state, the free schools that ensure a high level of education and social justice are trademarks, by means of which the Nordic countries have achieved excellent results in various international comparisons.

Nordic countries are widely known for their strong product development and technical leadership. Even though they are not generally considered very radical or fast-moving, even the largest Nordic companies are still seen as being flexible and competitive. The Nordic culture is extremely rational, which also informs its ability for critical thinking. The Baltic region's pace and change also requires a critical view of the old to make room for the new.

The Baltic region thus has the mutual ability for critical thought, a key factor in creative thinking.

The Baltic's role as an engine for Europe

The deepening of co-operation in the European Union has slowed along with its expansion. The European economy seems relatively stronger than before compared to other regions, which is largely due to problems in the United States. Despite this, Europe's growth figures are rather low and the goals specified in the Treaty of Lisbon will not be achieved. Europe still suffers from corporate domination, poor economic and social adaptability and a relatively low degree of innovativeness. In other words, high costs cannot be remedied with ideas and work efficiency.

In establishing co-operation between the countries and areas of the Baltic region it is vital that solutions for improving work productivity and innovativeness be sought, with an extremely critical eye and an open mind. This requires not only finding and sharing the best practices, but also unlearning many old operating approaches that compromise competitiveness. As regions go, the Baltic environs is

compact and its populations are very highly educated. Regional development has remained stable for 15 years and the Baltic Rim boasts some of the world's most prosperous, competitive and fastest-growing countries.

An ambitious basis for setting goals for Baltic co-operation should be the establishment of creative and adaptable economies, government and regional co-operation. If these characteristics were to be realised, it would not only make Baltic countries very competitive, it would also create common, effective operating models, which can be reproduced for use elsewhere in Europe.

If Baltic governments make rational, efficient and creative decisions, the Baltic region as a whole, with its over 80 million inhabitants, will become a new engine for the European Union's economy. The current combination of growth and wealth makes the region one of the Union's most interesting areas, and common Baltic policies make it possible for the region to further enhance its importance.

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Disparities and potentials in the BSR

By Ole Damsgaard

The Baltic Sea Region has experienced a tremendous surge of social and economic development since the beginning of the 1990s. This development has on the one hand been followed by an ongoing integration process between the countries in the Baltic Sea Region while on the other hand overseeing a polarization at the intra-national level between metropolitan regions and the more peripheral and less densely populated parts of these countries.

Another striking characteristic of the BSR-region is that the region continues to suffer from considerable East-West disparities in relation to e.g. wealth and demographic development. With this in mind and now that there are signs of a global economic slowdown on the horizon which may impact both the speed and the character of the future integration process it may be worthwhile to have a closer look at some of the most important potentials of and challenges facing the BSR-region.

Despite the fact that economic growth rates have for many years been consistently strong in the eastern part of the region considerable differences remain between East and West in terms of GDP per capita at the national level, see map 1. In addition, differences at the intra-national level between the capital regions and other regions, especially the more peripheral ones are increasing. The lowest (regional) values can be found in Belarus and Kaliningrad (below 25% of the EU27 level) while very high regional values can be found in the Nordic capital regions, in Hamburg and in Warsaw (more than 150% above the EU27 level).

Another important issue concerns demographic development where the Baltic Sea Region, in total, has experienced a slight overall population decline. The decline is driven by substantial natural losses (higher death rate than birth rate) which for most regions outweigh migration gains – especially in the Eastern part of the BSR. Generally speaking we can see that, over the last ten years, the East- West divide has undoubtedly widened in response to uneven population growth.

Another reality for BSR countries is that steady overall urban growth goes hand in hand with rural population decline. More particularly we can observe a spatial polarisation of the population towards the capitals and larger agglomerations in most parts of the BSR, which is followed by accelerating suburbanisation in and around several BSR metropolitan regions.

As a consequence of this, most of the other cities and regions in the BSR will increasingly suffer from a shrinking workforce as well as a 'greying' population. Such a development is not however unique in Europe. In the BSR however the shrinking labour force and the question of how far this might be compensated by in-migration from other countries and/or by productivity increases in the private and public sectors remains a burning issue.

The above-mentioned polarization tendencies between the metropolitan regions and other regions can to some extent however be explained by the fact that metropolitan regions now play an increasingly critical role in the global network economy.

In this regard Nordregio has recently carried out a study of 23 selected metropolitan regions in the Baltic Sea area, including Kaliningrad, St. Petersburg and Minsk¹, see map 2. Some of the important developments highlighted in this study will be discussed in what follows.

In respect of the metropolitan regions a significant difference can immediately be observed between the Eastern and Western parts of the BSR. Obviously the transformation of the Eastern half of the region and ultimately its integration into the global and European market will be a long-term process, which continues to be hampered by the various pre-conditions for development set in each half of the BSR. One such example concerns

international financial services which have not thus far established a sufficiently strong network to enable the interconnection of the Eastern metropolitan regions with the rest of Europe or with the international economy more generally. A functioning infrastructure enabling the inflow of international financial services is a precondition for significant investment by foreign companies. An exception to the general observation here is Warsaw, which has caught up in many respects with its Western BSR counterparts.

Given the potential market size of the Eastern part of the BSR and the market growth experienced there, such institutional barriers to growth and development need to be minimised. This includes additional services for international companies in order to ease their penetration into the BSR in general and into the Eastern part of the region in particular. Here the metropolitan regions play a crucial role, because only they have the 'critical mass' and the capacities to build up those services in order to reduce the institutional barriers faced. This will however, only deepen the differences between the metropolitan and non-metropolitan regions in the Eastern part of the Baltic Sea Region.

The East-West divide is somewhat lower when talking about metropolitan regions as centres for innovation, research and development. Here we discovered numerous competences, the existence of huge potential and comparably high levels of 'critical mass' in relation to the existence of talented and creative employees and strong research profiles across the BSR. This reality could then open the way for specific pan-Baltic co-operation initiatives.

On the issue of transport, which will enable the BSR's metropolitan regions to function as 'gateways' to the global economy we continue to see tremendous contrasts, specifically with regard to air transport. Flight connections between East-West in the Baltic Sea Region remain at a much lower level as compared to the available connections between e.g. the Nordic metropolitan regions.

Current patterns concerning sea transport are however more balanced while a number of strategic missing links concerning road and rail connections still exist in the Eastern part of the Baltic Sea Region.

In conclusion, the metropolitan regions continue to play an important role in the integration of the BSR into the global network economy. Nevertheless, a lack of specialised services in the Eastern part of the region, particularly in respect of international financial services, remain. On the other hand however huge potential exists in respect of R&D and innovation, - a potential which can only be fully exploited through further cooperation and integration across the Baltic Sea Region.

The ongoing polarization between metropolitan regions and other regions dominated by small and medium-sized towns undoubtedly remains an obstacle to future development particularly when viewed in relation to the economic and demographic trends alluded to above. The risk here is that the metropolitan regions of the BSR will, in the long run, be the only sufficiently integrated BSR-regions in the global economy, while the rest of the Eastern and considerable parts of the Western BSR will be left irretrievably behind.

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Director

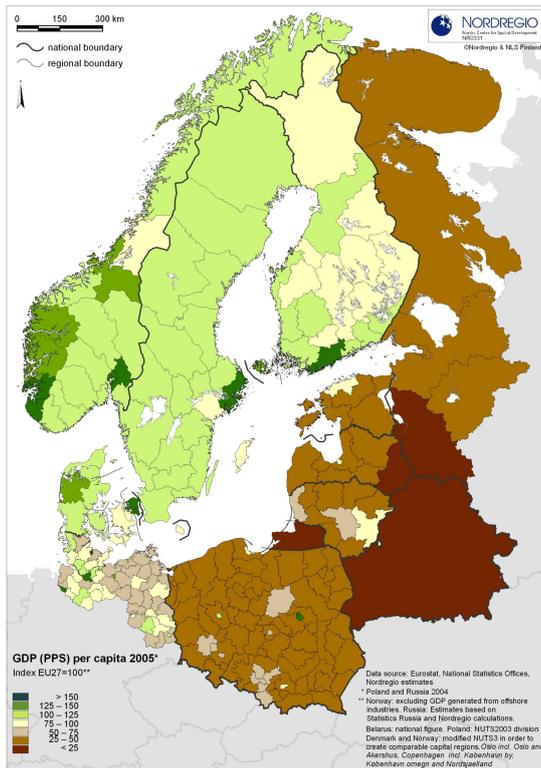
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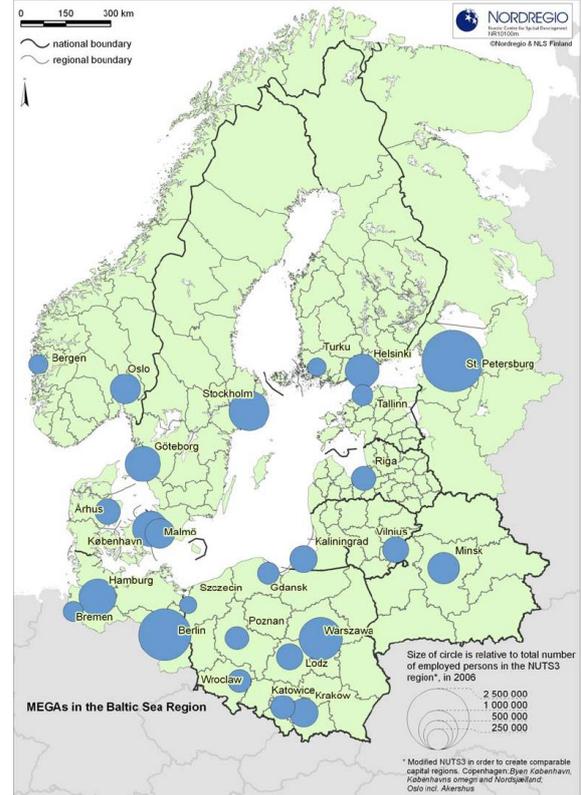


¹ This study will be published by Nordregio in October 2008

Map 1: GDP per capita 2005. Index EU27 = 100 (yellow)



Map 2: 23 selected metropolitan regions in the BSR



Cluster approach as a tool of industrial policy in the Baltic Sea Region

By Jarkko Heinonen

The benefits of clusters

Clusters are important for the competitiveness of a region. The network structure of a cluster opens up an excellent operation environment for small and medium size enterprises considering both growth and internalisation possibilities. A well functioning cluster structure with a subcontractor network also plays an important role for developing cost-efficient production of large industrial companies.

Cluster structures and well-functioning co-operation related thereto can be used to achieve benefits of large-scale production without one company being responsible for all production or organising it. Even small companies in the co-operation network could focus on developing their special expertise and production. Being able to focus on the core competence enhances the creation of both product and production innovations, which in turn has a direct positive effect on the cost-efficiency and competitiveness of the whole cluster.

The benefits from Baltic Sea Region wide clusters and cluster policy

The Baltic Sea Region forms a potential common market area in many ways, which is also visible in customer relationships. We may claim that Baltic clusters offer a more natural base for co-operation than more distant companies. That provides a good basis for developing a common cluster policy.

The countries of the Baltic Sea Region are mainly rather small national economies, which leads to the fact that the domestic markets for production factors are very limited. This means that, for example, the subcontractor network maintained by the leading company must extend to a geographically large area around the Baltic Sea. This makes it pertinent to take actions covering the entire Baltic Sea Region to ensure the international competitiveness of the clusters operating in the area.

Furthermore, the relatively small domestic markets in the Baltic Sea Region often lead to a situation, where new innovations developed in the area and enterprises established along with the innovations are struggling to grow big enough to achieve real potential in the international market. With the help of a cluster policy covering the entire Baltic Sea Region, a wider operational environment supporting business development should be established for the small innovation companies to ensure sufficient circumstances for growth.

We should also encourage a deeper integration of promising Russian clusters into the Baltic Sea networks. We may assume that this could be of added value to the process of trans-national cluster development.

Challenges

The critical mass important for the efficiency of operations, creation of cluster structures and international attractiveness of the industry is often not achieved at a regional level. Hence we should co-operate in the Baltic Sea Region in order to build larger and more attractive clusters within which companies operating in different regions and different countries could seamlessly develop co-operation. The problem is, however, that nationalistic views prevent co-operation far too often.

Furthermore, the supportive activities of the public sector must not be geographically limited. Broad regional co-operation is a requirement for the operation of clusters, especially in the Baltic Sea Region. Nevertheless, national

and local public organisations that support innovations are usually not allowed to use their funds outside the country or the region. This does not provide a good basis for the creation of geographically larger, and hence potentially more competitive, clusters.

One of the most important challenges in the Baltic Sea Region is that many key elements of the level of infrastructure do not match the transportation needs. Also the time required by border crossing needs to be reduced for both road and rail transports. The poor predictability of the time of arrival of transports quickly leads to serious problems in the operation of the subcontracting and co-operation network, and thus to the production efficiency of the cluster.

Enhancing the production environment of clusters

We can point out a few key areas of operation in which it would be possible to create better prerequisites for local clusters. These key areas include:

- Common vocational training
- Promoting the mobility of labour
- Harmonisation of working culture
- Funding research

The production of large industrial clusters in particular requires geographically extensive utilisation of labour and subcontracting resources. It is important for the organising of work and production efficiency that the standard knowledge and competence of different professional titles is the same regardless of the country of education.

It is very important for the operating conditions of the cluster that the cost-efficiency of production does not suffer even though labour resources from a large area might need to be utilised in the production process. On the basis of the companies' experiences, the free mobility of labour inside the EU is still not realised. Because working abroad usually lasts for a very brief period for a number of reasons, staff turnover is also great. This creates significant additional challenges to the effective organising of work.

The working culture in the Baltic Sea Region needs to be harmonised, so that introduction to working methods and regulation does not take up a disproportionate amount of working time. A consistent labour legislation as well as norms and practices need to be created for the Baltic Sea Region. This will clarify the labour markets and their common rules, promote safety at work and enhance the productivity of work.

One important part of many clusters, especially high-technology clusters, is the research conducted in universities and other institutions. The public sector could play an active role in promoting clusters by funding research and development. By pooling resources and allocating them to the most fruitful environment, rates of return on investment increase.

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Problems of the Archipelago Sea are self-created

By Harri Ekebon

Current awareness and media attention about the bad ecological conditions of The Archipelago Sea are considerable. The Archipelago Sea in front of south-western coast of Finland with its algal rafts have become the symbol of the state of the Baltic Sea for the rising amount of Finnish and foreign tourists. Awareness of the state of The Archipelago Sea is high and the citizen's pressure on the real action grows.

Reasons of the problems in and therefore their solutions are different whether it is Baltic Sea in general or The Archipelago Sea in question, which makes the outline of the matter complicated. Role of the Finnish agriculture as a source of the nutrition burden in The Archipelago Sea is central, i.e. at least 60 percent, as in the scale of the whole Baltic Sea it is under 10 percent. For example the direct impact of the much spoken St. Petersburg area emissions for the state of The Archipelago Sea is much smaller than it is e.g. in the Gulf of Finland. Ongoing progress in the sewage treatment in St. Petersburg will hardly improve the situation in The Archipelago Sea. However, the acceptance of the homespun and self-created origins of the Archipelago Sea's problems seems not to be easy for everyone. It would be enormously easier to search the guilty parties from further away and call for the others to act.

There is for the time being a wide inconsistency between the general opinion and the ongoing measures. The citizens are waiting and with a strengthening voice demanding real action in water protection. In practice the measures in the water protection are based in the different actors' volunteering and the use of different kinds of incentives. For example agriculture branch has recognised and accepted its own central role to the state of the Archipelago Sea. Protection measures designed for every farm can have a researched and effective impact in attempt to limit the nutrition burden. Furthermore, the willingness to this kind of actions is rising. This is a slow process and its results can be seen only after several years. Climate change has its own impact to the process by in different ways adding burden to the Archipelago Sea and thus weakening the effects of currently ongoing tasks. It is still uncertain how long can the current voluntary-based state of affairs can continue.

There is still hope remaining for the Archipelago Sea. A very positive sign is an observation about the improving conditions of the sea when the nutrition burden drops. Nature reacts in a positive manner quite quickly, which has been one of the main reasons for the establishment of the Protection Fund for the Archipelago Sea. The meaning of the fund is to support effective and carefully directed water protection measures, which in a strong probability have a quick and positive effect. The emphasis is thus put on to the support and speed up taking in use the best practices, not in research of new methods. The work is based on multi-year programme, whose measures have been prioritised on the basis of influence. Most resources have been directed to the measures having the most effective and quickest influence. Examples about these are the measures aiming at the diminishing nutritional emissions of agriculture. There are also measures in the programme that aim at affecting actors being able to advance the aspects related to water protection with their decisions. These kinds of actors include among others cities, towns and municipalities. For further information about the fund and its operational programme, please visit www.saaristomerensuojelurahasto.org.

The Protection Fund for the Archipelago Sea is a new sign of business life's growing interest on the state of the Baltic Sea. Majority of the fund's activities is financed with the support of private actors, companies, communities and private persons. John Nurminen foundation has made a successful effort for a long time in this area, not to mention all the actors. Strong involvement of private actors is an example of influence caused by strengthening citizen pressure on the decisions made in the companies. Social responsibility has already been written down in many companies' values for a long time, but its channelling depends on the citizens' and market's expectations. The Protection Fund for the Archipelago Sea offers a concrete influence channel especially for those companies having their action and interest area in south-western Archipelago Sea.

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Energy security and environment – energy challenges in the European Union

By Hanna Mäkinen

Energy issues are about to become one of the greatest challenges facing the European Union in the future, both from political, economic and environmental perspective. In a global scale highly topical energy issues include climate change, increasing energy consumption especially in developing countries of Asia and Africa, sufficiency of energy resources and energy supply, and increase in energy prices. For the EU the guaranteeing of the Union's energy security has become an essential, yet not easily achievable goal. The EU's increasing reliance on imported energy and the sufficiency and reliability of imported energy, mainly from Russia, are strongly affecting the energy security of the Union. Russia's restrictions on natural gas delivery and disputes with the transit countries, as well as the possible impacts of the political development of Russia on its energy deliveries have raised many concerns and discussion. Very important issues for the EU include also environmental issues, such as environmental effects of energy production and energy transports.

Internal and external policies of the EU will be strongly affected by energy issues, especially the need to guarantee the EU's energy security. Energy issues are in the focal point of EU-Russia relations as well. There is a strong tendency in the EU to develop a common energy strategy and a common energy policy, which would make the Union a stronger player in the negotiations with Russia. However, the differing opinions and interests of the EU-countries have hindered the efforts of the EU to speak with one voice in energy affairs.

Energy issues are highly topical, which guarantees that they will be widely discussed and debated both in a global and regional scale and throughout the EU as well. Therefore it's not surprising that the importance of energy-related issues has also been acknowledged among Finnish enterprises. According to a recent study by Peeter Vahtra and Valtteri Kaartemo (Pan-European Institute 2008) questions related to energy are high on priority for the 250 largest enterprises in Finland. The companies were asked to evaluate impacts of energy-related factors on their businesses. Almost 85 % of the respondents considered energy issues important and 40 % very important to their businesses.

The companies were first and foremost concerned about the increase in energy prices and guaranteeing stable energy delivery in the EU area. The increasing reliance of the EU on imported energy was regarded important to the companies' businesses. Especially the reliance of Finland on Russia as its main energy supplier was considered significant. The political development of Russia and its impacts on energy deliveries raised many concerns among the respondents. The development of common energy policy of the EU was also considered fairly significant, as well as increasing energy investments in the EU to meet the demand.

However, global energy challenges appeared to be considered more remote to the companies' businesses. Increasing demand for energy and competition for scarce energy resources in a global level were not considered as significant. Only global environmental effects of increasing energy consumption were considered fairly important among the respondents.

In general, environmental effects of energy trade were not as high in ranking in the companies' priorities as were the issues related to energy prices, stable delivery of energy and energy politics. Among the environmental issues included in the enquiry the development of sustainable and renewable energy sources was considered to have the greatest significance to their businesses. On the other hand, regional environmental issues related to energy were of a lower meaning. The companies found the environmental impacts of the North Stream pipe line to be quite insignificant on their businesses, as well as the oil transports in the Baltic Sea. This could be seen as quite surprising, considering the increasing risks of the energy transports in the Baltic Sea region.

According to the study, the Finnish companies are aware of the commercial meaning of energy issues, although not all issues were considered equally significant. Indeed Northern Europe has to face great energy challenges in the future. Due to its strategically important location as a transit area for Russian energy, Northern Europe plays an important role in the development of EU-Russia energy relations. On the other hand, the environmental risks of energy production and transports are severe for the ecologically very sensitive region. The rapidly increasing oil transports in the Baltic Sea produce the greatest environmental risk to the area. Currently probably the most discussed energy-related topic in the EU is also related to Northern Europe and the Baltic Sea – the North Stream natural gas pipe line which is supposed to be built in sea bottom. The debate has mainly been related to possible environmental impacts of the pipe line but the question has also been politicized in some EU-countries

The highly topical energy issues will also be discussed in the Pan-European Institute 20th anniversary conference "Energy Challenges in Northern Europe", which will be organized on 27–29 November 2008 in Turku, Finland. The conference will bring together leading professionals in the area of politics and economy to discuss the future energy challenges in Northern Europe. The aim of the conference is to bring new perspectives to the European Union's energy dialogue and to offer first-hand knowledge on the developments in the energy relationship between the EU and Russia. For further information on the conference, please visit www.tse.fi/pei.

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