Baltic Rim Economies
Estonia – Latvia – Lithuania – Poland
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Estonia

GDP surged by almost 11% in the third quarter

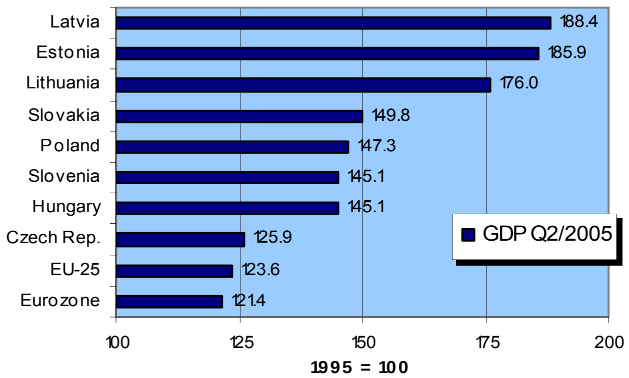
According to the preliminary estimate, the Estonian economy expanded by 10.8% over the third quarter this year compared to the corresponding quarter of 2004. A record high GDP growth was generated by the rapid increase in all the main economic sectors. Within the third quarter, retail trade grew by 9% y-o-y, industrial production by over 10% and construction by an amazing by 28% y-o-y. Estonia's economic performance considerably exceeded forecasts, once again.

The Estonian economy is expected to remain on a path of strong and broad-based growth. According to a recent forecast by the European Commission, Estonian GDP growth will reach an 8.4% annual rate this year. Furthermore, Estonian economy will expand by 7.2% next year and by 7.4% in 2007. The growth will still be based on the rapid increase in domestic demand, supported by the continuing positive trends in exports and the labour market. Moreover, Estonia's current account deficit is expected to narrow.

The Bank of Estonia recently revised its GDP forecast upwards significantly. However, the bank's forecast is slightly lower compared with the EC forecast. According to the central bank, the Estonian economy will expand by 8.0% this year and by an annual 6.8% rate during 2006-2007.

Despite the warning signs of an overheating economy, especially related to the booming real estate market and the steep growth of lending, Estonia's current economic situation is stable. The general government balance is estimated to reach a surplus of around 1-2% this year, public debt is the lowest amongst EU countries and the country's external balance is also slightly getting improving. Moreover, prices rises have decelerated during the past two months. The major concern for further growth will be a labour force shortage, contributing to a rapid rise of wages and thereby a possible decrease of foreign investments.

Volume index of GDP in some new EU countries



Source: Eurostat

According to Eurostat, Estonia's economy has nearly doubled in the past decade. In this period, amongst EU countries, the most rapid GDP growth was observed in Latvia. Simultaneously the Euro area's GDP increased by roughly 20%.

State budget expands remarkably for 2006

Estonia's state budget for 2006 has EEK 61.4 bn in revenues. The budget is 11% larger than in 2005 including the extra budgets. In 2006, Estonia's (flat) income tax rate will decline by 1 percentage point to 23%. Moreover, the amount of non-taxable income will rise from the current EEK 1,700 to EEK 2,000. The budget includes pension increases and also extends the period for which the parent's benefit is paid.

Wages up, unemployment down

The positive trend in Estonia's labour market continues, whilst the unemployment rate declined significantly during the third quarter. Unemployment stood at 7.0% of the active labour force, which is the lowest rate since 1993.

Estonia's average gross monthly wage stood at 7,786 kroons (EUR 498) in the third quarter. Average wages grew by 10.9% compared to the respective period of 2004. The highest gross wages were observed in that of financial intermediation, the average being EUR 966 per month.

EU budget plan accepted by the member states

The EU's budget plan for the years 2007-2013 was accepted by the member states in mid-December. According to Britain's revised budget plan, the new EU countries will receive EU aid of total of EUR 157 bn in this period, thus 7 bn more than in the UK's first proposal. According to the new financial framework, Estonia will receive around EUR 4.5 bn in 2007-2013. The EU's overall spending amounted to EUR 862 bn.

Tony Blair, the Prime Minister of Britain, visited Tallinn in early December and negotiated with the Baltic prime ministers about the planned budget cuts. The ministers strongly rejected the proposal to cut aid for new member states.

At present, according to the Ministry of Finance, Estonia has used only 14% of the allocated EU funds for 2004-2006. However, these funds are available until the end of 2008.

Some business highlights

- Tallink Group, the Estonian ferry company, was listed on the Tallinn bourse (OMX Tallinn) on December 9. A total of 34.7 mln shares were allocated in the offering at the price of EUR 5.27; Tallink announced that it will use its option to order another new ship from Aker Finnyards worth EUR 165 mln.
- Finnish-based Citycon plans to enlarge the Rocca al Mare shopping centre by 25,000 square metres. Currently the centre has a floor space of 35,000m^2.
- Tallinn city government is considering whether to allow or decline the planned 17-storey expansion of the Viru hotel in the Tallinn city centre.
- Estonia's largest construction company Merko Ehitus has signed a contract to build Nordic Hotel Postimaja in Tallinn. The contract is worth EEK 238 mln.
- According to the Milken Institute's Capital Access Index 2005, Estonia has the most efficient financial market amongst the Eastern European countries.
- The construction of a Russian-German gas pipeline across the Baltic Sea is to begin. The Baltics and Poland have opposed the project due to its environmental risks. Moreover, the project ignores the needs of other countries in the region.
- The Estonian shipping company Baltic Scandinavian Lines is to open a route to Germany next year. The company opened a route to Sweden in September.
- Estonian investment bank LHV faced a serious scandal, since the US authorities claim that two traders of LHV have earned money using confidential information.

Estonia - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	4.4	0.3	7.9	6.5	7.2	6.7	7.8	8.6	1-6/2005
Industrial production (y-o-y %-growth)	4.1	-3.4	14.6	8.9	8.2	11.0	7.9	9.9	1-10/2005
Inflation (CPI, end of period, y-o-y %-change)	6.5	3.9	5.0	4.2	2.7	1.1	5.0	3.9	11/2005
General government budget balance (% of GDP)	-0.3	-3.7	-0.6	0.3	1.5	2.6	1.7		1-12/2004
Gross wage (period average, EUR)	262	284	314	352	393	430	466	498	Q3/2005
Unemployment (% end of period, LFS data)	10.2	12.9	13.9	11.9	11.3	9.3	8.5	7.0	Q3/2005
Exports (EUR million, current prices)	2 252	2 239	3 445	3 698	3 642	4 003	4 731	4 405	1-9/2005
Imports (EUR million, current prices)	3 529	3 224	4 615	4 798	5 079	5 715	6 727	5 799	1-9/2005
Current account (% of GDP)	-8.7	-4.4	-5.5	-5.6	-10.2	-12.1	-12.7	-10.3	1-6/2005

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

Latvia

GDP growth continues at a record-high pace

Despite Estonia's accelerating economic growth, Latvia still holds the position of the fastest growing EU country. During the third quarter of this year, Latvia's economy expanded by 11.4% compared to the respective quarter in 2004. The same record-high rate was also observed in the previous quarter. In the third quarter, economic growth was still mainly based on the steep increase in the construction and trade sectors.

During the first nine months of this year, Latvia's GDP increased by 10.1% y-o-y. In this period, the most rapid increase was observed in the trade sector, which grew by 17% y-o-y. Transport and communications as well as construction increased by 16% and manufacturing by slightly over 5% compared to the corresponding period in 2004. Within these industries, the steepest growth was observed in the sales of road vehicles, in the transport of passengers and in the construction of residential buildings. Latvia's GDP is estimated to expand by at least 9% in 2005.

According to the European Commission's recent forecast, Latvia's economic growth will remain the fastest amongst EU countries throughout the next two years. However, growth is expected to decelerate slightly due to the calming investment boom. Domestic demand continues to drive GDP growth.

European Commission's forecast for 2006

	EU-25	Estonia	Latvia	Lithuania	Poland
GDP (in real terms)	2.1	7.2	7.7	6.2	4.3
Private consumption	1.6	6.5	7.8	8.0	3.4
Public consumption	1.9	5.9	2.6	4.9	2.8
Investment	3.5	6.5	10.0	8.2	8.2
Unemployment (LSF)	8.5	6.0	9.4	8.1	16.8
Inflation (HCPI)	2.2	3.3	6.0	2.8	2.3
Government balance*	-2.7	0.6	-1.5	-1.8	-3.6
Government debt*	64.2	4.0	13.0	20.2	47.0
Current account *	-0.4	-6.8	-10.5	-7.1	-3.5

Source: Europen Commission Autumn Forecast 2005 *(% of GDP)

Inflation does not ease up

In November, Latvia's (harmonised) consumer price index stood at 7.5% y-o-y. Amongst EU countries, by comparison, the second highest annual price increase was noticed in Malta, where the respective rate was 4.3%. In Latvia, the most rapid price increase was observed in transport, in hotels and catering, in housing and in foodstuffs. In all of these categories prices went up by more than 10% y-o-y.

Latvia's high inflation is mainly based on the internal factors related to the strong domestic demand, although the global trend of rising energy prices does not ease the situation. Moreover, domestic demand is supported by money from abroad. Latvian residents who work abroad bring their wages to Latvia, which also contributes to the consumption boom. Currently Latvia's retail trade volume is growing the most rapidly of the EU-25.

In order to restrain inflation and lending, the Bank of Latvia raised the reserve ratio for banks from 6% to 8% as from December 24.

Wages increase sharply

The rapid growth of wages continued in the third quarter of this year. Latvia's average gross monthly wage stood at EUR 353, increasing by 17.4% compared to the corresponding quarter in 2004. Taking into account the steep rise in prices, real wages went up by around 10% y-o-y. In comparison, the average gross wage increased by 10.9% y-o-y in Estonia and by 9.4% in Lithuania during this period. In Poland, however, the average wage grew still moderately by 3.4% y-o-y.

In Latvia, over the third quarter, the most rapid wage increase was observed in the sea and air transport industries, where wages went up by more 50% y-o-y. In the manufacturing sector, the average wage grew by 19% in a year.

Along with rising wages, Latvia's unemployment rate declined significantly in the third quarter. The number of job seekers decreased to 99,400 persons, down by 15,000 y-o-y. In the third quarter, Latvia's unemployment rate stood at 8.7%. The rate declined by 1.3 percentage points from the corresponding quarter a year earlier.

Exports grew by 34% in ten months

Steep growth in Latvia's foreign trade has continued over this year. During the first ten months, exports increased by almost 34% y-o-y outpacing imports, which grew by 25% respectively. The value of exports amounted to EUR 3.3 bn, already exceeding the total value of 2004. The most notable increase was observed in the export of electrical machinery and equipment.

Over the year 2005, the share of foreign trade with old EU countries (EU-15) has slightly decreased. On the contrary, trade with new EU countries as well as with CIS countries has increased significantly. Currently, on the export side, Latvia main trade partners are The United Kingdom, Estonia, Lithuania and Germany, all of which's share is around 10% of Latvia's exports. In the import side, Germany and Lithuania are the most important trade partners with their 13-14% share of the country's total imports.

Some business highlights

- According to the EU's new budgetary framework, Latvia will receive a total of EUR 5.7 bn of EU aid during the years 2007-2013.
- Riga Free Port and the Estonian ferry operator Tallink have not yet signed an agreement on opening the Riga-Stockholm ferry route. According to the preliminary plans, the route should be opened in January 2006. At present the route is estimated to be opened in March. The Riga Free Port plans to raise its port fees by 45% in 2006.
- In the first 9 months of this year, freight by rail increased by 5% y-o-y to 44 mln tons. Freight transport by roads went up by 10% to 37 mln tons. Correspondingly the amount of cargo loaded in Latvian ports increased by only 1% to 42 mln tons in this period.
- Latvia's banks' aggregate profit totalled LVL 178 mln (EUR 253 mln) in eleven months of 2005, up by 70% y-o-y. At present there are 23 banks in Latvia.
- Prisma, the leading retail chain in Finland, plans to invest around EUR 50 mln in Latvia during the next 2-3 years. The company will open 3 or 4 supermarkets.
- Finnish travel agency Kaleva Travel Group has acquired a 100%-stake in SIA Via Riga, the second largest travel agency in Latvia.
- Five Latvian banks have established a common forum to enforce Latvia as a financial centre of the Baltic region. The founders of the forum are Aizkraukles Banka, Trasta Komercbanka, Paritate Bank, Regionala Investiciju Banka and Baltic International Bank.
- Italian-based property developer Pro Kapital plans to invest at least EUR 180 mln in the Kliversala district in Riga.
- Latvian pharmaceutical manufacturer Sanitas made the highest bid for a 47.5% stake in the Polish Jelfa S.A. The bid has not yet been approved by the sellers.
- The 2006 NATO Summit will be held in Riga in November. This will the first time when the summit will take place in a former Soviet State.

Latvia - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	4.7	3.3	6.9	8.0	6.4	7.2	8.3	10.1	1-9/2005
Industrial production (y-o-y %-growth)	2.0	-8.8	3.2	6.9	5.8	6.5	6.0	5.1	1-10/2005
Inflation (CPI, end of period, y-o-y %-change)	2.8	3.2	1.8	3.2	1.4	3.6	7.3	7.4	11/2005
General government budget balance (% of GDP)	-0.6	-4.9	-2.8	-2.1	-2.3	-1.2	-0.9		1-12/2004
Gross wage (period average, EUR)	202	225	268	282	297	298	314	353	Q3/2005
Unemployment (% end of period, LFS data)	13.7	13.2	13.3	12.9	11.6	10.3	10.3	8.7	Q3/2005
Exports (EUR million, current prices, average exch. rate)		1 613	2 020	2 232	2 416	2 559	3 204	3 323	1-10/2005
Imports (EUR million, current prices, average exch. rate)		2 758	3 453	3 910	4 284	4 634	5 671	5 509	1-10/2005
Current account (% of GDP)	-9.7	-9.0	-4.8	-7.6	-6.7	-8.2	-12.9	-10.7	1-6/2005

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

Lithuania

GDP grow by 7.6% in the third quarter

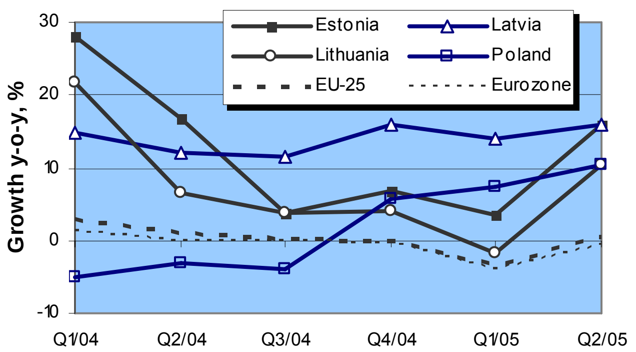
Lithuania's robust economic growth continues, although the current growth pace is around 3-4 percentage points below the Estonian and Latvian ones. In the third quarter of this year, the Lithuanian economy expanded by 7.6% compared to the corresponding quarter of 2004.

In the third quarter, Lithuania's economic growth was based on a strong increase in all the main industries, excluding agriculture and mining and quarrying. The most rapid increased was noticed in financial intermediation, which expanded by 12.5% y-o-y. More than a 10% annual increase was also observed in construction, in retail and wholesale trade, in hotel and restaurant services as well as in transport and communications. The growth of manufacturing slightly decelerated over the quarter, but grew still strongly by 7.5% y-o-y. In 2005, the manufacturing output of transport equipment and motor vehicles, non-metallic mineral products as well as rubber products has grown strongly. On the contrary, one traditional industry, the manufacturing of textiles and clothing has decreased compared to the previous year.

Over this year, Lithuania's exports and imports have grown steadily hand in hand around 25% y-o-y. The strong growth of exports is expected to continue next year, since Lithuania's neighbouring countries' economic performance is developing rapidly fuelling their import demand.

Lithuania's economic growth is expected to gradually weaken during the forthcoming years, although remaining at around 6%. Domestic demand will remain as the main engine, although with slightly weaker growth rates. However, the reduction of the personal income tax stimulates consumption and private investment. The growth of investments will be supported by significant EU grants. According to the EU's adopted budget plan, Lithuania will receive EU aid worth LTL 36 bn (EUR 10.4 bn) in 2007-2013.

Volume index of construction output



Source: Eurostat

Lithuania's construction output increased by 12% in the third quarter, supported by a steep increase in the construction of new buildings, which grew by 27% y-o-y. In the EU, at present, construction is growing by double-digit numbers only in the Baltic region and in some other new member states.

Service sector expands rapidly

According to a survey conducted by the Lithuanian statistical authorities, the income of transport, communication and service sector enterprises increased by almost 34% y-o-y during the first nine months of 2005. The income of transport enterprises grew by 39.5% y-o-y, driven by a rapid increase in supporting and auxiliary transport activities, as travel agencies. The income of service sector enterprises increased by 36%, supported with a 54%-increase in real estate activities. The lowest growth rates were observed in the education and health care enterprises, although even they grew quite strongly over the year. None of the service industries faced negative growth rates.

Regional development in 2004

Regional differences in economic development are still remarkable in Lithuania, although its economy is not so centred in the capital region as in Estonia and Latvia, for example. In 2004, Lithuania's GDP per capita amounted to LTL 18,200 (EUR 5,250). However, out of ten counties, only the Vilnius region (LTL 26,200) and the Klaipeda region (LTL 18,700) exceeded the country's average. GDP per capita in the capital region was 2.6 times higher than in the country's poorest region, Tauragė.

Vilnius County contributes more than one third of Lithuania's GDP, whilst only one fourths of the country's population lives in the region. This is mainly through the larger role of the financial sector in the capital region.

Four candidates remaining to acquire MN

The long-lasting negotiations related to the selection of new strategic investor for the Mazeikiu Nafta oil refinery complex still continues. Currently the representatives of the Lithuanian government and Yukos are negotiating with Kazakh-based KazMunayGaz and with Poland's PKN Orlen. However, the other two bidders, Russian Lukoil with the US-based CoconoPhillips, or the Russian-British joint venture TNK-BP are still considered to be a possible selection.

In late November, the Amsterdam court dismissed Russian state-owned Rosneft's request to freeze the international assets of bankrupted Yukos. The company's subsidiary Yukos International UK holds a majority stake of 53.7% in Mazeikiu Nafta, Lithuania's largest industrial company.

Some business highlights

- Mega, a new shopping and entertainment centre was opened in Kaunas. The centre includes 72,000 square metres floor space for about 130 shops, a cinema and some bars and restaurants.
- Hungarian low-cost air carrier Wizz Air has launched flights from Kaunas to Warsaw. The route is operated four times a week. The Irish budget airline Ryanair will start flight from Kaunas to Stockholm on February 22 next year.
- In 11 months this year, the turnover of reloaded freight in Klaipeda port increased by 6% y-o-y up to 19.7 mln tons. In November, the turnover increased by 14%.
- The real estate consultancy company Re&Solution, operating in Lithuania and Latvia, has acquired the Latvian property management company Kristensen Baltic. Due to this acquisition, Re&Solution becomes the biggest shopping centre property manager in the Baltic States.
- In the first nine months this year, Lithuanian hotels and other accommodation industry served 728,000 guests, up by 21.6% y-o-y. The overall hotel occupancy rate grew from 38.2% to 42.8%.
- Mobile phone operator BITE has contracted Ericsson for the supply of the 3G mobile systems infrastructure in Lithuania and Latvia until 2008.
- Irish-based Duke House Asset plans to invest EUR 35 mln in a new shopping centre in Vilnius.
- The new property tax on real estate used for commercial purposes comes into force in January 2006. The 1%-tax is planned to be in force until 2011.

Lithuania - main economic indicators	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP (y-o-y %-growth, constant prices)	7.3	-1.7	3.0	6.4	6.8	10.5	7.0	6.9	1-9/2005
Industrial production in sales (y-o-y %-growth)	8.2	-9.9	2.2	16.0	3.1	16.1	10.8	6.3	1-10/2005
Inflation (CPI, end of period, y-o-y %-change)	2.4	0.3	1.4	2.0	-1.0	-1.3	2.9	2.8	11/2005
General government budget balance (% of GDP)	-3.0	-5.6	-2.5	-2.0	-1.4	-1.2	-1.4		1-12/2004
Gross wage (period average, EUR)	208	231	263	274	293	311	335	399	Q3/2005
Unemployment (% end of period, LFS data)	12.6	15.3	16.9	17.9	13.0	11.6	10.6	8.5	Q2/2005
Exports (EUR million, current prices, average exch. rate)		2 583	3 841	4 778	5 526	6 158	7 478	7 636	1-10/2005
Imports (EUR million, current prices, average exch. rate)		4 340	5 650	6 767	7 943	8 526	9 959	9 969	1-10/2005
Current account (% of GDP)	-12.1	-11.2	-5.9	-4.7	-5.1	-6.8	-7.7	-6.5	1-6/2005

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

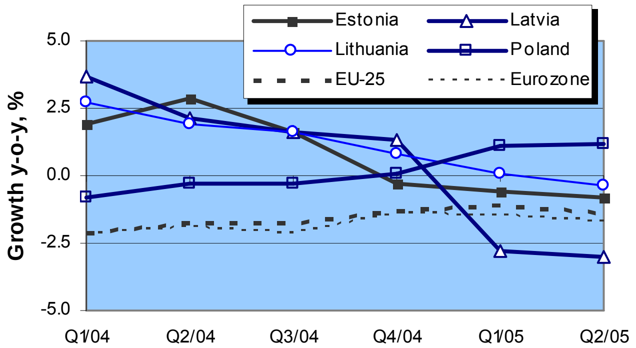
Poland

GDP growth of 3.7% in the third quarter

Overall optimism about the Polish economy is increasing, since GDP growth accelerated significantly in the third quarter of this year. The country's GDP expanded by 3.7% compared to the corresponding period a year earlier, supported by a 5.7%-increase in gross fixed capital formation. Individual consumption grew by 2.7% y-o-y, thus only moderately, but notably faster than during the first two quarters of 2005. The growth was based on the value-added increase in the private sector, while the public consumption increased by only 1% y-o-y. During the third quarter, a significant increase was noticed in construction output, which expanded by 8% y-o-y. Retail trade went up by 5% and industrial production by 4% y-o-y respectively.

According to the European Commission's recent forecast, Poland's domestic demand will replace exports as the driving force of economic growth in 2006 and 2007. Both investments and private consumption are expected to speed up in the forthcoming years. The EC forecasts that Poland's GDP will expand by 4.3% next year and slightly faster in 2007. The major problem of the Polish economy, the highest unemployment rate in the EU, is expected to decline slowly by around 1 percentage point in a year. Another main concern, the country's large public deficit, is expected to remain close to the current level around 3.5% of projected GDP. However, due to higher than expected revenues within the first eleven months of this year, Poland's current year's budget deficit might be lower than estimated in the state budget for 2005.

Employment growth in industry overall



Source: Eurostat

In 2005, the growth of manufacturing has been a disappointment, since the total manufacturing output increased by only 3.1% in the first ten months of this year compared to the corresponding period of 2004. However, during the first ten months, the manufacturing of machinery and equipment increased by almost 16% y-o-y. Respectively, the manufacturing of textiles dropped by 5% and the manufacturing of wearing apparel even more than 11% over the year.

Despite this weaker than expected development in the Polish industrial sector, the sector's employment has grown steadily by around 1% y-o-y during this year. For example in the Baltic States, in spite of their robust economic growth, the amount of the industrial labour force has decreased over this year. In Poland, the amount of the industrial work force declined sharply during 2000-2003 causing the current mass unemployment problem. However, the effectiveness of Polish Industrial companies has improved significantly since those years. On the other hand, Polish companies are starting to face capacity constraints due to delayed investments and their prudence towards hiring new employees.

Inflation declined sharply in November

Poland's annual inflation rate has lowered significantly during this year. In January 2005, the consumer price index stood at 3.7% y-o-y, whilst in November the respective rate was only 1.0%. Comparing to November 2004, the prices of clothing and footwear declined by 6% and the prices of food stuff by 0.5% y-o-y. The slight price rise was due to a 10%-increase in fuel prices and a 3%-increase in housing costs.

Exports up by 5% in ten months

Poland's exports grew by almost 5 % over the first ten months of this year. When measured in euros or US dollars, the increase was around 20% in this period because of the strengthening of the zloty. In zloty terms, Poland's imports declined by 2% in the respective period. Due to this positive trend in exports, Poland's current account deficit has notably narrowed in 2005.

During the past two years, the growth of exports has been mainly based on the expanding trade with the Eastern European countries. On the contrary, the share of foreign trade with EU countries has slightly decreased despite the still increasing total volume. However, Germany has remained the main trade partner, both in exports and imports. In the first ten months of this year, Germany's share was 28% in exports and 25% in the imports side.

Poland is to receive EUR 60 bn in 2007-2013

According to the EU's new budget framework for the years 2007-2013, Poland will receive a total of EUR 59.7 bn from the EU's structural and cohesion funds. Poland's annual contribution to the EU budget will stand at around EUR 3 bn.

Poland has spent so far only a small part of the EU structural funds allocated for the years 2004-2006.

Some business highlights

- According to the study "Investment Attractiveness of Polish Voivodships and Regions in 2005", conducted by IBnGR and PAIiIZ, Śląskie, Mazowieckie and Małopolskie Voivodships are the most attractive counties for investments.
- The gross revenue from privatisation amounted to PLN 3.8 bn (EUR 950 mln) in the first 11 months. The budget for 2005 has PLN 5.7 bn in privatisation revenues.
- The six subcontractors of LG Philips LCD have signed a contract with the government to invest more than PLN 1 bn and to employ 7,000 persons. The public aid for the project is worth PLN 122 mln, plus cheap land base and some tax reliefs.
- Dutch Eureko, the largest private shareholder (32%) of the insurance company PZU, has filed a PLN 6 bn claim against the Polish government due to the delay in implementing their agreement regarding selling an additional 21% of PZU.
- The confectionery and beverages manufacturer Cadbury Schweppes plans to invest EUR 100 mln in the construction of a new chewing gum factory in Poland.
- Electrolux, the Swedish-based manufacturer of home appliances, will shift production from its factory in Nurnberg (Germany) to Poland.
- Polish biotechnology company Bioton plans to build a new plant in China and Ukraine. The company also has a factory in Russia.
- French retailer giant Carrefour plans to double the number of its stores over the next 5 years. The company also plans to expand its existing petrol stations network and to build two new shopping centres.
- The Treasury Ministry has published a list of strategic companies for public safety. The list includes companies mainly in the energy sector. The government will have the *golden veto* right to oppose certain decisions made by the companies' board.

Poland - main economic indicators	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**as of**
GDP (y-o-y %-growth, constant prices)	5.0	4.5	4.2	1.1	1.4	3.8	5.3	2.4	1-6/2005
Industrial production (y-o-y %-growth)	3.5	3.6	6.7	0.6	1.1	8.3	11.7	3.0	1-10/2005
Inflation (CPI, end of period, y-o-y %-change)	8.6	9.8	8.5	3.6	0.8	1.7	4.4	1.0	11/2005
General government budget balance (% of GDP)	-2.1	-1.4	-0.7	-3.7	-3.3	-4.8	-3.9		1-12/2004
Gross wage (period average, EUR)	314	401	472	557	544	497	505	584	Q3/2005
Unemployment (%, last survey in the year, LFS data)	10.6	15.3	16.0	18.5	19.7	19.3	18.0	18.1	Q2/2005
Exports (EUR billion, current prices, average exch. rate)	25.1	25.7	34.4	40.4	43.4	47.5	60.0	58.2	1-10/2005
Imports (EUR billion, current prices, average exch. rate)	41.5	43.2	53.1	56.2	58.3	60.3	71.8	65.5	1-10/2005
Current account (% of GDP)	-4.1	-7.6	-6.0	-2.9	-2.6	-2.2	-4.4	-0.9	1-6/2005

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

Poland and Baltic Sea Regional Cooperation

by Stefan Meller

Economic cooperation in the Baltic region is a tradition that goes back to the mediaeval time. In the cities like Tallinn, Stockholm or Gdansk one can still find signs of cultural and economic vitality which once emanated from this European inland sea.

Since 1989 – after a long break – we are back on track to built on the positive tradition of the past. Once more, the Baltic Sea region becomes a European growth area and rises to the challenges of globalization.

The impressive economic results of Poland an Baltic states is the best proof of this. Those countries have been successfully restructuring their economies for many years both in terms of changing legal framework and structure of industry.

Today Poland's foreign trade with partners from Council of Baltic Sea States (CBSS) accounts for approx. 42 % of total trade turnover (with clearly visible dominant role of Germany as a major trading partner).

For many years trade figures for CBSS countries have been noticeably higher than those for other trade partners. Only in 2004 our export to CBSS area grew by 30 %, reaching over 33 bln USD. The substantial part of foreign investments in Poland originates from Baltic Sea region. Companies from Sweden and Germany are amongst the ten biggest investors.

Poland as a member state of the European Union is vitally interested in improving the international competitiveness of its own as well as European economy. Therefore, we give our full support to the initiatives of strengthening and deepening the regional cooperation with a special attention to:

- cooperation in the energy sector and the development of infrastructure,
- eliminating barriers to trade and investments,
- reducing bureaucracy and creating better conditions for entrepreneurs (with focus on small and medium sized companies).

Latest economic results of countries of Baltic Sea rim clearly proves that business people have already started to explore the potential of a market of up to 100 million consumers. For example, volume of trade between Poland and Sweden almost tripled over last four years. Tourism and cross-border cooperation become increasingly important for local communities. By the fact of EU enlargement, countries like Poland got a change to fully participate in benefits of free trade in the region, but are also interested in other than trade forms of cooperation in following sectors:

- telecommunication and IT,
- energy management and distribution,
- housing and industrial construction,
- food industry,
- environment protection and eco – agriculture.

Thanks to the intensive economic cooperation between the CBSS countries, the Baltic Sea region will keep its position as a leading growth area in Europe and contribute to the mission of building lasting security in the region.

Professor Stefan Meller

Minister for Foreign Affairs of the Republic of Poland

Triple Trade in Ten Years - a Vision for the Baltic Sea Region

by Stephan Müchler

Since the beginning of the 90s, enterprises around the Baltic Sea Region have been trying to develop trade with the neighbouring countries on the other side of the Baltic Sea. The period between World War II and the dramatic changes in the autumn of 1989 seems to be more and more of a brief, strange period in the history of the region. Already in 1992, the Chambers of Commerce and Industry around the Baltic Sea responded to the needs of their member companies and founded the Baltic Sea Chambers of Commerce Association. Since then, BCCA acts as a network for more than 50 chambers in the region. Promotion of more trade in the region has always been one of our top priorities.

The propects today in the winter of 2005/2006 look very promising. Since the late 90s, the economic development of the region has been very strong in most of the countries. Poland together with Estonia, Latvia and Lithuania are continuously showing steady growth rates and this is of course reflected in trade development.

Since a couple of years BCCA has been promoting our vision, Triple Trade in Ten Years – 3T. This ambitious but realistic vision of more trade is based on our strong belief in the future opportunities of the region. Also, since the early 90s, trade has actually tripled in the Baltic Sea Region. Proximity is still a major force for more trade and contacts, and our region offers business opportunities within a reasonable travel distance in a large number of industries. If the enterprises shall be able to fulfil the possibilities however, necessary action must be taken in the following five areas:

Attitude – This is still one major obstacle in the BSR and perhaps the most serious one. Prejudices make people assume things about their neighbours, which limit the possibilities. To be able to deal with these prejudices there are two major tools. The first tool is contacts, where tourism is of large importance. The strong and positive view on the region shared by a majority of business peoples and public officials must be spread to the public. The second tool is facts; our authorities must gather relevant information and make this available in order to eliminate remaining prejudices.

Post-enlargement – Previous enlargements of the European Union give strong arguments for the importance of the post-enlargement process. If we manage to concur the national regulations, the advantages of a fully functional common market will further boost the economic development in our region. As in other parts of Europe, one of the most crucial issues has to do with the free movement of labour and in this perspective the service directive of the European Union is very important.

Infrastructure – The strong connection between the need for more transport and the growth of wealth is very well documented. In the BSR this means that governments and authorities need to develop the infrastructure to meet the demands that will be generated in a near future. These large investments will also bring regions around the Baltic Sea together, establishing interesting corridors of strengths in various sectors. In a shorter perspective it is also important to tackle a number of minor logistic bottlenecks that exists. These bottlenecks can seem to be of little importance from a national perspective, but often play a major role for the flow of goods for our neighbours.

Russia – When the Russian economy accelerates further in the coming years, the impact will be very noticeable in the rest of the Baltic Sea Region. Considering the opportunities for our region the importance of Russia is obvious. If we only manage to fully integrate the metropolitan areas around St Petersburg and Moscow, this alone will alter the economic geography in our region, increasing the regional market. But is not just a matter about business, we also need to fully interact with the research and development sector in Russia to improve our common competitiveness.

Free Trade – Limitations to free trade will limit the progress of our neighbours and in the long run weaken our own possibilities. This is the simple fact. But at the same time the globalisation is an ongoing development that from time to time is a tough process, imposing structural changes that affect our societies. To be able to sell the idea of free trade as a win-win game to the public is a mission for responsible politicians and the business life alike.

BCCA believes that 2006 is an excellent opportunity for politicians from the Baltic Sea Region to make the most of our region. Today, when almost all countries in our region are members of the European Union we need to market our opportunities in competition with other parts of Europe. Political initiatives are on the way with for instance the new version of the Northern Dimension Action Plan. The Baltic Sea Strategy from Members of the European Parliament is another good example. However, political rhetoric is simply not enough, but must be backed by concrete activities and decisions. The well-known Finnish decisiveness and action-orientation make the approaching Finnish Presidency of the European Union during the second half of 2006 the best opportunity for a number of years to promote our part of Europe. As well as support the positive development in the region, for the benefit of all Europeans.

Stephan Müchler

President of Baltic Sea Chambers of Commerce Association

European Integration is Bearing Fruit

by Kari Jalas

Finnish companies expect three basic things from European integration: Political and economic stability, dismantling of trade barriers and an operating environment that supports the international competitiveness of European companies. New EU Member States around the Baltic Sea are offering all of these.

The Central Chamber of Commerce of Finland uses its specially developed success indicator to evaluate the performance of European economies. On the basis of this indicator, the most successful economies in 2005 are Luxembourg, Latvia, Estonia and Lithuania (The Central Chamber of Commerce of Finland, Euro-Zone Economic Scan 2/2005, www.chamber.fi).

The success indicator is based on a growth and a stability component. Latvia, Lithuania and Estonia all rank in the top four for the growth component. These countries have experienced rapid economic growth and an increase in investments. In Latvia and Estonia employment has been growing faster than the average of the surveyed countries.

Estonia is the highest ranking of the three countries in the stability component, with Latvia and Lithuania ranking lower. Estonia is doing well as a result of its small national debt and surplus in the public sector. All three countries have big current account deficits that lower their rankings in the stability component.

Skilled workforces, low production costs and improving infrastructure attract international enterprises to expand their business activities into these countries. Poland takes a central position between East and West. Its national economy is as big as that of the nine other new EU Member States combined.

EU membership has clearly improved the business environment in the Baltic States and Poland. Finnish enterprises are sure to benefit from these rapidly developing markets. However, there is much more to be done to remove still existing trade obstacles.

EU Membership has improved the business environment in the Baltic States and Poland

The Central Chamber of Commerce of Finland conducted a survey concerning the functioning of the European Internal market of the Baltic countries and Poland in April 2005. A total of 280 Finnish companies with operations in the countries in question responded to the survey. Similar surveys were carried out in 2001 and 2002 (The Central Chamber of Commerce of Finland, The Finnish Business Perspective of the Baltic and Polish Markets, 2005, www.chamber.fi).

Finnish companies expected a large increase in the significance of the Estonian, Latvian, and Lithuanian and, in particular, Polish markets over the next five years. 80 per cent of the respondents predicted an increase in the significance of the Polish market. According to the enterprises the primary means by which Finnish companies can benefit further from this growing market potential will be by increasing their own exports, establishing subsidiaries, forming partnerships with local companies and increasing subcontracting.

Although the significance of the Polish market was on the rise, 57 per cent of the survey respondents still named Estonia as their primary market. Second position was shared by Latvia and Poland. Lithuania was viewed as a slightly less important market.

Estonian, Latvian, Lithuanian and Polish business environments have clearly improved over recent years. Finnish companies rated the countries and gave Estonia the best score (in a scale from 4 to 10 (best) with 7.56 (7.15 in 2001). The business environments of Latvia and Lithuania were rated slightly lower than in Estonia, with both countries receiving a score of 7.04 (as compared to 2002; Latvia 6.50, Lithuania 6.48). Poland received a score of 6.89 (as compared to 6.59 in 2001). The business environments were compared to Finland, which received a score of 9.

One fifth of the respondents felt that business culture in Estonia had improved during the last few years. The decrease in bureaucracy and growth in the economy combined with EU membership have brought about interest in the Estonian market. EU membership and improved business culture were seen as the most positive developments in Latvia. Almost half of the respondents in Lithuania recognized EU membership as the most important positive change in the country's business environment. Economic growth, developments in transportation and logistics were also underlined. One quarter of the respondents viewed EU membership as the most significant step forward for the Polish market. Bureaucracy has decreased and corporate culture has improved in Poland.

Estonia's primary problems were its low price levels (17 %) and low levels of purchasing power (15 %). The biggest problem in the Latvian market was the lack of language skills (17 %). Price levels (10%), trade practices and corporate culture (10%) were also mentioned as problems. The most significant problems for the Lithuanian market were its trade practices and corporate culture (22 %). Price levels (19 %) and stiff competition (19 %) were also seen as problems. In Poland, the biggest problems were in trade practices and corporate culture (23 %). Also mentioned were problems related to price levels (21 %), financing (19%) and bureaucracy (17%).

The activities of the authorities have improved across the board since the surveys that were conducted in 2001 and 2002. The greatest improvements have occurred in the activities of customs and border control authorities as well as those of the inspection and certification authorities.

A number of Finnish companies are planning to invest in the markets of the Baltic countries and Poland. Over half (55 %) of the large companies that responded to the survey plan to invest in either Estonia or Latvia during the next year, whereas 38 per cent of the large companies plan to invest in Poland.

Almost one third of all the respondents had invested in Estonia in the preceding 12 months. During the same time, 19 per cent of the respondents had invested in Latvia, 16 per cent in Lithuania and 23 per cent in Poland.

The Baltic Sea Area is already one of the fastest growing hotspots of the global market. However, its potential is not yet fully recognized. Unfortunately two crucial drivers of economic growth are still missing in the area: free movement of labour and a common currency, the euro.

Chambers of Commerce around the Baltic Sea are working hard to foster European integration in the area. The Baltic Sea Chambers of Commerce Association (BCCA) is committed in promoting prosperity and competitiveness in the region. The Central Chamber of Commerce of Finland has held a Vice Presidency in the BCCA since 2004.

Dr. Kari Jalas

The Central Chamber of Commerce of Finland

Poland after the Elections: Addressing the Nexus between Fiscal and Labor Market Reform

by Ralf Wiegert

Since the parliamentary election in September, Poland's political landscape has been undergoing a profound shift. The SLD-dominated government suffered a crushing defeat, and the leading role was taken over by the right-wing Law and Justice (PiS), which formed a minority government headed by Prime Minister Kazimierz Marcinkiewicz. It is tolerated by populist and, mostly, conservative parties, including Samoobrona, the Polish Peasants Party and the League of Polish Families. Many had expected PiS to team up with the liberal PO (Civic Platform), which came in on second place in the elections, but these hopes were dashed as coalition talks failed in October. In the election campaign, PiS highlighted their goal to transform the entire political process, alter the constitution, and root out corruption. The question is, will they do likewise with the economic legacy?

As regards Poland's economic and financial woes, which include the highest unemployment rate in the European Union (17.3% in October this year) and stubbornly high budget deficits, it is obvious that at least the same attention paid to reforming political processes is required for economic and financial matters. Indeed, the key policy challenge for the new government remains fiscal consolidation. Unfortunately, this needs to be done amid a nascent recovery of domestic demand and expensive social policies (thanks to still-large structural problems in rural areas and heavy industry that cause persistently high unemployment). It was encouraging, though, that GDP growth has been recovering recently, equaling 3.7% year-on-year in the third quarter, which compares to 2.1% in the first quarter 2005. Of course, this result is a welcome boost for the new government, which may thus find more room for cutting spending or raising revenues next year.

The fiscal deficit (consolidated general government according to ESA-95 accounting standards) hit 3.9% of GDP in 2004. In 2005, however, tighter spending management and strong revenues have allowed the deficit to remain considerable smaller than envisaged in the original budget plan. The fiscal gap (ESA-95) will likely remain only slightly above 3% of GDP. Without doubt, this is an encouraging sign, although still much too high given that the economy has been growing vigorously last year.

Alas, the data according to the European Standards of Accounting (ESA) underestimate the true state of the Polish fiscal deficit. For, following the introduction of a second, privately managed capital-based but nonetheless mandatory pension pillar in 1999, the Polish government continued to include revenues for this part of the pension system into fiscal coffers. After all, the fiscal gap would be some 1.5% of GDP larger if Open Pension Funds' (OFE) revenues were excluded and interest payments on government bonds held by OFE included into budget accounting. Moreover, the stock of public debt currently trails very close to the lowest threshold level set by the constitution (50% of GDP by Polish accounting standards) and will eventually surpass it by end-year, a fact that automatically imposes fiscal limits for next year's budget Much harsher rules would be applied if the debt level exceeds 55% and the highest threshold level—60% of GDP. In the latter case, the government would have to submit a balanced budget for the following year. Naturally, this makes the case for fiscal consolidation even more compelling, irrespective of the Maastricht criterion, which is relevant for Eurozone accession.

These malign fiscal perspectives apart, it remains doubtful, though, whether a short-termed fiscal injection or a temporary monetary boost would suffice to push the Polish economy back to the momentum seen in 2004 – a policy framework that is frequently cited by leading PiS politicians. For, alas, despite high corporate profits in 2004 and still-healthy growth this year, Poland's corporate sector seems still reluctant to rehire workers, and the unemployment rate remained the highest in the EU by far. Fixed investment, moreover, has only hesitantly gained steam this year, although the inflow of European Union funds, high corporate profits in 2004, and recent policy rate reductions should have boosted investment significantly.

Reviving investment and, in the same vein, reducing unemployment, depends on the government's efforts to remove distortionary tax rules and simplify the tax system, tackle red tape and corruption, and, after all, consolidate fiscal finances in the sense that spending gets rationalized and the overall fiscal burden on the economy is reduced. Those who argue for pro-active monetary policy should note that the high fiscal deficit is a good deal responsible for the current level of the policy rates, and cutting back the deficit would give the RPP more leeway for slashing the rate.

Indeed, there is a nexus between fiscal and labor market woes. According to the OECD, the tax wedge, defined as personal income taxes plus social security payments minus cash benefits, was equivalent to 41.9% of a so-called 'average production worker's earnings' (APW) in Poland in 2004 (single worker without children with 60% of APW), while amounting to 41.5% for a couple with two children and one earner (100% of APW). The former figure puts Poland within the leading group of eight OECD countries, which display a level of higher than 40% as well, while the latter implies Poland ranking second, following only Turkey (42.7%).

A high tax wedge is particular detrimental for a country still undergoing structural shifts, and also for a country which is set to grow faster than other, more advanced countries. A large tax wedge puts the brakes on employment, because it is discouraging people to take up work while adding too large a tax burden onto employer's labor costs total.

That said, the new government's recently stated intentions are a mixed blessing for the economy. Although Marcinkiewicz reiterated earlier made promises to impose a ceiling for the central government budget deficit of 30 billion zloty (Global Insight estimates the deficit at 32-33 billion zloty in 2005), the new government, at the same time, made several costly spending pledges on subsidies for road and housing construction and on social transfers.

As a consequence, the future path of Poland's fiscal finances remains unclear, and it is hard to see how the new government will eventually manage to match both the deficit target – which is essential for budget consolidation –, spending pledges and satisfy their populist allies in parliament at the same time. Sacrificing the deficit target might be the most likely solution to this conundrum, although the new government will surely try to remain as close as possible to it. Real reform of Poland's tax system, including the income tax, remains a distant perspective under these circumstances, unfortunately. After all, though, the government's policy priorities will become more apparent only next year, as the cornerstones of next year's budget had been set by its predecessor, and any major reforms have thus de facto been postponed.

Dr. Ralf Wiegert

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The China Phenomena in the Baltic Sea Region

by Kari Liuhto

China has received a lot of attention from foreign investors due to the huge potential of its market, low production costs and the high growth rates of its economy. Due the aforementioned reasons, foreign direct investment (FDI) flows to China are impressive. Whilst admiring China's performance, one should not forget that that growth rates related to FDI are also considerable in the Baltic Sea region (BSR).

In fact, the Baltic Sea region's FDI growth is even higher than that of China in the past ten years, and particularly faster during the past 5 years. In the period 1995-2004, China's inward FDI stock more than doubled. During 2000-2004, it grew by 8% only. During the past 10 years, the inward FDI stock of the Baltic Sea region more than tripled. During this decade, it has grown by 57%, indicating much faster growth than in China. In terms of FDI inward stock per capita, the BSR would clearly outperform China.

Even if the FDI growth rates flatter the Baltic Sea region, one should not get too excited over them since a major part of the investment flows in the region are internal ones. In other words, the nine countries surrounding the Baltic Sea region invest in each other. For example, some 60-80% of all FDI in the Baltic States and Finland originates from another BSR country. Though the figure in Denmark, Poland and Sweden is considerably lower, it is still around 25%. Russia receives approximately 10% of all its FDI from the BSR and Germany 5%. Investment flows in the region result mainly from capital flows from the west of the region to the east (see BRE 2/2005).

As a great part of the FDI flows is due to intra Baltic investments, the region as a whole does not receive new capital but the capital only moves from one shore to another. Therefore, the China phenomenon in terms of high FDI growth rates in the Baltic Sea region is, to a great extent, a statistical bubble. In order to change the situation for the better, a common investment promotion agency and strategy for the whole region should be constructed.

Development of FDI inward stock (USD billion)

	1995	2000	2004	Multiplier 1995-2004	Multiplier 2000-2004
Denmark	23.8	73.6	98.2	4.13	1.33
Estonia	0.7	2.6	9.5	13.57	3.65
Finland	8.5	24.3	55.9	6.58	2.30
Germany	192.9	271.6	348.0	1.80	1.28
Latvia	0.6	2.1	4.5	7.50	2.14
Lithuania	0.4	2.3	6.4	16.00	2.78
Poland	7.8	34.2	61.4	7.87	1.80
Russia	5.5	32.2	98.4	17.89	3.06
Sweden	31.1	94.0	163.0	5.24	1.73
BSR-9	**271.3**	**536.9**	**845.3**	**3.12**	**1.57**
China	311.5	651.6	706.5	2.27	1.08

Sources: World Investment Report 2002 & 2005, UNCTAD

If the China phenomenon related to the FDI growth in the BSR is a statistical bubble, one should not forget that the China phenomenon takes place in the region in another form. In other words, economic relations with China are growing rapidly, imports in particular. In 2004, China accounted for some 3-7% of imports of all the BSR countries, excluding the three Baltic States, where the China accounted just 2% of their imports.

The relative importance of the BSR countries' exports to China is rather modest. Due to Russia's geographical location it is natural that China forms a substantial part (7%) of its exports. However in other BSR countries, China accounts for, on average, less than 2% of these countries' exports.

As investments have a tendency to follow export flows, some Chinese companies have already invested in the Baltic Sea region. Although China is statistically a minor player in the region, two Chinese investments in the region deserve special attention.

The construction project called the "Baltic Pearl" in the St. Petersburg region is China's biggest investment project in Russia and probably the largest project of the Chinese companies in the Baltic Sea region. According to this investment plan, a group of half a dozen Chinese firms aim at investing USD 1,25 billion to build a 180-hectare residential district in the City of St. Petersburg. The first part of the Baltic Pearl should be finished in 2008.

Huawei Technologies present another type of Chinese investment in the Baltic Sea region. In 2002, the company founded its R&D unit in Sweden. This Chinese telecom giant aims at harnessing Swedish expertise in Internet telephony and third-generation cellular technology. Obviously, the goal of Huawei Technologies is not to set up production in Sweden but to carry out R&D work there and bring the results of this knowledge to the use of its parent company.

To conclude, Chinese investments in the Baltic Sea region is still a rarity but probably in the future the presence of the Chinese firms will grow along with the accumulation of capital in China, which pushes its firms abroad to acquire fresh management skills and advanced technologies.

In my opinion, the companies of the Baltic Sea region should already prepare for this novel phenomenon though it is still unlikely that the presence of Chinese investments in the Baltic Sea region would grow as fast as the presence of the Russian firms. Despite a slower expansion, a thorough study concerning the business entry of Chinese corporations in the region should be carried out sooner rather than later. Such research might aid policymakers in anticipating the possible consequences of the Chinese business entry to the BSR.

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