

# Baltic Rim Economies

Estonia –Latvia –Lithuania –Poland –Baltic Russia  
Bimonthly Economic Review

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## Estonia

### Slowdown of economic growth continued in the second quarter

According to Statistics Estonia, economic growth was 7.3% in the second quarter by preliminary estimates, compared with the same period last year. The slowdown of GDP growth already began in the first quarter, when the economy expanded by 9.8%. The growth, in value added, has decelerated most in manufacturing, wholesale, transport and storage. Value added in railway and water transport has decreased. The slowdown of GDP growth is in line with the soft landing scenario suggested by the Bank of Estonia.

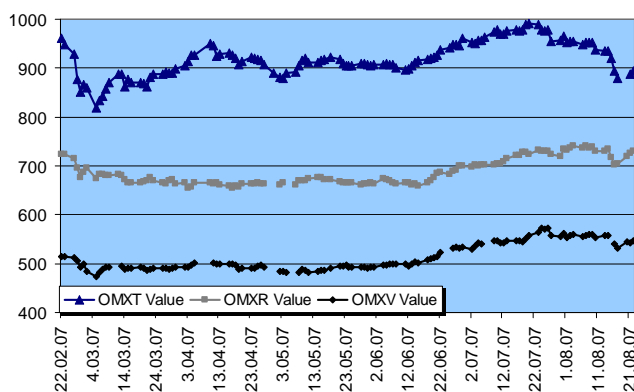
Rapid growth in financial intermediation, construction and the retail trade continued. GDP in constant prices grew by 1.0% compared to the first quarter of 2007. The Estonian Finance Ministry predicts the continuation of an economic slowdown in the third quarter as well. There are several indicators showing the cooling down of the Estonian economy – lower economic confidence index, slowdown in exports growth, slowdown in value added of firms due to high price pressures in wages etc.

The slowdown of the economy is also reflected on the Tallinn Stock Exchange, which lost 10% of its index value in one week in the middle of August. Price movements in the Tallinn Stock Exchange are also more volatile compared with the Riga Stock Exchange and the Vilnius Stock Exchange.

### The decrease in unemployment continues

The unemployment rate decreased to 5.0% in the second quarter according to Statistics Estonia. Compared to the second quarter of 2006, unemployment decreased most in North-eastern Estonia, from 14% to 9.8% in the second quarter of 2007. The unemployment rate was lowest in Western Estonia (3%). Growth in employment was merely 1.3%, due to very high employment growth in 2006. According to the Estonian Labour Force Survey, employment has increased mainly due to a decrease in inactive people and unemployment. Employment has significantly increased among youths. There were 70000 people employed in the age group 15-24, 5% more than a year ago.

### Index Values of Baltic Stock Exchanges



Source: OMX Group

Estonia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	7,9	6,5	7,2	6,7	7,8	9,8	11,4	7,3	Q2/2007
Industrial production (y-o-y %-growth)	14,6	8,9	8,2	11,0	8,0	9,7	7,0	4,5	6/2007
Inflation (CPI, end of period, y-o-y %-change)	5,0	4,2	2,7	1,1	5,0	3,6	4,4	6,4	7/2007
General government budget balance (% of GDP)	-0,6	0,3	1,5	2,0	2,3	2,3	3,8		1-12/2006
Gross wage (period average, EUR)	314	352	393	430	466	555	596	660	Q1/2007
Unemployment (% end of period, LFS data)	13,9	11,9	11,3	9,3	8,5	7,9	5,9	5,0	Q2/2007
Exports (EUR million, current prices)	3 445	3 698	3 642	4 003	4 770	6 190	7 647	3 275	1-5/2007
Imports (EUR million, current prices)	4 615	4 798	5 079	5 715	6 704	8 213	10 576	4 596	1-5/2007
Current account (% of GDP)	-5,5	-5,6	-10,6	-11,6	-12,5	-10,5	-14,8	-10,4	1-3/2007

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

### Clear cooling of the real estate market

According to the data of notaries, in the second quarter of 2007 13,750 notarised real estate contracts were made, with total value of 1.1 billion euros – that accounts for 10% less in the number of contracts and 13% less in the total value of contracts compared to the year before. Nevertheless, the growth in the number of real estate contracts increased by 1%, but that does not fit with the usual seasonal pattern of growth in the real estate market in the second quarter.

The real estate market has calmed down significantly during recent years. Higher interest rates, more conservative loan policies of banks and high prices have reduced the demand side in the real estate market, while the supply side remains high. The majority of real estate specialists forecast a downward correction in real estate prices in the near future, but no fatal real estate crash is foreseen. The real estate market is concentrated upon Tallinn and Harju counties, where 54% of the contracts with a value more than three thirds of the total value of buying-purchase contracts were made.

### Price indices also high in July

The Estonian economy faces a considerably high inflation rate. According to Statistics Estonia, the producer price index increased by 0.5% compared with June and 8.7% compared with July 2006. The producer price index has risen most in the manufacturing sector, especially in wood and wood products, food and beverages.

There has also been an increase in export and import prices. In July 2007, the change in the export price index was 0.9% compared to June 2007 and 9.1% compared to July 2006. The change in the import price index was 0.4% in July compared to June 2007 and 2.8% compared to July 2006.

The consumer price index was up by 6.4% in July 2007 compared with July 2006. The monthly percentage change compared with June 2007 was as high as 1.1%. The CPI rise was mainly influenced by the increase in prices of heating energy, fuels and dairy products. The price change in services was more than 10% y-o-y in July 2007.

### Some business highlights

- § International rating agency Standard & Poor's degraded Estonia's sovereign rating from stable to negative. Their rating was lowered because of increasing risks generated by very high domestic demand and high current account deficit in Estonia.
- § SAS Group has announced a plan to acquire Estonian Air and Air Baltic from the state. SAS currently owns a 49% stake in Estonian Air and 43% of Air Baltic
- § Finnish cable production company PKC Group is expanding their activity in Estonia through a subsidiary. PKC is planning to increase employment in Estonia because of the high quality of the Estonian labour force.
- § Banks are reporting good financial results for the first half of 2007. SEB Ühispank increased its profit by 30% earning EUR 52 mln profit during the first half of 2007. Sampo Pank increased its profit by 50% during its first five months under the ownership of the Danske Bank Group.
- § Merko Group, Estonian biggest construction company increased its half yearly profit by 43% compared with 2006 despite the slowdown in the real estate market. Total sales increased by 45%.
- § Latvian company Sakret, producing construction material, opened a factory with a total investment of around EUR 6.5 mln, which is the biggest Latvian industrial investment into Estonia so far.

## Latvia

### GDP growth continues

The good growth performance continues in Latvia. As the GDP grew at a rate of 11.2% in the first quarter of 2007, the growth in the second quarter is estimated to be 11.3% compared to the 2<sup>nd</sup> quarter in 2006 according to econometric calculations by Central Statistical Bureau. If this estimate turns out to be correct, the growth rate in Latvia has been above 11% for nine consecutive quarters and implies that Latvia is among the fastest growing economies in the European Union. The main driver behind this rapid growth has been a strong domestic demand boosting the service sector, which has expanded by 11.5% y-o-y and contributing 8.6% to the total growth. A sharp rise in financial intermediation of 21.4%, as well as a trade increase of 15.7% were the main contributors to this expansion in the service sector.

Despite Latvia's good economic performance, there have been some signals that the peak of growth has been passed in 2006 when the growth was 11.9%. However, even if the growth slightly levels off, the forecasts still show strong growth for Latvia for 2007 and 2008. The flip side of the booming economy is the risk of an overheating of the economy.

### Industrial production output slows down in 2007

After five years of rapid growth in industrial production, output rose only by 1.3% in the second quarter of 2007 compared to same period of the previous year. This figure is based on the seasonally adjusted data of the Central Statistical Bureau. Mining and quarrying increased by 14.4%, electricity, gas and water increased by 5.5% whereas manufacturing decreased by 0.2%. However, there are some manufacturing sectors that have experienced robust growth in their output. For example, there was an increase of 20.3% in the manufacturing of electrical machinery and equipment. The output of rubber and plastic products manufacturing rose by 14.3%. There were also manufacturing sectors where output decreased in the second quarter of 2007, such as the manufacturing of wood articles with a decrease of 9.9% and the manufacturing of other transport equipment with a decrease of 12.5% in its output. According to the Bank of Latvia, the modest overall growth in industrial production was mostly due to narrowing wood production volumes.

### External sector starts to recover in Latvia

The value of exports in June 2007 increased in comparison to June 2006 by 17.7%, after quite slow growth in the first quarter of 2007. The value of imports, on the other hand, was 27.2% higher in June 2007 than in the same period of the previous year.

In 2006, the current account deficit was 21.1% of GDP and was largely due to deterioration in the trade balance caused by strong domestic demand. In addition to rapid GDP growth, this also indicates that the Latvian economy is overheating. The deficit has continued to be quite high in 2007 as well, but as the growth in exports strengthens and weakening domestic demand abates import growth, the current account deficit should start narrowing. It is estimated that the current

account deficit should reach a level of less than 20% of GDP by 2008.

### Latvia's foreign trade in June 2007

EXPORTS	% of total
Wood and wood articles	23.6
Base metals	15.0
Agricultural and food products	12.8
Machinery and mechanical appliances	10.6
Prepared foodstuffs	7.9
IMPORTS	% of total
Machinery and mechanical appliances	19.5
Transport vehicles	15.3
Mineral products	12.9
Agricultural and food products	11.2
Base metals	10.1

Source: Central Statistical Bureau CHANGE appliances to appliances in this table!

The most important export articles are wood and articles of wood, base metals, and agricultural and food products. Especially wood and wood articles increased their significance in June 2007 since the exports of wood and wood articles increased by 27.9% compared to June 2006. The exports of mineral products decreased by 19.5% in the same period, now comprising only 3.9% of Latvia's total exports. The value of imports increased in all the main commodity groups in June 2007 relative to June 2006. The imports of mineral products increased by 29.6%, base metals by 28.2% and plastics articles by 23.1%. The most important import articles are machinery and mechanical appliances, transport vehicles and mineral products. The main trading partners for Latvia are the EU countries, of which Lithuania and Germany stand out as the single most important ones.

### Banking sector

The restructuring of the banking sector has been accomplished in Latvia, and today the sector is almost completely privately owned. There are 21 banks and three branches of foreign banks in Latvia. Overall, the banking sector is doing quite well; banks reached profits of almost EUR 213 mln during the first five months of 2007, which is up 61.4% y-o-y.

### Some business highlights

§ Latvian banks reported EUR 258.11 mln in aggregate profit in the first half of 2007, which is 64 percent more than in the same period of last year, a spokesman for the Bank of Latvia said. Latvian banks posted EUR 379.3 mln in preliminary 2006 profit, a 38.1 percent rise from 2005.

§ Latvia has been ranked the 18th most-friendly country for launching a new enterprise, a study by the CNN Time Warner Group shows. The rating has been based on such factors as the average time it takes to launch a new business, bankruptcy laws, tax policies and employment regulations. The most start-up friendly country is New Zealand, followed by the US.

§ Itera Latvija plans to build a EUR 365 mln gas power plant in Latvia, together with Gazprom and E.ON Ruhrgas International AG. The Russian gas giant has said it could provide the necessary amounts of gas, but would not take part in the project otherwise since it would not make a profit for them.

Latvia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	6,9	8,0	6,5	7,2	8,5	10,6	11,9	11,3	4-6/2007
Industrial production (y-o-y %-growth)	3,2	6,9	5,8	6,5	6,0	5,6	4,8	1,2	6/2007
Inflation (CPI, end of period, y-o-y %-change)	1,8	3,2	1,4	3,6	7,3	7,0	6,8	9,5	7/2007
General government budget balance (% of GDP)	-2,8	-2,1	-2,3	-1,6	-1,0	-0,2	0,4		1-12/2006
Gross wage (period average, EUR)	268	282	297	298	314	350	430	508	Q1/2007
Unemployment (% end of period, LFS data)	13,3	12,9	11,6	10,3	10,3	8,7	6,8	6,9	Q1/2007
Exports (EUR million, current prices)	2020	2 232	2 416	2 559	3 204	4 086	4 594	2 730	1-6/2007
Imports (EUR million, current prices)	3 453	3 910	4 284	4 634	5 671	6 879	8 828	5 300	1-6/2007
Current account (% of GDP)	-4,8	-7,6	-6,6	-8,1	-12,9	-12,3	21,1		1-12/2006

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

## Lithuania

### GDP

At the moment, the Lithuanian economy is the most stable of the Baltic countries. Economic performance has been robust in Lithuania, and there are no signs of overheating as in Latvia. Even though the growth in Lithuania has been more modest than in the two other Baltic economies, it has been able to maintain steady growth rates throughout 2006 and the first half of 2007. According to first estimates by Statistics Lithuania, GDP growth was 8.0% in the second quarter of 2007, which is slightly less than 8.3% in the first quarter of 2007. The overall growth for H1 has been 8.1%, beating all expectations. It is estimated that the growth rate will be approximately 8% for the rest of the year.

GDP growth has been largely led by domestic demand contributing positively to the service sector. The most vigorous growth was recorded in the construction sector, which grew by 26.2%. Also wholesale and retail, real estate, communications and transport sectors have been growing rapidly.

### Labour market trends

The unemployment rate has been steadily declining in Lithuania. The rate of unemployment was 6.4% in the first quarter of 2006, whereas in the same period in 2007 the rate was 5.0%. The employment prospects have constantly improved, much due to the economic boom that has prevailed in all the Baltic countries. Partly this positive development is explained by a rise in emigration after accession to the European Union. Of all the Baltic countries, this has been most prominent in Lithuania. However, as a result of business sector expansion and emigration by the labour force, there is a risk of labour shortage in certain economic sectors.

Due to strong domestic demand and labour supply constraints, real wages have been growing very quickly. The growth rate of real wages surpassed 10% in all Baltic countries in 2006. In Q1 of 2007, the growth rate was already as high as 22.9% in Lithuania. Despite this, the Lithuanian Parliament has proposed that the minimum wage should be raised from 35% to 60% of the average monthly gross wage. In June 2007, the minimum monthly earning was EUR 174.

### Foreign trade

The rate of export growth has been declining in Lithuania. Exports grew by 7% in H1 of 2007 compared to the corresponding period in 2006, whereas imports grew by 15.4% in the same period. The largest increase in exports was recorded in the exports of plastics and articles thereof, which grew in H1 of 2007 by 93.7% compared to H1 in 2006.

The poor performance of the exports growth could be interpreted as a sign of the deteriorating competitiveness of the Lithuanian economy. In January-June 2007, the foreign trade deficit was EUR 2477 mln, which is 42.2% higher than in the corresponding period in 2006.

In the first half of 2007, the most important commodities, both in exports and imports, were mineral products, machinery and mechanical appliances, and vessels and associated transport equipment. The largest trade partners for Lithuania are Russia, Germany, Latvia and Poland. Also the EU area as a whole plays a significant role in Lithuania's trade.

Lithuania - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	3,0	6,4	6,9	10,3	7,3	7,6	7,5	8,1	1-6/2007
Industrial production in sales (y-o-y %-growth)	2,2	16,0	3,1	16,1	10,8	7,3	8,9	4,7	6/2007
Inflation (CPI, end of period, y-o-y %-change)	1,4	2,0	-1,0	-1,3	2,9	3,0	3,8	4,8	6/2007
General government budget balance (% of GDP)	-2,5	-2,0	-1,4	-1,3	-1,5	-0,5	-0,3		1-12/2006
Gross wage (period average, EUR)	263	274	293	311	335	421	459	504	Q1/2007
Unemployment (% end of period, LFS data)	16,9	17,9	13,0	11,6	10,6	8,3	5,6	5,0	Q1/2007
Exports (EUR million, current prices)	3 841	4 778	5 526	6 158	7 478	9 502	11 250	5 952	1-6/2007
Imports (EUR million, current prices)	5 650	6 767	7 943	8 526	9 959	12 446	15 384	8 429	1-6/2007
Current account (% of GDP)	-5,9	-4,7	-5,1	-6,8	-7,7	-7,2	-10,8	-13,2	1-4/2007

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

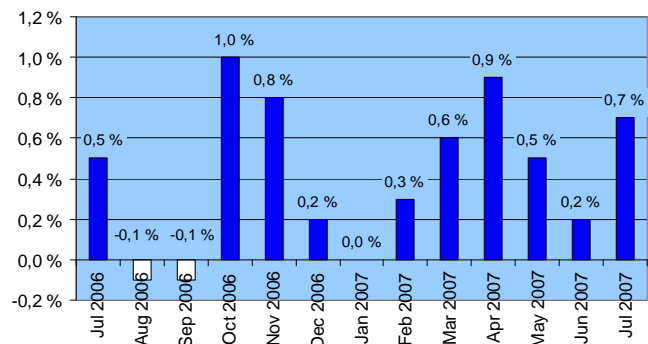
### Utilisation of IT technologies

The use of computers and the Internet in enterprises has been increasing steadily in the 2000s. According to Statistics Lithuania, 90.5% of the enterprises used computers and 88.4% used the Internet in their everyday work in the beginning of 2007. However, computers were used only by 29.1% and the Internet by 25.5% of employees in these enterprises. Almost one half of all Lithuanian companies have their own websites, even though only 53.6% of the companies have an Internet access.

### Inflation

In July 2007, the average annual inflation was 4.4% in Lithuania. The inflation over twelve months was 5.1% in July, which is among the highest in the EU and also well above the level qualifying for EMU under the Maastricht criteria. Once again, higher inflation rates were recorded in Latvia and Estonia. The mean average annual inflation in the EU area was 2.1%. Statistics Lithuania informs that the prices grew by 0.7% in July 2007 compared to June. Prices for consumer goods increased by 0.4% and prices for services grew by 1.6% in July.

### Price changes for consumer goods and services



Source: Statistics Lithuania

### Some business highlights

- § Tele2, a Lithuanian mobile operator reported 25% higher revenue in H1 of 2007 compared to the first six months in 2006. The fast growth in profits shows that company's strategy, including low prices, has been effective.
- § Commercial banks keep on growing in Lithuania. There has been notable growth in assets, loans, deposit portfolios and profits according to the Bank of Lithuania. The overall profits earned by commercial banks rose by 75% from the first half of 2006.
- § There are plans to build a new nuclear power plant in Lithuania. The new facility is meant to replace the Ignalina nuclear power plant, which will be shut down in 2009 at the request of the EU. It is planned that the first nuclear reactor starts to operate in 2015.
- § MG Baltic, Lithuania's business corporation, announced the completed takeover of Latvia's Kalnozols Celtnieciba, a construction firm. MG Baltic Investment, an investment subsidiary of MG Baltic, purchased a 75% stake in Kalnozols Celtnieciba, Latvia's sixth largest construction company, for an undisclosed sum.
- § The Mazeikiu Nafta oil refinery announced first-half losses above EUR 14.5 mln, a substantial decline compared to earnings of EUR 107 mln for the same period last year. The refinery's revenues for H1 of 2007 fell 40.9% y-o-y to EUR 1.2 bln.

## Poland

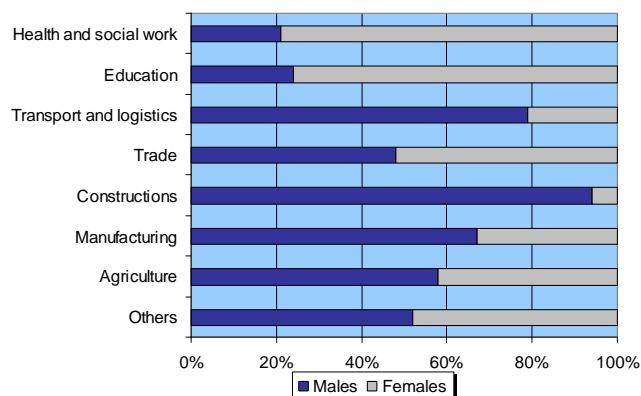
### Slowdown in economic growth

The growth in GDP in the first quarter of 2007 equalled 7.4%, which was the highest level for ten years. However, according to preliminary estimates, the GDP growth somewhat slowed down in the second quarter to 6.4%, indicating that economic growth above 7% is probably not sustainable in Poland. On the demand side, strong growth is continuing, but the growth of the supply side has more hindrances. Production growth is declining. Industrial output increased by only 5.6% in June y-o-y, whereas it clearly exceeded the 10% rate in the first quarter. The production growth in June was the lowest growth ratio of the Polish economy in the last couple of years. Considerable growth was achieved in manufacturing, where the total sales growth was 12.8% y-o-y in the first half of 2007. The growth in electricity, gas and water supply was quite moderate and there was a decline in the mining industry.

### Manufacturing sector is performing well

During the first half of 2007, the manufacturing sector has grown 12.8% y-o-y, despite the slowdown in Q2. The growth rate is slightly lower than in 2006, but still substantial. The growth rate of non-metallic raw materials, machinery and equipment, leather and metal products has been above 22%. From all sub-sectors of manufacturing, only the production of clothing and furs has declined by 2.8%. The highest share of total manufacturing output belonged to the food and beverages sector with 19.5%. Other more significant sub-sectors of manufacturing were motor vehicles, chemical products and metal products. There has been rise in wages, employment and labour productivity, indicating a strong performance by the manufacturing sector.

### Participation in employment by gender



Source: Central Statistical Office, Labour Force Survey Q1, 2007.

### Foreign trade in Poland

According to data provided by the Central Statistical Office of Poland, the total foreign trade turnover during H1, 2007 has been more than EUR 102 billion, which is 13.5% more than H1 of 2006. The growth of exports has been 12.2%, whilst imports grew by 14.6%, therefore increasing the current account deficit in Poland.

The regional structure of foreign trade has remained nearly the same. Around 80% of Polish exports go to EU countries and nearly 65% of imports are brought from the EU. Germany is the most important trade partner for Poland in both exports and imports. More than one fourth of the Polish foreign trade turnover is made with Germany. Other more important export markets are in Italy and France. 8.6% of their imports came from Russia, 6.9% from Italy and 6.8% from China in H1 of 2007.

### Improvement in the labour market

A high unemployment rate and low employment are still fundamental problems for the Polish economy. Nevertheless, the first half of 2007 has been quite promising and a remarkable improvement in employment has been achieved. The average employment by the enterprise sector increased by 4.4% compared to the same period in 2006. The rise in employment is caused by economic growth and production growth in the services sector and other labour intensive sectors.

The number of registered unemployed decreased by a remarkable 23.8% to 1.9 million persons. The unemployment rate has gradually dropped to 12.4% in July 2007, whereas it stood at 19.5% in January 2005. However, it should be noted that the decrease in unemployment is partly caused by the migration of Poles.

Good conditions on the labour market and increasing employment create a wage pressure for firms. The average salary has increased by 8.4% during H1 of 2007 compared with the same period in 2006. The steepest wage increases have been in manufacturing and trade.

### Some business highlights

- § There has been significant growth in warehouse and logistics. New warehouse space has increased by approximately 140% during three years compared to mid 2004 and as at the end of Q2 2007. Total modern warehouse space in Poland is about 2.9 million sq m.
- § The sales of aluminium foil rose by two percent in the first half year of 2007 after an already strong first half year in 2006. According to the European Aluminium Foil Association (EAFA) sales reached 452,000 tonnes compared to 443,200 tonnes from January until June 2006.
- § Commercial Metals Company (USA) announced today that CMC Zawiercie S.A. (CMCZ), CMC's steel mini-mill located in Zawiercie, Poland, will install a new rolling mill at an estimated cost of USD 170 mln. The mill will have a rolling capacity of approximately 650,000 metric tons of rebar, merchant bar and wire rod.
- § The Board of Directors of BorgWarner Inc. is about to invest USD 120 mln in key investments for the continued growth of the Powertrain technology supplier. These investments include a new Technical Centre in China, a new production campus for the Drivetrain Group in Mexico and a production facility for turbochargers to be located in Poland.
- § JP Morgan is preparing to enter the Polish market. The firm is conducting talks with distributors who would sell its products in Poland and they applied for notification of its investment funds with the Polish Financial Supervisory Commission (KNF).
- § According to a new ranking by the Federation of European Employers (FedEE), Poland is the most attractive investment location in Europe. Poland's key perceived assets are a large pool of young, well-trained workers and the availability of seasonal labour. It scored lower on training, internet use and regulations on hiring and firing.

Poland - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	4,2	1,1	1,4	3,8	5,3	3,5	6,1	7,4	1-3/2007
Industrial production (y-o-y %-growth)	6,7	0,6	1,1	8,3	12,6	4,1	5,7	10,4	7/2007
Inflation (CPI, end of period, y-o-y %-change)	8,5	3,6	0,8	1,7	4,4	0,7	1,4	2,3	7/2007
General government budget balance (% of GDP)	-0,7	-3,7	-3,3	-2,9	-3,3	-6,1	-3,9		1-12/2006
Gross wage (period average, EUR)	472	557	544	497	505	591	692	750	Q2/2007
Unemployment (%; last survey in the year, LFS data)	16,0	18,5	19,7	19,3	18,0	16,7	12,2	11,3	Q1/2007
Exports (EUR billion, current prices)	34,4	40,4	43,4	47,5	59,7	71,4	87,5	54,7	1-6/2007
Imports (EUR billion, current prices)	53,1	56,2	58,3	60,4	71,4	80,6	100,0	62,0	1-6/2007
Current account (% of GDP)	-6,0	-2,9	-2,6	-2,1	-3,5	-1,7	-2,3	-4,5	1-3/2007

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

## St. Petersburg

### Service sector boom

The first half of 2007 proved the trends observed in 2006 to be quite stable. The development of the service sector and its branches (construction, transport, communication and trade) was impressively better than that of industry. Moreover, among industrial branches food and light industry experienced the highest growth (17.0% and 21.0% respectively), whilst electronic and transport machine building faced a deep decline of output (-17.2% and -29.2% respectively). Growing branches are supplying their products mostly to the regional market; the outsiders are either exporting or supplying their goods to other Russian regions. Together with the expanding gap between industry and services this trend proves that the local market of St. Petersburg is becoming the most attractive target for regional producers of goods and services due to increasing demand.

### Construction as the leader

Construction is the brightest example here: during the last 2 years the price of real estate more than doubled from EUR 919.7 in June 2005 to EUR 2069.1 in June 2007 (per square metre of residential space, average). That booming demand was the engine of rapid growth in construction in 2006 and the first half of 2007. The total amount of apartments finalised in January-June of 2007 grew by 39.9% y-o-y, while constructed residential space increased by 28.0% y-o-y. Relative saturation and stagnation of the real estate market in January-April 2007 was followed by a rebirth of consumer demand in May-July 2007. This new wave of consumer activity was generated by a large discount and sales promotion campaign organised by the leading construction companies in order to revive the market.

### Dynamics of regional economic development, St. Petersburg

	2006	Jan-June 2007
Industrial production, y-o-y, %	-7.0	10.2
Manufacturing	-8.7	10.8
Energy, gas and water production*	8.3	7.3
Construction, y-o-y, %	35.6	22.2
Transport, y-o-y, %	20.9	14.5
Communication, y-o-y, %	38.3	24.6
Retail trade, y-o-y, %	14.5	19.3

Source: Petrostat, 2007

\* Also includes the distribution of energy, gas and water

Increasing demand for local short-distance automobile transport services led to an impressive 43.8% growth of cargo turnover in this SME-dominated sector in the first half of 2007. At the same time, the highly monopolised and export-focused pipeline and sea transport sectors experienced a decline of 1.2% and 2.0% respectively. The rapid development of the trade and catering sector in the first half of 2007 was a result of the increasing real monetary incomes of St. Petersburg residents which grew by 7.8% in January-May 2007, y-o-y. The huge increase in communication sector occurred mostly due to a rise in tariffs.

### Inflation accelerates

Consumer prices in St. Petersburg grew faster in the first half of 2007 (10.0% y-o-y) than a year ago (9.6% y-o-y). From December 2006 to June 2007 the half-yearly growth of consumer prices was 6.8% which is rather close to the projected annual figure. Moreover, this is the breakage of a five-year decreasing trend. Producer price growth reflects the boom in the service sector: a semi-annual growth of service prices reached 9.7%, and corporate tariffs in communication rose by 20.3% in January-June 2007. As a result annual inflation in St. Petersburg in 2007 might exceed that of 2006.

### Incomes come out of shadow

Improvement of legislative framework and general changes in business environment caused a gradual transfer of corporate incomes from the "shadow" to the legal sector of the regional economy. In the first five months of 2007 total financial result (profits minus losses) of St. Petersburg companies reached EUR 2.9 billion which was 30.5% higher than in January-May 2006. The number of loss-making organisations decreased by 10.1% during the same period. These changes influenced the regional budget. The profit tax revenues in the first half of 2007 increased by 47.4% y-o-y, whilst the total growth of budgetary incomes turned out to be a more modest 19.9% y-o-y. The share of profit tax in the regional budgetary incomes reached 42.3% leaving VAT and excises far behind with 13.9% and 7.2% respectively. That was a positive turn in the regional corporate finances, reflecting both the high incomes of the businesses and their increasing transparency.

### Some business highlights

- § Minister for Economic Development and Trade German Gref, St. Petersburg Governor Valentina Matvienko and NYMEX president James Newsam signed an agreement on creating in the city a petroleum exchange for REBCO (Russian Export Blend Crude Oil) which is presently traded at NYMEX, New York. The new exchange might already be launched in 2008.
- § British developer Bovis Lend Lease International Ltd won a tender for constructing the "Okhta-Centre", a huge 400-meter tower for Gazprom headquarters on the bank of the Neva. The sum involved in the contract remains confidential.
- § Dutch company Royal Boskalis, together with German construction giant Hochtief signed a contract with Russian state company Rosstroy for building a southern part of the St. Petersburg Dam. The contract's value totals EUR 350 mln; construction will be financed by the federal budget.
- § St Petersburg's government announced a tender for the complete reconstruction of Apraksin Yard, the largest marketplace in the city centre. The project's budget is EUR 300 mln.
- § Global chemical giant Unilever plans to transfer its deodorants production from Leeds, UK, to St Petersburg. Thus the company expands the production line of its plant in St. Petersburg which is already the largest Unilever's plant in Europe.
- § Japanese company Suzuki Motor Inc. started to construct a new automobile plant in Shushary, south of St Petersburg. Planned investment totals EUR 93 mln.
- § Regional bank Sankt-Peterburg issued Eurobonds amounting EUR 75 mln; the issue was organised by J.P. Morgan and UBS.
- § St Petersburg's largest cable producer Sevkabel launched a new production complex based on equipment supplied by Finnish machine-builder Maillefer. Sevkabel invested nearly EUR 15 mln in the complex and now plans to expand its 8.4% share of Russian cable market (national cable market capacity reached EUR 2.8 bln in 2006).

St. Petersburg region- main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
Regional GDP (y-o-y %-growth, constant prices)	10,5	4,5	17,7	8,4	7,2	8,4	8,4	10,2	Q1/2007
Industrial production (y-o-y %-growth)	26,2	0,2	31,4	5,8	14,1	4,2	-7,0	10,2	H1/2007
Regional inflation (CPI, y-o-y %-change)	23,5	16,3	16,6	13,0	12,7	12,0	10,0	10,0	H1/2007
Gross average wage (monthly, EUR)	n/a	n/a	217,1	209,3	284,9	344,5	406,9	453,3	5/2007
Unemployment (% average annual)	7,9	4,4	4	4,3	2,8	2,4	2,4	2,4	H1/2007
Exports (EUR million, current prices)	2 736	2 134	1 839	2 428	3 210	3 953	5 499	1 224	Q1/2007
Imports (EUR million, current prices)	2 693	4 423	5 158,0	5 123	5 560	8 081	10 299	2 797	Q1/2007
FDI inflow (EUR million, current prices)	158,4	126,8	88,9	62,1	90,0	200,5	512,4	185,1	Q1/2007

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

In 2002 and 2004 average wage is for December of corresponding year

## Leningrad region

### Uneven economic development

The GDP of Leningrad region grew in the first quarter of 2007 by only 5.3% y-o-y, which is less than St. Petersburg's GDP and the national GDP results of the same period (increase by 10.2% and 7.9% respectively). The region's economy developed unevenly during the first 6 months of 2007, and this was proved by semi-annual results. Industry, transport, communication and trade sectors of the regional economy showed significant growth whilst construction and agriculture reduced their output compared to the first half of 2006.

### Development of regional economy, Leningrad region

	2006	Jan-June 2007
Construction, y-o-y, %	7.9	-5.0
Transport, y-o-y, %	20.1	42.4*
Agriculture, y-o-y, %	8.2	-1.4
Communication, y-o-y, %	15.7	12.2
Retail trade, y-o-y, %	22.0	11.5

Source: Petrostat, 2007

\*Note: high growth in H1 2007 could be partly explained by the rise of transport tariffs of Baltnefteprovod, a regional pipeline monopoly

Development of the regional industrial sector becomes more dependent on large FDI projects. In the first half of 2007 industry grew mostly due to the automobile cluster having a 35.3% output surplus. This, in turn, was linked with expanding production by the Ford Motor plant in Vsevolozhsk. Transport machine-building is becoming a key cluster for the regional economy: its semi-annual output rose up to EUR 430 mln and its share of total industrial output reached 11% with only the food industry being ahead of it.

The temporary fall in the construction sector in January-May 2007 was a result of stagnation on the regional real estate market. Nevertheless, in June the results improved compared to previous months as a new huge IKEA mall was completed and a certain revival of demand for residential apartments and houses took place.

Agriculture remained in a continuing recession in the first half of 2007. Despite that situation, certain sub-sectors of agriculture had a better performance than the sector in general. For instance, cattle farming increased its output by 3.0% and hog livestock grew by 27% y-o-y in January-June 2007. Russia's future WTO entry might change the structure of regional agriculture, keeping strong industries (meat production) and suppressing weak ones (most of the remaining agricultural branches).

### Inflation comparatively modest

While in terms of economic development the Leningrad region is far behind its neighbour St. Petersburg, prices in the region increase slower than in the city. Consumer price inflation in the first half of 2007 was 7.8% y-o-y. This was a low result when compared to the first half of 2006, when consumer prices in the region grew by 10.8% y-o-y.

Industrial producer prices even slightly decreased during the first 6 months of 2007 by 0.2%. Comparatively low inflation might become a stimulus for further investment increase.

### Budgetary achievements

In January-May 2007, the fiscal authorities received EUR 0.5 bln of tax revenues and a budget surplus of EUR 148 mln or 29.0% of total budget revenues. The share of surplus in budget revenues grew impressively during the first 5 months of 2007. The volumes of collected taxes increased as well: profit tax by 43.2%, excises by 48.2%, natural rent payments by 21.7%. The regional government was not only improving the financial discipline of taxpayers by repressive measures, but also restructured the indebtedness of certain non-payers. That policy resulted in a budgetary surplus which could be used for infrastructure development projects planned by the regional government. The growth was also linked with the increasing incomes of their taxpayers which grew by 60% y-o-y in January-June 2007.

### Living standards improve

Incomes of the population and real wages continued to grow rapidly in the first half of 2007, by 15.9% and 16.3% respectively, y-o-y. Their demography is improving slightly as well: in January-May 2007 the natural reduction of population decreased by 15% y-o-y due to an 8% lower mortality and a 3% higher birth rate. Migration inflow into the Leningrad region increased by 10% y-o-y in the first half of 2007.

### Some business highlights

- § Governor Valery Serdyukov was reappointed for his third term by President Vladimir Putin. His new five-year term was supported by the regional parliament, 38 of the 50 members voted for Serdyukov.
- § Energy monopoly RAO UES and the Leningrad region adopted an Energy System Reconstruction Programme. It also includes the construction of two new power distribution stations. The Programme should be implemented until 2011; the planned investment is EUR 2.0 bln.
- § According to the head of Russia's Olympic Sports Association Vladimir Kozhin, the Leningrad region will become the second most important Olympic area in the country after Sochi. The federal government plans to create a large skiing complex between Toksovo and Kavgolovo; construction will start soon and take two years.
- § Russian petrochemical giant SIBUR announced its plans to construct a terminal for its liquefied gas exports in Ust-Luga. The planned annual capacity of the terminal is 1 million tonnes, investment totals EUR 112 mln. The terminal will substitute the export routes via Finland, Latvia, Belarus and Ukraine, presently used by SIBUR.
- § The Ford Motor Company plans to continue expanding its production facilities in Vsevolozhsk, Leningrad region. Their planned investment of EUR 75 mln would enable the company to raise its annual production in the region from 72 to 125 thousand vehicles.
- § SZNK-Beton, the second largest concrete producer in St. Petersburg and the Leningrad region, invested EUR 1.5 mln in the construction of a concrete plant in Janino, Leningrad region. The plant was finalised in July, 2007, and the investor plans to construct 10 more concrete plants in the region during 2007-2010.
- § Company EnergoProekt launched a new metal constructions plant with a monthly production capacity of 800 tonnes. This has enabled the company to become the third largest producer of metal constructions in North-West Russia.

Leningrad region - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
Regional GDP of (y-o-y %-growth, constant prices)	12,8	8,5	16,3	14,6	8,8	8,3	8,1		1-12/2006
Industrial production (y-o-y %-growth)	26,8	10,7	35,6	20,9	10,3	5,9	26,9	0,5	1-4/2007
Regional inflation (CPI, y-o-y %-change)	23,5	19,6	14,8	13,0	14,9	12,0	9,9	4,0	4/2007
Gross average wage (monthly, EUR)	105	141	152	173	190	259	324	349	3/2007
Unemployment (% average annual)	12,7	10,8	9,6	9,2	7,5	7,8	6,2	5,8	1-2/2007
Exports (EUR million, current prices)	1 786	2 350	2 301	2 580	3 886	4 862	5 444	1 323	1-3/2007
Imports (EUR million, current prices)	328	810	939	1 061	1 372	2 562	2 858	696	1-3/2007
FDI inflow (EUR million, current prices)	222,5	266,0	121,9	104,5	106,6	178,7	288	50,7	1-3/2007

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

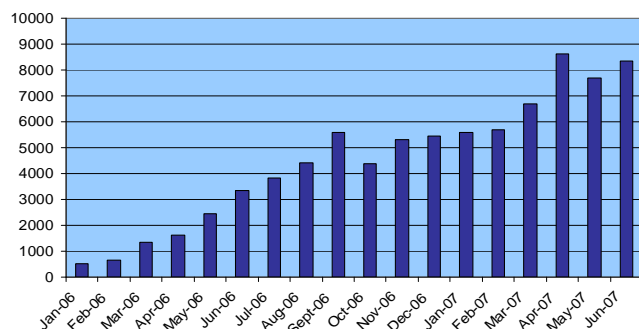
## Kaliningrad region

### Manufacturing growth rate is likely to slow

Industrial production in Kaliningrad rose by 53.5% in the first half of 2007 y-o-y pushed up by a rapid expansion in manufacturing. However, there are signs that growth in manufacturing may slow significantly in the near future. Production of TVs in Q2 declined by 14% compared to Q1. Although the production of cars continues to grow rapidly, clouds are gathering over Avtotor, the only producer of cars in Kaliningrad. The Association of Russian Automakers sent a letter to Prime Minister Fradkov asking him to revoke a duty-free regime for Avtotor, which it enjoys because of a 10-year transitional period that was instituted by a federal law on the Kaliningrad Special Economic Zone in 2005. Experts say that it was increasing production of inexpensive cars under the Chinese brand Cherry, which competes directly with cars from the Russian automakers that caused this letter. The Chairman of Avtotor's board, Mr Sherbakov, said that the government is already preparing such a decree.

In addition, a low base effect that helped to inflate growth rates in manufacturing in the first half of the year should lessen because manufacturing production grew strongly in the second half of 2006 after a lull in the first months of that year.

#### Monthly car production in Kaliningrad



Source: Kaliningradstat

Results in other manufacturing sectors were not uniform: while food production has declined by 7.8%, production in wood processing increased by 38.6 and in textiles and apparel by 34.8%.

#### Growth rates by sectors, y-o-y, %

	2006	1H 2007
Industrial production	68.2	53.5
Mining	17.0	1.9
Manufacturing	40.6	126.4
Utilities	370.0	19.4
Construction	-8.9	48.9
Retail trade	16.1	16.7

Source: Kaliningradstat

The construction sector continued to enjoy a strong demand for new apartments, offices and commercial property. The volume of construction work rose by 49%. Growth in residential construction was especially rapid: in the first half of 2007 developers built 68% more sq. metres of housing than in the same period of the previous year.

Kaliningrad - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	2007	as of
GRP (y-o-y %-growth, constant prices)	6,8	15,2	3,4	9,5	9,4	12,9	12,0	11,6	n/a	
Industrial production (y-o-y %-growth)	3,9	32,4	12,9	10,2	4,7	26,6	18,9	68,2	53,5	1-6/2007
Inflation (CPI, end of period, y-o-y %-change)	34,5	17,5	21,0	9,8	17,5	11,7	11,1	7,9	9,3	6/2007
Gross wage (period average, EUR)	47	67	99	125	137	155	193	285	330	1-5/2007
Unemployment (% end of period, LFS data)	15,8	15,6	10,6	7,1	7,5	6,4	5,9	5,9		Q2/2006
Exports (EUR million, current prices)	303	514	508	497	507	876	1 470	1 973	495	1-3/2007
Imports (EUR million, current prices)	761	947	1 169	1 701	1 894	2 419	3 283	4 187	1 053	1-3/2007
Exports (sales) to Russia (EUR million, current prices)	n/a	459	691	802	989	1 449	1 901	2 471		1-12/2006
FDI inflow (EUR million, current prices)	3,9	7,1	3,6	6,3	12,4	18,0	15,1	16,9	10,0	Q1/2007

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

### Investment: robust growth

Investment in fixed capital rose by 65% in May on a year earlier and by 38% in the first five months of the year. It shows increasing business confidence and contrasts with the lacklustre investment results of 2006. The new SEZ regime attracts more and more interest from investors but legal uncertainties highlighted by the Avtotor case (see above) might undermine this attractiveness.

At the same time, the profit of the corporate sector (excluding the financial sector and small enterprises) fell by 55% in January-May 2007 compared to the same period in 2006. This plunge was almost exclusively due to the drop in profit of a local subsidiary of the Russian oil giant Lukoil: excluding the mining sector, total net profit (profits minus losses) for all other sectors was just 100 mln roubles or less than €3mln.

### Consumer inflation

Consumer inflation in June was unexpectedly high – 1.1%, pushed up by an increase in food prices by 1.5%, especially by the rapid rise in vegetable and fruit prices – by 7.9%.

### Immigration numbers lag behind expectations

The regional government has announced ambitious plans to attract hundreds of thousands of Russian-speaking migrants, first of all from the FSU countries, to Kaliningrad in the next few years and the region was included in the state programme to facilitate immigration. So far results have not been very encouraging: an increase in the inflow of immigrants in the first five months of 2007 was only about 100 people – much less than was hoped for. Most immigrants came from Kazakhstan and other Central Asian countries but it seems that most of them do not have any connection to the state programme.

### Some business highlights

- § A new agreement between Russia and the EU on visa facilitation actually made the visa regime between Kaliningrad and its neighbours - Poland and Lithuania more strenuous. Now residents of Kaliningrad have to pay a € 35 fee to get a Polish or Lithuanian visa (which were previously issued free of charge) and provide an invitation. The Polish consulate in Kaliningrad reported that the number of visas it issued in June decreased by 70% compared with previous months. Many tourist companies that organised weekend trips to Poland and Lithuania for Kaliningrad residents say that demand for such trips fell drastically
- § Kaliningrad Investbank merged with the Moscow-based Conversbank in July and became a part of the Conversbank financial group that also includes the Lithuanian Snoras bank
- § One of the largest Russian developers, the PIK group, bought a land plot in Svetlogorsk, a tourist town on the Baltic coast, and is going to invest about \$300 mln to build 320,000 sq.m. of residential properties
- § As another sign of growing interest in the Kaliningrad property market, the second largest Kaliningrad-based retailer Vester bought several land plots in Kaliningrad and is planning to build 150 sq.m. of residential properties until 2010. It also decided to sell its book retail business to Novosibirsk's Top-Kniga.
- § A large meat processing plant should open in Kaliningrad in November this year. The plant is a joint venture between the Russian agricultural holding Miratorg and Brazilian company Sadia SA. The partners invested about \$100mln in the plant.
- § The Kaliningrad maritime commercial port is expanding warehouse facilities for its container terminal to increase its capacity to 250,000 TEU p.a.
- § Kaliningrad Regional Duma (Parliament) refused to conduct a referendum on establishing a gaming zone in the region by saying that this issue was decided by federal legislation. However, opponents of the gaming zone vowed to continue their fight against the zone and hold a meeting in the central square of Kaliningrad.



## The European Union's role in protecting the environment of the Black Sea region

by Stavros Dimas

Almost 600 kilometres of the Black Sea coastline became part of European Union territory when Bulgaria and Romania joined the EU on 1 January this year. With a surface area greater than that of our two newest member states, and collecting its waters from a catchment area six times larger than its own surface, the Black Sea is one of the world's great seas. But in being virtually cut off from other oceans and accessible only through a narrow, shallow channel – the Bosphorous – it is particularly vulnerable to the effects of pollution.

Almost one third of the entire land area of continental Europe drains into the Black Sea. Waters from as far away as Germany and Poland can bring a host of environmental problems. Nitrogen and phosphorous originating from agricultural fertilizers, livestock manure and untreated sewage pose one of the main threats. These nutrients are over-fertilizing the natural ecosystem and choking its oxygen supply. This has led to radical changes over the last 40 years that are threatening the sea's biological diversity – its natural wealth of plant and animal species - and economic activities such as fishing and tourism.

Although the Black Sea ecosystem has shown signs of recovery since nearly collapsing from pollution in the 1980s, it remains fragile. More than ever before, the prosperity, stability and security of our Black Sea neighbours are of concern to the EU. It is no secret that environmental problems bring regional tensions. The Black Sea's widespread environmental problems can only be tackled through regional cooperation. A recent Communication from the European Commission, and backed by the EU Member States, has put Black Sea cooperation firmly back on the political agenda and flagged environment as one of the main areas for cooperation.

At first glance it may seem that new regional processes for cooperation need to be created. But for the environment such mechanisms already exist. It is implementation that is lagging behind. The EU has been working with the region for many years and its new status as an EU coastal zone offers an opportunity to redouble our efforts. We will focus on implementation and improving how existing institutions work. The EU is making available financial support for environmental protection by Black Sea countries, ranging from structural funds for EU member states to assistance instruments like the European Neighbourhood and Partnership Instrument (ENPI) for those outside the EU.

The European Commission recognised the need to address marine environment problems at regional level in our 2005 EU Marine Strategy and our proposal for a Marine Strategy Directive, which will require member states to cooperate with neighbouring countries. They will be encouraged to use regional seas conventions, including the Convention on the Protection of the Black Sea against pollution, to reach this

goal. With Bulgaria and Romania now EU member states, accession of the European Community to this important convention becomes a priority.

The most important river flowing into the Black Sea is the Danube, and in recognition of this link the Commission in 2001 launched the Danube-Black Sea initiative, or DABLAS as it has become known. DABLAS aims to support implementation of the two regional conventions dealing with the Danube and the Black Sea and to improve coordination between them. A key activity has been to get a range of infrastructure projects off the drawing board with the involvement of the international institutions - such as the European Investment Bank and the European Bank for Reconstruction and Development – to address the regional environmental hotspots identified in the work of the two conventions. Consequently new projects have been implemented on the ground that is both environmentally significant and financially 'bankable'. This has been seen as a success in the water sector and spreading this approach to other sectors is now being considered.

The Commission will also work with the countries of the region to combat climate change. We attach particular importance to making use of the Kyoto Protocol's two market-based mechanisms to promote emission-saving projects in third countries, the Clean Development Mechanism and Joint Implementation. This year the EU is launching a €5 million technical assistance project on climate change in the region.

As well as taking action at regional level, we also have distinct relations with each of the non-EU countries bordering the Black Sea. Turkey, as a candidate for EU membership, is in the process of aligning itself with our requirements. Financial support is available to help it build the sewage treatment plants and other environmental infrastructure needed to comply with these demanding environmental standards. Other countries are covered by the EU's European Neighbourhood Policy, with cooperation guided by the jointly agreed national action plans and priorities that underpin this policy. Cooperation with Russia takes place under a partnership and cooperation agreement.

The new political landscape gives us the opportunity to strengthen our work in the region. We owe it not just to our newest EU citizens in Bulgaria and Romania but to all people living in the region to redouble our efforts to ensure a brighter future for the Black Sea.

*Stavros Dimas*

*European Commissioner for  
the Environment*



## Latvia - transit land and destination

by Ainārs Šlesers

Latvia is a transit land. Our geographical position - a cross-road for international transit flows has created number of opportunities to become an important partner in trade relations between East and West, North and South. There are two major transit channels going via Latvia: the North-South, connecting Finland to Germany, and the East-West, connecting Moscow to the Port of Ventspils and beyond. Being centrally located in Northern Europe it is also the first and last EU border with Russia (except for Estonia and Finland), making it ideal for East-West trade.

Riga, largest Baltic city, is located in the middle of region in less than two hours' flight from the population of half a billion people.

This determines our strategic aim: to secure stable growth in cargo transport, attracting new cargo flows, to ensure increase in cargo value-added processing, to develop Latvia as international logistics and distribution platform and advantageous transit corridor. Upon my initiative, a governmental working group has been established in order to facilitate transit and logistics sector development by putting particular emphasis on ports' development and integration of ports, railway, and roads network into a single logistic network.

Our transport system with a high density of roads and well-developed transport infrastructure for maritime and pipeline transport serves the transit needs and opportunities. Latvian transport system has become an integral part of the Trans-European Transportation Network TEN-T, and we are actively accommodating the EU funds for the further modernization of transport infrastructure.

Without doubts, our main asset is three non-freezing international ports (Riga, Ventspils, and Liepāja) well linked into the country's infrastructure by rail, road and pipeline. Being practically ice-free even during the most severe winters is a great advantage over the neighbouring ports in North.

Latvian Railway is the main link in the Latvian transit chain. While integrating our railway infrastructure in the common EU transport system, our rail system shares the same gauge standards (1520 mm) and has common information systems with Russia and the CIS countries. It provides an infrastructure base to facilitate the growing trade flows between the EU and Russia/CIS, and eventually China and other countries in Far East.

While the main cargo types processed by the Latvian Railways are oil products, coal, mineral fertilizers, metals, and wood - containers are seen as perspective trend in cargo transportation. An example - a regular container train *Baltica-Transit* is operating from Riga to Kazakhstan with the perspective plans to extend the route further to China.

As a new impetus for the *Rail Baltica* project, a decision on reconstruction and modernisation of the existing railway infrastructure connecting Estonia, Latvia, and Lithuania was agreed by the Transport Ministers of all three Baltic States as a first step towards the initial project of building a European standard fast-speed railway line. The Memorandums of Understanding have been signed with the respective Ministers agreeing on next steps to be taken in *Rail Baltica* development course, such as, coordinated project proposals for the EU TEN-T program, further feasibility studies required for European gauge line, harmonization of technical and operational parameters, etc.

One of Latvia's main challenges in the transport sector remains improvement of the quality of roads. At present, 65 % of the excise tax on petrol is devoted to road infrastructure. According to Latvian legislation, this share will gradually increase up to 80%, but currently the Ministry of Transport has submitted a proposal to increase the share up to 95%. The

road reconstruction program for the years 2007-2013 will be implemented with the financial support from the EU structural funds; several public-private partnership projects are foreseen for constructing new highways along the main transit axis.

Another pressing issue is long queues of trucks on the Latvian/EU-Russian border. These queues, regularly reaching records of over 42 kilometres and 1500 trucks in the direction to Russia, are endangering the road safety situation and creating major inconveniences for both truck drivers and local population.

As Latvia, of course, is not in a position to solve it on its own, we are in active dialogue with authorities of Russia and other countries experiencing similar problems (like Finland and Estonia). We are also insisting on keeping this matter on agenda of the European Commission.

Number of actions is envisaged to improve the situation: modernisation and expansion of the border control points, construction of terminals or truck parking sites next to them, road construction projects in the West - East direction. At the same time, given the trends and potential for the growth of cargo flows between the EU and markets of Russia and CIS countries, a construction of the highway *Riga-Moscow* is needed urgently for which we need support from both Russia and European Commission.

After signing the border agreement in spring, our relations with Russia have improved. In July, the Latvian-Russian intergovernmental commission (IGC) has finally met and adopted a work program. Furthermore, a comprehensive debate of government officials and transport business representatives was organized and a Transport working group was established within the IGC. It serves as a good basis for further cooperation.

In June, *TransContainer*, a subsidiary of Russian Railways company, opened a representation office in Riga with a perspective plan to increase container freight turnover between Latvian ports and Russia up to 1 million containers by 2010.

Development of the transport infrastructure facilitates also the increase of passenger transportation, both for business and tourism purposes.

The International Riga Airport continues its impressive growth rate. In 2006 the airport served 2.5 million passengers, which is an increase of 33% compared to 2005. In the first half of 2007 passenger numbers have already increased by 25.6% and we are expecting a 2-millionth passenger to arrive in Riga at the second half of August. 1 million passengers have been carried by the national carrier *airBaltic*, the second largest market player is *Ryanair*.

Currently Riga is linked with direct flights to more than 50 destinations in Europe, America, Asia, and Africa. We are the closest point in the EU to the East, so, in next years there will be more flights to Asian countries.

Our policy of cancelling the duty for passenger departure and reducing charges for aero navigation and services of the airport, making them lowest in the region, has clearly paid off. It increased competition, significantly reduced ticket prices and made travelling by air affordable to practically everybody. And our goal of having a 10 million passenger airport in nearest future is no longer a dream, it will be a reality soon. In order to accommodate such an expansion, new airport development plan has been elaborated (currently the airport has almost reached the limits of its capacity). We are constructing a practically new terminal and extending the existing runway. Construction of the second runway is foreseen for later on.

Development of infrastructure at the regional airports in Liepaja, Ventspils, and Daugavpils will contribute to the growth of tourism and business in the western and eastern regions of Latvia.

Liepaja airport is already operating commercially and in June 2007 it became a second international airport. Now *airBaltic* performs not only regular flights two times a day on route Riga – Liepaja, but also daily flights on routes Liepaja - Copenhagen (Denmark) and Liepaja - Hamburg (Germany). Flights from Riga to Ventspils are foreseen for the next year. The necessary developments are being studied for perspectives in Daugavpils, the largest industrial city and transport hub in eastern Latvia.

The civil aviation sector gives a valuable contribution to the development of tourism industry, which continues to boom in Latvia – according to statistics the number of foreign visitors has increased by 13% during the first quarter of 2007; 25% of

longer-term visitors were in Latvia for the first time. Visitors spent 72 million EUR during that period which is an increase by 20% compared to the same period in 2006.

It proves that Latvia is increasingly becoming an attractive destination for tourists and for business.

*Ainārs Šlesers,*

*Minister of Transport of the  
Republic of Latvia*



## May the Baltic way be the European way

by Pii-Noora Kauppi

The Baltic area is fast becoming a text book example of a dynamic business environment. European Union membership of the three Baltic States and Poland has made the area into one big market. Healthy tax competition has increased trade and investment flows. The prospects for the four core freedoms of the EU - people, capital, goods and services - look strong in the Baltic.

But the Baltic is already a significant actor. According to World Bank figures, with \$33,56 billion in foreign direct investment flows in 2005, the Baltic region (excluding Germany), with only a fraction of the population, was not far behind China, the world's largest single recipient of FDI.

The economies of the Baltic rim are complementary, contrary to the Mediterranean for example. Labour markets are flexible and the population is well-educated. They have demonstrated a capacity and a willingness to move around the region, not only between Sweden, Denmark and Finland, but also the Baltic States. Witness the ground-breaking labour dispute in Waxholm involving the Latvian construction company Laval. Despite the ruling by the European Court of Justice upholding Swedish collective wage agreements, the ice is broken and it will be a reference point for future EU labour movements. The structural dynamism of the Baltic area is unrivalled in Europe. It is the EU's most competitive region and it will only increase its attractiveness for foreign investors.

In OMX, the joint stock exchange operator, the region possesses one of the most promising capital markets in Europe. The bid from NASDAQ and the rumoured rival bid from Dubai's stock exchange testify to its potential. OMX offers a single platform for companies to raise cash, giving rise to more liquid and more transparent securities markets. The infrastructure for clearing and settlement of OMX trades is also one of the most efficient cross-border mechanisms in Europe.

There are also problematic policy areas confronting the Baltic. Firstly energy policy, which indeed seems to cause problems for the whole union. Russia's interest is to deal not with the union as a whole, but bilaterally with individual member states. EU common interests have successfully been split as a consequence. The new Baltic pipeline Nord Stream is a vivid example. For Russia it is as much about politics as about energy. The previous German government should have anticipated the ire of the Baltic States. It could have made a stronger case for their suggestion to build the pipeline on land, through the Baltics and Poland. It would probably be less expensive, better for the environment and bring benefits for the energy management of these countries and would thereby not be a project just between Russia and Germany.

The EU needs a common energy policy. Dependence on Russia is problematic, both because its capacity to keep the oil and gas flowing is questionable due to chronic underinvestment, and because of its habit of shutting the valves for political purposes. Bilateral agreements should be avoided and a common European ground should be established. The Baltic area can lead the way in this debate.

Secondly, the union is still lacking solidarity and a robust common defence to back it up. The crisis provoked by the Soviet war memorial in Tallinn was a stark illustration. We cannot let any of our Member States be left on their own in a case of crisis - even a diplomatic one. What is the point of the union, its values and common policies, if in reality they are not enforced and guarded?

The Baltic is a strategically important region. We all, the Finns and the Baltics in particular, have a specific interest in maintaining balanced and secure relations with our eastern neighbour. Sometimes it is forgotten in Brussels how long our common border with Russia actually is. A united Baltic area could show the way towards a united EU policy on Russia. A united foreign policy is what we need if we dream of ever being a powerful actor in world politics.

Thirdly, our common concern is also the environment and the fragile Baltic Sea. It has been estimated, that the Baltic Sea is the most polluted sea in the world. Cooperation with Russia is once again vital. More than anything, the countries surrounding the Baltic Sea have to convey to our European friends that the Baltic Sea is not just their business anymore. It is Europe's new Mare Nostrum, which makes it our common concern. The Baltic Sea could be in a pilot project for solving our common environmental threats with the necessary supranational action.

In spite of all the problems yet to be solved, the Baltic area is clearly a frontrunner in several sectors. It has vigorously implemented the four freedoms of European Union, to the envy of other Member States. It has shown that we can build a successful common home market area and rapidly adjust and improve our economies. There is a lot to learn here for the rest of the EU. In the future, the Baltic area can play an important role in tackling Europe's new common challenges.

*Mrs. Pii-Noora Kauppi*

*Member of the European Parliament (EPP-ED Group)*

## I regard myself as a son of the Baltic Sea

by Antti Peltomäki

I was born in Helsinki and spent my childhood in Kotka. After a spell inland during my school years, I returned to the Baltic Sea, first to Turku to do my military service and then to Helsinki to study, to talk politics and to work. Although I have nothing particular against Riihimäki and Brussels, I really feel at home only when I see, smell and taste the sea.

For a little boy the Kotka harbour was the most exciting place in the world. In the Finland of the 1960's there was no other place you could experience the international atmosphere as vividly as in Kotka. The crews of the ships that were taking on cargo in the harbour or waiting to dock monopolised the roads, pubs and football pitches – maybe even the girls – for several weeks at a time.

However, as a little boy I never travelled very far on the Baltic Sea. The furthest I got was Kaunissaari – that is as far as the janitor's boat took us. At that time I knew nothing about Suursaari, which had been ceded to the Soviet Union. The southern coast of the Baltic Sea seemed to lie further away than the islands in the South Sea, which I dreamt of sailing to when I grew up. I still haven't made it to the South Sea, but I did make several boat trips to Sweden and once even all the way to Denmark and Germany with my parents.

At the end of the 1970's, when I came back to the coast after my school years spent inland, the sea of adventures of my childhood had become a very political sea. During my time as a politically active student, the East-West confrontation was ever present and we Finns were very keen to ease the tension. I remember having participated in some kind of a Peace Cruise myself on a ship called Konstantin Simonov. We travelled all the way to Tallinn and Riga, but I suppose that, instead of bringing about love and peace, we just managed to get a massive headache.

In the late 70's and early 80's, I travelled to Poland on the Pomerania a couple of times on my way to continental Europe. Those trips opened my eyes and ears even more. In those days Poland was already different, and it was not just a question of courageous protest by the Solidarity movement. Having met ordinary young people from Poland and East-Germany, I started for the first time to believe that change was possible.

When the Estonian activists started to visit the secretary of international affairs and many other colleagues of mine in the offices of the National Coalition Party almost on a weekly basis, I knew that a historic day was about to dawn. The southern coast of the Baltic Sea could become closer to us than the South Sea islands – or not. Although official Finland was very careful in its comments, many Finns were very enthusiastic about the possibility of following and sharing the historic moments on Estonia's, Latvia's and Lithuania's road to independence. I was one of those Finns, too.

The biggest watershed in the history of Europe were undoubtedly the fall of the Berlin Wall and the disintegration of the Soviet Union. These events created a completely new political situation in Europe, but in the Baltic region their effects could even be compared to the Big Bang. They did create a certain amount of political instability, but above all they

generated a huge amount of economic and human dynamics in the area of the Baltic Sea, Russia included.

Now that Poland and the Baltic countries have joined NATO and the European Union, the political, military and economic situation differs radically from that of my childhood's Kotka. The little boy's sea which ended in Kaunissaari is now the whole Baltic Sea, from coast to coast.

I still have not had the opportunity to take a boat to Suursaari. Nevertheless, I am more than happy when I stand on the deck of my friend's sailing boat on our way from Kotka to Tallinn and see all the ships plying back and forth between Finland and Estonia. I even cannot seem to be worried about the oil tankers heading west from the Koivisto harbour or about the cargo ships arriving at Kotka harbour from Germany with luxury cars on board for wealthy Russians. Although I do understand the various concerns about gas pipelines and electrical cables going under the Baltic Sea and maybe even a tunnel between Helsinki and Tallinn in the future, I like these projects – simply because they bring together countries, businesses and people in the Baltic Sea region.

When we look at the economic development of the Baltic region during the last decade, we have to conclude that there are tangible results to be seen and that there is an enormous amount of potential still to be exploited. The Nordic countries are at the top of the class in implementing the EU's Lisbon Strategy, each in their own way. The economic development in the Baltic countries has been extremely rapid, and the investments the Nordic businesses have made in the Baltic countries and in Poland have increased the economic integration in the Baltic Sea region notably.

The giants of the Baltic Sea, i.e. Germany and Russia, have tended to overlook the Baltic Sea, failing to see the possibilities it can offer, but I am sure that they will follow the smaller countries when they learn to look closely enough and to see clearly enough. Even if Moscow and Berlin do not always understand the significance of the Baltic Sea, it is enough for us to see that St Petersburg, Hamburg and Rostock are aware of its potential.

This is what a little boy from Kotka wants to say!

*Antti Peltomäki*

*Deputy Director-General*

*Information Society and Media DG*

*European Commission*

## Kaliningrad is the city to invest in

by Yury Savenko

Kaliningrad is the administrative centre of the westernmost region of Russia, which is separated from the mainland Russia by hundreds of kilometers and by the borders of two sovereign states.

The unique geopolitical location predetermines ample perspectives and provides plenty of opportunities for cooperation. There is no other region in Russia which has enjoyed the status of the Special Economic Zone for such a long period of time. This regime allowed to create new industries such as car assemblage, production of the complex household appliances and electronics, furniture, laminated wood structures, poultry processing industries and some others.

The Federal Law "On the Special Economic Zone in the Kaliningrad region" came into force from the 1<sup>st</sup> of April, 2006. It aims at the promotion of the establishment of the high – tech competitive industries. Within this period of time 17 Kaliningrad enterprises with the total volume of more than 8 billion rubles have been registered as the new residents of the Zone. The project aimed at building of the 2<sup>nd</sup> line of enterprises processing vegetable oils has been launched. The production of automatic gearboxes for the Russian automobile complex and erection of the factory manufacturing the ceramic bricks has been set up. Several smaller projects on electric appliances assemblage and wood processing are being implemented.

In 2006 the total volume of investments into the stock capital of the large and medium sized enterprises constituted 15, 3 billion rubles. According to the data for the beginning of the year of 2006 the accumulated foreign capital amounted up to 136, 5 million dollars. During the year 66 million dollars of foreign investments were received. There are 2, 3 thousand organizations with foreign capital.

Kaliningrad is a favorable area to invest the capital in building. During 2006, 109 industrial and community facilities were built i.e. 1,5 times more than during the previous year. The total area of these objects constituted 281 thousand square meters i.e. 48 thousand square meters more than in 2005. In the sphere of commercial real estate several large-scale investment projects are being implemented: multifunctional complexes "Europe – centre" and "Clover – house", trade and ethnography centre "Fishing village", hotel complex at the Verkhneye Lake.

In order to assist in the building of dwelling houses the municipal authorities have elaborated the necessary project and regulatory documentation. Among them are the programs aimed at the construction of houses, development of communal infrastructure, gasification and power industry, etc. In 2006, 369 thousand square meters of dwelling houses were put into operation, i.e. twice more than in 2005. This is an exceptional record in the history of our region.

The authorities aim at providing sustainable urban development, making the city comfortable for citizens and at implementing business operations. The General Plan of Kaliningrad for the period till 2015 is adopted. One of the most important tasks is to bring the numerous objects of the city's infrastructure up to the new and modern level. During the last 5 years the corresponding city budget lines were increased by almost 2,5 times. The Public Private Partnership is used as one of the tools for achieving the strategic goals to the city development. The preparation to the concession of the municipal unitary enterprise "Kaliningrad "Teploset" is being performed.

There is a close cooperation with the Federal agencies and the Ministries of Russia on the financing of the city's in-

frastructure objects in relation to the Federal target and investment programs. The sewerage pumping plant, coast-protecting structures erected on the right embankment of the Pregel river are among them. The construction works at some other objects are being performed.

The construction of the second elevated bridge over the Pregel river, which is the largest project, (the cost is more than 3,4 billion rubles), has been launched in 2006.

The policy aimed at the formation of favorable image of Kaliningrad, creation of the conditions for effective operation of business and attracting investments is carried out. This work is open for the public. All adopted municipal regulatory documents and other decisions are covered by mass media and presented on the City Hall website. The most updated information useful for would-be investors and entrepreneurs is presented there as well. Administrative assistance is rendered to the investment projects implementation. The investors are advised on the economic, law and organizational issues of business arrangement.

The Kaliningrad City Hall maintains close relations with the Regional Industrialists and Entrepreneurs Union, Foreign Investors Association, business unions, Chamber of Commerce and Industry, Exhibition Centre "Baltic Expo".

Being the member of different Unions of the Russian cities, Kaliningrad hosts and takes parts in various seminars, conferences, exhibitions and other undertakings contributing to the development of interregional economic cooperation.

International cooperation is among the priorities of the Kaliningrad City Hall activities. At present Kaliningrad has 27 foreign partner cities and cooperates with them throughout the whole scope of local self – government activities. Kaliningrad is the member of the Union of the Baltic Cities. In 2006 the city joined the world-wide organization "United Cities and Local Authorities". Kaliningrad actively participates in the projects funded by the European Union, governments of Sweden, Denmark, Germany and other countries. The opportunities contributing to the development of the economic links are widely used. Within their framework the joint undertakings, business missions exchanges are regularly carried out. In 2007 the representatives of the local authorities and business took part in the presentation held in Lithuania and Poland. The delegation of the city participated in the 18<sup>th</sup> international exhibition of the investment projects "MIPIM – 2007" which was held in Cannes (France).

It is pleasant that Kaliningrad is marked and highly appreciated by the Council of Europe. In 1999, the city was awarded the Flag of Honour for the achievements in the international activities, in 2003 – the Plaque of Honour, in 2005 – the highest reward – the Prize of the Council of Europe. Currently Kaliningrad is the only Russian city awarded such a prize. In 2006 the city was awarded the Flag of Concord by the Fund "Concordia" of the Lithuanian Republic for the consolidation of friendship, peace and concord between different nations.



*Yury Savenko*

*Head of the City of Kaliningrad,  
Mayor of the City*

## The Baltic Sea in the new strategic context

by Raimo Väyrynen

In recent years, two issues have dominated the agenda of the Baltic Sea politics; the protection of its marine environment and the emphasis on economic transformation and co-operation. In both respects, progress has been made. Even if the state of the Baltic Sea environment has not noticeably improved, public consciousness of its dismal condition is more widely spread than ever before. We know, for instance, that one half of all phosphorus entering the Baltic Sea originates from Poland. It seems that the environmental conditions for its entry to the European Union, as well as their implementation, have been too lax.

The economic progress of all Baltic republics, and especially of Estonia, has been impressive. Their economies have also become quickly more international, although in a somewhat lopsided manner. Multinational corporations from Nordic countries, especially from Finland and Sweden, have invested heavily in the Baltic republics. Many of them have developed active corporate strategies to capture their share of the growing markets. The downside of this development is that the Baltic countries themselves have not invested enough in the production capacity and productivity which neglect is largely due to their neoliberal economic policies.

The positive tendencies are obviously welcome as they hint to the emergence of a security community in the region and, ultimately, of a *mare pacificum*. It can no longer be argued, as the Soviet Union tried during the cold war, that the Baltic Sea is a *mare nostrum*. Yet, the strategic significance of the Baltic Sea has not entirely faded away. To the contrary, it appears that new games of competition are emerging in the region.

Economic competition is a natural concomitant of the spread of the market in the Baltic Sea Rim. However, such a competition is seldom only commercial in nature. With the presence of major or medium powers in the region – such as Russia, Germany, Poland, and Sweden, - economic strategies have also political elements. Especially in Russia, the state agency combines economic objectives with political goals.

One element of such competition concerns the construction of ports, mostly for foreign trade purposes. Russia is investing heavily in the construction of commercial ports both for the export of oil, of which the port of Primorsk is the prime example. East of St. Petersburg, Russia is planning an export port of Ust Luga that may be ready in about ten years when it is expected to handle annually 35 million tons of coal and other bulk commodities.

It is well known that Russian authorities and companies have been using pressure tactics against ports of Baltic Sea countries to play them against each other and derive various benefits from them. For instance, Russian exports through Latvia have been occasionally restricted in an effort to gain a stronger control over the port of Ventspils. The new Helsinki port of Vuosaari and the Tallinn port of Muuga are also becoming active participants in the commercial rivalry in the Baltic Sea area.

The German-Russian, or the Putin-Schröder plan to construct of a gas pipeline (North Stream) from the Russian part of the Gulf of Finland to Germany (from Vyborg to Greifswald), crossing the economic zones of coastal countries, is also loaded with politics and potential strategic consequences. North Stream is controlled 51 per cent by Gazprom, while E-E-ON and Wintershall of BASF Group are the minority shareholders.

Poland and the Baltic countries fear that Moscow aims to create a transportation route that it is able to control fully and play them, as well as the consumer countries, against each other. In Sweden, there have been somewhat overblown fears that the control and maintenance station near the island of Gotland could be used by Russia also for military purposes. Yet, it is an undeniable fact that a main purpose of the expanding Russian Baltic navy would be to protect the new pipeline (against whom the question remains).

The Baltic Sea region is witnessing even more serious military tensions as a result of the U.S. plans to deploy a radar system in the Czech Republic and some ten antiballistic missiles in Poland to counter the potential threat from emerging nuclear-weapon powers, especially North Korea and Iran. These plans have been very controversial not only in the Czech and Polish public opinion, but also among most NATO members. Thus, there is a pretty strong opinion against incorporating Europe in the strategic defense plans of the United States.

The criticism against the deployment plans has been especially pronounced in Russia which has issued a threat not only to target the new systems by its own missiles but also deploy new short-range missiles (Iskander-M or SS-36 Stone) in Kaliningrad. These missiles are tactical only in terms of their short range as they can reach much of Northern and Western Europe. If the deployment of these missiles in Kaliningrad, as suggested by the first Deputy Prime Minister, Sergei Ivanov, is realized, the military tensions in the Baltic Sea region will assume a new dimension.

If Russia, furthermore, will decide to withdraw, as mentioned in Moscow, from the Intermediate-Range Nuclear Forces (INF) Treaty, the situation will become even more serious. After all, the conclusion of the INF Treaty in 1987 was a turning point in the cold war and the decision to back-track from that accomplishment would be a turn to the worse. Promising trends in the Baltic Sea cooperation would be badly undermined by the new missile and naval race in the region.

*Professor Raimo Väyrynen*

*Director of the Finnish Institute of International Affairs*



## The Baltic Sea Region as an arena for income level convergence

by Paavo Okko

The eastern enlargement of the EU created a union with large income differences. The Baltic Sea Region is now a good laboratory to see how income differences are narrowing via integration. Factor price equalisation is the ultimate measure of integration and the income level convergence has been the basic trend in the EU. So it will be in the case of the Baltic Rim, too. Low income countries have a potential for to catch up the rich ones. Also the average growth rate of the EU will be higher when large income differences do exist and low income countries are capable to narrow those differences.

There is a large literature on growth and income convergence. It is mainly in favour of per capita income level convergence via growth, but the catching-up and convergence are possible only under certain circumstances. The countries with sufficient human capital, infrastructure and institutional settings are capable to adopt and use new technologies successfully. Investment in physical capital is a necessary but not a sufficient condition for convergence. The new EU members of the Baltic area belong to the common single market. They have no technical restrictions to adopt same technologies but their capacity to absorb may be different. That is why there is no ultimate guarantee for convergence.

According to a convergence measurement about the EU14 (Luxemburg excluded) the speed of convergence has not been constant but income levels have been converging in the past. The speed of catching-up in 1961-98 was on average 2.05 % per year. It was slowest in the 1980's (0.83 %) and fastest in the 1990's (3.59 %). When different types of countries have an access to the same technology and to the single market, their long run income levels are near to each other but actual levels are far from each other. The crucial issue is how soon these differences will be narrowing in the large EU.

The basic expectation is that income gaps will be narrowing but it will be an issue of the long run. E.g., the gap in the per capita GDP between Estonia and Finland was about 60 % when Estonia became the member of the EU. If the convergence rate would be only 2 % per year, the difference would be still about 15 % after 70 years! Comparing Finland and Estonia gives an example on the convergence phenomenon in the Baltic Sea Region.

The average growth rate of Estonia in 1995-2006 was 6.6 % and of Finland 3.8 %. The per capita income level difference between the countries was roughly 60 % in 2004. If Estonia would keep the same growth rate until 2015 its income level will be doubled. If Finland is capable to grow by 3.8 % per year up to 2015 its income level will be 50 % higher than in 2004, but anyway, the income level difference between Finland and Estonia will be larger than in 2004 (about 70 %)! This means that if growth rates are coming to be at the current level, there will be so called beta-convergence but not sigma-convergence between these two countries. The first one means that low income countries have higher growth rates. If growth rate differences are high enough – or the original gaps low enough - to push the original income level differences smaller, we have a stronger form of convergence called sigma-convergence. In the case of Finland and Estonia we would have also sigma-convergence if the growth rate of Finland would be, e.g., 2.5 % and of Estonia the previous 6.6 %. By these rates the income difference between Finland and Estonia would be narrowing being still 44 % in the year 2015.

Convergence calculations are interesting, but their results depend heavily on assumptions made. In an optimistic case it will take about 25 years from the ten Central and Eastern

European new member countries to catch up to the level of 70 % of the EU25. The variation is large. A comparison to the EU15 shows that, it will take 30 years to come to the level of 70 % of the EU15. Even if the tendency of convergence is in existence, income differences will remain forever in practice.

Anyway, there is now a large potential to catch-up. Catching-up economies must be capable to create innovations but they must have also capacity to learn from others – using the main strategy to learn new things. A special way for that is offered by foreign direct investments (FDI). FDIs mean an effective way of absorbing knowledge capital into a low income country. It is not only the question of comparative advantages of a country but also competitive edges of firms located in a country. According some simulations the speed of convergence is faster if FDI flows between members are larger. We can see evidence of this in the Baltic Sea Region. It is understandable that also Russia is willing to get FDIs, but FDIs are sensitive to institutional setup. EU members are in a better position in this respect.

Even if the real convergence is going on, the nominal convergence criteria of the EMU process may be difficult to fulfil. We have seen that higher growth rates tend to mean higher inflation rates. The single currency may mean problems to fast growing low-income countries showing real convergence but having problems with nominal convergence. The EMU was established actually for a final stage of a very deep integration. Some new EU members seem to be willing to enter into the Euro area perhaps too early. It is lucky enough that there is also a tendency that the membership of the Euro area makes a country to develop faster into the direction, which makes it to be more suitable for a currency area. Experiences of Finland from the Euro period offer a good example of restructuring in this way.

A status of equal factor prices is like the absolute zero point in low-temperature physics: it will be never reached exactly! Income differences are fuel of economic growth, and an integration process has not yet come to the end as long as differences still exist. A crucial condition is that the new members invest enough both in physical and human capital. FDI is a good way of mutual adjustment. A successful catching-up process of the new members means possibilities for the old members, too. The high income level member countries must be capable in increasing their productivity in accordance with their cost level. A restructuring in which the old members are losing some production to new areas within the union is their possibility to allocate more into more productive sectors. Capacity to transform is required both from the old and the new members. This is also the crucial issue for Europe as a whole. It may seem paradoxical that an internal restructuring problem can help Europe in solving a simultaneous external problem of adjustment for the global competition. But that is a real option for Europe and the Baltic Sea Region is an important source of economic dynamics in order to get a more effective Europe.



Paavo Okko  
Professor of Economics  
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## Nordea plans for growth in the Baltic Rim markets

by Hans Dalborg

Nordea has ambitious growth plans in the Baltic Rim markets. We expect to open around 200 branches in these markets over the next three years. It could even be more because Nordea has identified Poland, Lithuania, Latvia, Estonia and Russia as the geographical markets in focus for growth.

For the financial services industry, Northern Europe means opportunities.

This region – the Nordic and Baltic Rim markets – is one of the fastest growing areas of Europe. The Nordic countries have enjoyed higher growth rates than the EU average over the last 10 years and are seen as some of the most competitive markets in the world. The Baltic Rim countries are expected to grow about three times as fast as the European average in the years to come and banking is likely to grow twice as fast as that in these markets.

As the largest bank in Northern Europe, Nordea already plays an important role in the integration of the Nordic and Baltic Rim economies. The bank is positioned to benefit from the growth of this region - but also to contribute to it.

### Proven growth record

The creation of Nordea started 10 years ago. In a “merger for growth” in 1997 between Merita of Finland and Nordbanken of Sweden, a strategy to form the leading bank in the Nordic and Baltic area was laid out. Uni Bank of Denmark and Christiania Bank of Norway soon joined the group. Activities in Poland, the Baltic Countries and Russia started to grow.

The philosophy was straightforward. In the Nordic countries, we are similar enough to work well together, different enough to have a lot to learn from each other and many enough to provide a solid home market. The Baltic Rim Countries are our closest neighbours with longstanding historical ties. Trade, investments and tourism between our markets develop rapidly.

With more than 10 million customers the over all strategy now is to increase our services for existing customers – our “share of wallet”. In the Baltic Rim markets too, organic growth is preferred. It is a safety first strategy in an environment that we need to learn better and markets that can learn from Nordic banking practices.

In the last five years Nordea has achieved income growth of 26% and cost decreases of 2 per cent. Return on Equity has been stable around 20 per cent. Our record of modest acquisitions and strong organic growth in the Baltic Rim countries is part of this success story. We can not rule out bad surprises in these markets (either) but at least we have proven able to avoid them so far.

Recently, Nordea won the category for “Best Regional Bank in the Nordic and Baltic regions” in Euromoney’s Awards for Excellence 2007. In addition Nordea won best bank in Denmark, Sweden and Finland. Euromoney’s panel of judges has taken into account volume of business transacted, innovation and leadership, credit ratings, quality of assets and earnings and efficiency ratios and key performance indicators.

### Baltic Rim – a priority area

Now we have adopted a reinforced organic growth strategy with the financial target to double the risk adjusted profit in seven years, which implies 10 per cent average annual growth. The strategy is to improve profitability through organic growth in Nordic home markets and “near abroad emerging markets” – corporate lingo for the Baltic Rim markets.

Today’s starting point for this growth strategy is as follows. Nordea is number one in the market in Finland (and among Nordic customers in Private Banking in Luxemburg), number two in Denmark and Norway and holds a number two-three position in Sweden. In Estonia, Latvia, Lithuania and Poland our market ranks are 3, 4, 6 and about 18 respectively. In Russia we are among the top 50.

In Poland we have over one million customers (including life insurance), two per cent of the retail banking market and roughly 50 percent of the market for Nordic corporations operating there. With at present close to 50 branches, our goal is to have a network of 200 branches in Poland within three years.

In the Baltic countries we have around 10 per cent of both the retail and the corporate market.

In Lithuania we have about 35.000 customers and 10 branches. In Latvia we have 40.000 customers served by 17 branches. In Estonia 17 branches serve more than 50.000 customers.

In the next few years we aim to have at least 100 branches in the three Baltic countries.

Overly optimistic? No. Last year revenue was up 40 per cent and total lending up 50 per cent in Poland and the Baltic States. Profit almost doubled.

In Russia, Nordea now is the majority owner of Orgres Bank with 20.000 customers and 35 branches in Russia’s centres for growth: St Petersburg and Moscow. Intensive efforts have been initiated to upgrade these branches and to expand the branch network.

The Russian market is expected to grow steadily and our focus initially will be on Russian corporate customers, Nordic corporate customers and personal customers in the high end segment.

### Shared values to support growth

We strongly believe all this is doable with Nordea’s leading position. Furthermore, our strong profit orientation – focus, speed and performance – is now complemented with three additional values to underpin sharing of best practice in the whole group. They are: “Great customer experience”, “It’s all about people” and “One Nordea Team” – values for organic growth.

When our first Finnish-Swedish merger was announced and we invited leading banks in Denmark and Norway to join, quite a few eye brows were raised. But after our strong over all performance in the past five year period few question the seriousness of Nordea’s ambitions to be the leader in Northern Europe or our ability to deliver on plans.

I am personally confident that in five years Nordea will have grown substantially and that a considerable part of that growth will be attributed to our success in the Baltic Rim Economies.



*Hans Dalborg*

*Chairman  
Nordea*

# Stockmann has succeeded in internationalisation of its department store operation

by Hannu Penttilä

Baltic countries and Russia have offered a good market for not so often seen successful "green field"-investments

"Department stores do not travel well" has been during many decades a well known phrase within the international department store community. The explanation of this sentence is based of the fact that traditional department store companies have globally done very modest attempts to internationalize their business and in cases they have done that, most attempts have proved to be big failures. For some reason department store business has stayed a very local business.

Of all the international companies maybe the most well known French department store company Galeries Lafayette has made the most attempts for internationalisation. The company however closed very soon their store in New York and withdrew its operations from Far East and even from Moscow, where they had a small operation in GUM department store in the 1990es. The only city outside France, where Galeries Lafayette has today an own department store operation is Berlin, where the store had its 10th anniversary last autumn. According to available information, last year was the first year when that store was able to make a break even result of its operation. The latest internationalisation attempt in Galeries Lafayette will be made this year when the French will together with a local partner open a franchising store in Dubai.

Maybe the most successful internationalisation in traditional department store business, in addition to Stockmann's operations, has been made by the German Galerie Kaufhof, which some years ago bought a 15-stores Innovation chain in Belgium and converted it to Galerie Inno, according to their own Kaufhof-concept. The Spanish giant, El Corte Ingles, who has almost a monopoly position in their home market, has recently opened two stores in Portugal.

Stockmann is a 145-year old public company with estimated sales 2007 of above 1.6 billion euros, 11 000 employees and three business units. Department store business is the core business of the company, but the company is actively expanding also its other divisions, fashion store chain Seppälä (127 stores in Finland, 29 stores in all three Baltic countries and 21 stores in Russia) and its mail order and internet company Hobby Hall, which operates in the same markets, starting Russia in the end of this year.

The small Finnish market and the limited expansion potential of all its businesses in the home market has already long time ago forced Stockmann to search for new markets in the neighbouring countries. Stockmann was the first western retailer in the former Soviet Union and opened its first small stores in Moscow already in 1989. The entry to the Estonian market happened 1993, Latvia 2003 and Lithuania (Seppälä) 2005. The department store business has today, beside the seven stores in Finland, four full scale department stores in Moscow, fifth opening 2008, a large shopping mall and department store complex under construction in down town St. Petersburg and full scale department stores in Tallinn and Riga. Stockmann does not yet operate with a department

store in Lithuania, but it is very clear that the store will be opened as soon as a suitable location has been found.

The success of all our stores has been good from the very beginning and all the stores have achieved or exceeded their targets. Opening a full scale department store is a heavy investment, and therefore, a normal rule of thumb is that the first full year is heavily loss making, the second year you halve your losses and the third year you will make a break even result or a small plus. Our Baltic stores however, have formed a pleasant exception of that rule. The Tallinn store reached a positive result already during its first full year of operation and the store was expanded very soon after its opening. The second expansion is at the moment on the drawing board.

Our store in Riga was also very well received by the customers and the store made a positive result during the second full year of the operation. At the moment we are also planning an expansion and a new parking garage for our customers.

Even if our department store business is running well in as well Estonia and Latvia, where the economy has been booming in the last years, there were considerable differences in entering those markets. Entering Estonian market was very easy and bureaucracy did not set up unreasonable obstacles. The situation was considerably more difficult in Latvia, where we during several years investigated many projects, before the entry could be made. Generally speaking one can say that everything that can be done to deregulate and to beat bureaucracy, protectionism and corruption, will improve the international competitiveness of the Baltic region.

Maybe the largest problem for a retailer in all our market areas, but especially in the Baltic countries, is the labour availability. When the wage level in these countries increases strongly annually, the turnover of staff causes problems. Of course you can say that this is a pleasant problem for the society as it, because of the competition, increases the level of earnings and appreciation of retail business. The net emigration makes the labour shortage worse, and it in deed is a big problem for retailers.

Despite problems Stockmann has against old beliefs been able to internationalise its department store business in a successful way. The customers have accepted us. If I look pictures taken at the same time last spring during "Crazy Days" - campaign in our stores in Finland, Russia, Estonia and Latvia, I could not tell the difference between the pictures. A lot of happy customers.

*Hannu Penttilä*

*CEO of Stockmann group*

*President of the International Association  
of Department Stores*

# Safety on the Baltic Sea and protection of the marine environment - risk anticipation

by Paavo Wihuri

In the last ten years, a lot of work has been done for the safety and environmental protection of the Baltic Sea. All measures have been proactive. The Helsinki Convention, or HELCOM, formed by the Baltic rim states plays a crucial role in protecting the marine environment.

In the maritime safety and security efforts and protection of the marine environment, however, the most crucial body is the International Maritime Organisation. Due to the global nature of the IMO, there is a delay in the enforcement of decisions, which to many outsiders seems painful and unnecessary. After the 9/11 strikes, however, the IMO showed its ability to react fast by creating the International Ship and Port Security Code in the space of a few years. The wide-ranging obligations of this Code were implemented over a short period of time in administrations and ports as well as onboard ships.

In the EU, community legislation has invested the Commission with a strong role as a co-ordinator of the safety and security efforts. The co-ordination work of the Commission has shown to the member states that co-operation is power, and this has also been taken onboard by the governments of the member states. The co-ordination meetings have set out to seek a strong European consensus through compromises. Unfortunately, the coin also has its other side. A compromise made in the Commission's co-ordination meeting often waters down the original national proposal. The adoption of compromises based on watered-down proposals may often be difficult in the IMO, and sometimes it may even happen that elements of the original national proposal are reintroduced in the adulterated proposal by nations outside Europe. Each European proposal rejected in the IMO reduces our authority as pioneers of safe shipping and environmental protection. I find this situation worrying for Europe; Europeans cannot see that depending on the method of calculation, European shipping and influence in the IMO only represents 27-28% of the global total. If we include tonnage owned by Europeans but flagged outside Europe, the share of Europe is some 34% of the world shipping. It therefore follows that we cannot dictate the course of action to the rest of the world. Someone should analyse the situation and then decide on a European strategy and tactics in the matters of maritime safety and security and protection of the marine environment. It seems pointless to set goals if the mechanism for achieving them is not working, or at the very best it is not running on all cylinders.

## On the protection of the marine environment

The spread of non-indigenous species via ballast water is a serious threat to the sensitive environment of the Baltic Sea. The entry into force of the IMO's International Ballast Water Convention would be necessary in order to stop invasions and maintain the biological integrity of our sea. The ratification of the Convention poses quite a challenge in the Baltic Sea area, however. Due to the small size of the Sea, ballast water exchange meeting the requirements of the Convention cannot be performed within the Baltic. Some methods of ballast water treatment may also be inappropriate in the Baltic because of the low salinity and the seasonally low temperatures. In addition, surveys and inspections of compliance with the provisions of the Convention may prove to be impossible, since reliable and practical methods are still to be developed. As has unfortunately been experienced in many parts of the world, the spread of non-indigenous species has the potential to cause

serious, irreversible consequences to both the environment and the economy. In order to prevent such disasters in our unique sea, it is therefore imperative to rise to these challenges before it is too late. The designation of specific ballast water exchange areas should be one step further along the way. This must be done in co-operation with the North Sea countries. The other challenges will require dedication on part of governments, researchers, shipbuilders, seafarers and other stakeholders.

On the subject of ballast water, no voices have been raised in Europe about the problem caused by the ballast waters of inland waterways traffic. Inland waterway vessels travel along canals from Black Sea harbours to ports in the Baltic and the Nordic Sea and vice versa. I cannot believe that organisms carried in ballast water to another area only are a problem when transported through the sea.

While ships are sailing within SOx emission control areas (SECAs), they have to use either fuel oil, the sulphur content of which does not exceed 1.5% m/m, or an exhaust gas cleaning system to reduce the total emissions of sulphur oxides from a ship to 6.0 g /SOx/kWh or less. Waste streams from the use of such equipment may not be discharged into enclosed ports, harbours and estuaries unless it can be demonstrated that such waste streams do not have an adverse impact on the ecosystems of such enclosed areas, based upon criteria communicated by the authorities of the port State to the Organization. IMO MEPC 55 established a correspondence group to develop criteria for wash water discharges from exhaust gas SOx cleaning systems. Most members of the correspondence group agree that the two key parameters are pH values in the outlet water and oil concentration. Some members consider that also other hazardous substances like Ni, Pb, Hg, Cd and some PAH compounds should be regulated.

*Paavo Wihuri*

*Director of Maritime Safety and Security  
Finnish Maritime Administration*

## Trends and challenges for ports in the Baltic Sea region

by Christian Ramberg

### **New investments are needed in ports and in infrastructure, but investments cannot alone guarantee the balanced development of the maritime transport sector of the Baltic Sea region**

The maritime transport volumes in the Baltic Sea region have grown considerably during the last ten years and will continue to do so according to recent forecasts. The growth of trade is expected to be proportionally highest in the eastern parts of the region and the analysis indicates further that the total transport operations will double within 20 years. This will of course mean that considerable investments are needed in ports and the transport infrastructure in the region. Baltic Sea routes, port facilities and hinterland connections have to be efficient, but investments alone will not be enough. In order to enhance productivity or to attract other foreign investments infrastructural costs, taxes and legislation should also be harmonized. Transport industry must moreover cooperate in a different way than before.

The growth in maritime transports in the Baltic is well known to most of us and new investments in a number of ports along the Baltic coastline are also a fact, but other things i.e. maritime policies and instruments needed to secure the sound development of the industry are perhaps not so known.

From the ports viewpoint, the key issues will be; how to maintain productivity, ensure port capacity and protect our common environment by making decisions based on the sustainable development.

At present, a broader EU Maritime Policy is being prepared in the Commission followed by a new EU Port Policy. Hopefully both will help the maritime regions as a whole.

As one member port in both Finnish Port Association and in AMRIE Port of Turku have had a chance to follow the policy work in progress for some time. According to the Commission, the Green Paper should combine the competitiveness and employment objectives of the Lisbon agenda with improving the health of the marine environment. The Green Paper puts forward several areas for discussion; sustainable maritime development, quality of life in coastal regions, ocean management tools, maritime governance and European maritime heritage and identity.

European Seaport Organization ESPO sees that seaports feature prominently in the Green Paper and are identified as key-elements in the logistics chain as well as business locations, but equally providing residential space and tourist facilities. The Green Paper further acknowledges that the growth in trade and shipping is dependent on having adequate port capacity and recognises that this need is under competition from environmental objectives.

If we look at the new Port policy paper one can easily share the view ESPO have; that sustainable development of port capacity and adequate hinterland connections is the most urgent issue that needs to be addressed. Environmental guidelines for the application of environmental legislation to port development would be a first important step to provide more legal certainty.

The Commission has also announced that it will publish a working paper on Motorways of the Sea. This document will describe the state of play for the Sea Motorways and provide an outlook for their implementation. The document will prepare the first call for project proposals which will open in December this year.

Another policy paper was also prepared in October 2005. Union of the Baltic Cities UBC Logistic Task Force presented a document with general recommendations and some practi-

cal ideas. In the UBC policy paper cities, in dealing with issues concerning maritime logistics cities should promote the harmonisation of maritime transport infrastructure and standardisation of cargo equipment to facilitate intermodal transports (e.g. standardisation of containers, port-ferry interface and ramps). Ports should support the development of port-hinterland connections and encourage public private partnerships in investments in port and port-hinterland infrastructure. And also promote the harmonisation of infrastructure costs for different kinds of transport modes and for different users in the BSR countries and promote a common approach to maritime fees and dues to create compatible operating environments. And furthermore support the enlargement and strengthening of the EU transport networks and promote cooperation and coordination between different regions in planning and developing transport infrastructure and more specifically transport corridors including new priority projects such as Motorways of the Sea.

Many of the above mentioned recommendations are evident and there should not be too many problems to make changes, but one of the problems is that things are not changing fast enough.

The Baltic Sea is an important transport corridor, but as we know, dense traffic can also generate problems. The marine environment is very sensitive and there is a growing concern about the rapidly increasing oil shipments.

But what can Ports do in order to contribute to the conservation of nature?

Ports can contribute to the development of a sustainable logistics chain, as ports are key elements of the Trans-European Network. Ports can encourage wide consultation, dialogue and cooperation between port administrations and the relevant stakeholders at local level. Ports can also generate new knowledge and technology and develop sustainable techniques which combine environmental effectiveness and cost efficiency. Furthermore ports can enhance cooperation between port administrations and facilitate the exchange of experiences and implementation of best practices to avoid unnecessary duplication and enable port administrations to share the costs of environmental solutions. This is very important, because earlier ports did not share too much information with each other.

Cooperation is also important on all levels. The market in which ports and shipping lines are operating has been substantially changed during the last two decades. To be competitive today, ports and other players in the logistic chain must cooperate and meet the demands on cost and performance by the users in a new way. Ports, Shipping lines and operators in the transport chain must work in a closer partnership relation than before to improve Cost efficiency and overall productivity. Here the port product (services offered by the logistics companies in the logistic chain together with the port) is in itself a chain of consecutive links, while the port as a whole is likewise a link in the global logistics chain. We can see this development happen in Port of Turku and in many other Baltic ports as well.

To summarise, ports like Turku and other organizations can contribute to the development of the Baltic Sea region in many ways. Just to give some examples. The City of Turku and the Port of Turku have both been active on EU level in the consultation of the EU Maritime Policy Green Paper. Furthermore, the City and Port of Turku took also part in the preparation of UBC Maritime Logistic policy. At present Port of Turku is involved in the preparation of a Motorway of the Seas project together with the ports of Hamburg, Rostock,

Stockholm, Kristiansand and Naantali. The Nordic Triangle Sea Motorway NTSM project proposal, [www.ntsm.org](http://www.ntsm.org) is a good example of a successful cooperation in the logistic chain.

The concept Motorways of the Seas can in fact be a fundamental element in the great picture discussed here and at the same time a method to deal with many of the questions we are trying answer, because as a practical project NTSM covers many important things such as infrastructure investments, sustainability, intermodal transports and cooperation.

*Christian Ramberg*

*Managing Director  
Port of Turku*

## The changing role of the trade association

by Harry Piela

The Finnish-Lithuanian Trade Association, SuLi, has been highly active for over ten years.

In the 1990s the role of SuLi was fairly clear and there was a lot to do. Doors were opened, new channels created, enterprises were assisted and authorities “bashed”. Countless seminars and round-table discussions, both in Finland and in Lithuania, were efficient instruments of change. Many company representatives received valuable help in running their business. On the other hand, members of the SuLi Executive Committee had a ringside seat at the relations between our countries, and public administration was (and is) much appreciated.

Today, everything is different. Lithuania is a member of the EU. Most of the major companies have their own offices in Vilnius or have established other channels of their own. Even tourism is on the increase. The trade association is forced to renew itself and rethink its *raison d'être*. Of course, some things have remained unchanged. The trade between our countries is small in comparison with, say, the trade between Finland and Estonia.

Is there a need for a trade association? If yes, why? What will be the role of SuLi?

We have discussed these issues and asked for the opinion of the members.

We compared our activities with associations which have been active for decades. Part of them has clearly focused on pleasant social events, part on influencing politics and part on consultation.

However, the members sent a clear message that the trade association is needed but that it must concentrate on promoting business. This was a good signal, and it was further emphasized by the fact that SMEs are beginning to participate more actively. Members range from private persons to Finnish subsidiaries of the world's biggest corporations. Accordingly, needs do vary.

We decided to focus on the following: assisting SMEs, creating relations with high-level decision-makers and promoting project activity. Project activity will surely soon give good results. As an example we might mention the development of collaboration between centres of excellence. The “Sunrise Valley” in Lithuania is a project which needs foreign expertise to develop. In Finland we have that expertise. What we need now is to help these parties to find each other and get things going. Even here SuLi has taken an active role in bringing the parties together.

Trade is always a two-way business; so the trade association also helps Lithuanian companies to cooperate with Finnish organizations. However, the jesting remark of a representative at a meeting – “We haven't seen many representatives of Lithuanian companies in reindeer herding areas” – reflects the need to promote business operations.

We believe that the trade relations between our countries will develop favourably. We also believe that SuLi has a place and a function in this development. Welcome along!

*Harry Piela*

*Member of the Executive Committee  
Finnish-Lithuanian Trade Association*

## A new mesostructure for Russian mining industry

by Veikko Kärnä

The Soviet Union collapsed in 1991, and was divided into 15 sovereign states. This event, which has been described by President Putin the biggest geopolitical tragedy of the 20<sup>th</sup> century, also changed the mesostructures of Russian Industry branches; in other words the overall governing structure of enterprises. My focus in this article is on the Russian Mining Industry, RMI, and the individual mines, which according to my research faced three transitional phases from 1990 till 2006: autonomy phase, privatization phase and consolidation phase.

The autonomy phase of transition took place from 1990 until about 1995. Starting already in Gorbachev era and continuing during Yeltsin's liberalization period the Soviet mining ministries were abolished. This era is characterized by the weak and passive ownership of the Russian state through Regional property committees. During this time the mines, who already earlier in the end of Soviet Era were working according to "khozaschet" (financial autonomy) principle received for instance the possibility to independently buy materials and equipment abroad. The policymakers expected that the mines would take the initiative into their own hands. But they didn't do that; they reacted passively, and remained faithful to the old Soviet traditions. They did not seem to use the freedom; they had received as a result of the liberalization policy of Yeltsin government. They seemed to follow a "no-change" strategy. This empirical observation was peculiar, because at the same time the Russian mines had very poor productivity compared to their peers in the West. It was apparent that they needed investments to buy modern equipment and structural changes to improve their organizations.

The privatization phase, which took place right after the autonomy phase, is the period during which the RMI's enterprises were sold by the state to its private owners. The new owners during this phase of transition could have been the management, the so called "red managers", sometimes together with the personnel, or it might have been private businessmen or privatization funds or other outside owners of the industry. As a result the government did not own the whole mining industry as it did during Soviet period, although some strategically important mining enterprises remained in governmental ownership; Alrosa diamond company and Tvel uranium company to name a few.

The third phase of transition, which can be identified as the process of consolidation, has been going on since the end of 1990s. The owners of the industry have started to advance their assets by purchasing new mining enterprises and consolidating them into their group's mining houses. As a result, the once sporadic spread of hundreds of gold, diamond, precious stones, iron ore, and coal mines in the mining sector has been consolidated and is now dominated by a dozen giant holdings, which have taken the role of previous mining ministries in the mesostructure of Russian Mining Industry.

It seems that only as a result of consolidation, a new phase in the RMI has been emerging: modernisation of the enterprises. The new owners of mining enterprises have started to invest money into their assets and some organizational changes have also happened.

Based on my research I argue that Russian Mining Industry has gone through an extraordinary transitional development, which results in the following: Firstly, the development of the RMI during the transitional period has been contradictory, and as a result there are now two approaches to mining as business: In the first approach mining is regarded as an intracompany source of raw materials for the group's own factories. The mines are located lowest on the production chain, which aims to the production of finished products, not raw material.

Another approach of the RMI is to have mining as an independent raw materials or commodity trade business. The mining companies trade only with their own raw materials selling them to processing plants, which are owned by separate business groups.

Secondly, power has returned back to the centre, to Moscow. Before the transitional period of Russian Mining Industry there were six mining ministries, which were monopolies. After 15 years of transition, the previously autonomic and then private mines in the Russian periphery are now parts of about a dozen Moscow based oligarchic mining conglomerates, which have taken the role of earlier branch ministries. The autonomy of mines has been liquidated, and the mines are now almost in the same position, in which they were before the liberalization. Their independent decision making has been reduced to bare minimum.

Thirdly, old Soviet structures have reappeared. Mainly, this concerns the vertical integration, which is evident in the mining companies of RMI, in which mining is regarded to be the intracompany source for raw materials and mines, processing plants and smelties form vertically integrated business structures.

Furthermore, a special Russian type of governing the enterprises has been born: so called management companies are typically in charge of the business activities of the mines. These management companies do not own the mines they are running, the mines can be owned by offshore companies, but the owners of the mines have authorized the management company to run the business activities on their behalf. This type of corporate governance appeared together with the Yukos case, and can be regarded as the owners' attempt to avoid confiscation by the government. The whole responsibility of non-paid taxes would be on the management companies, and would they be bankrupted the original offshore owners could keep their assets.



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\* Public defence of his doctoral dissertation was held on June 1 2007

## Corporate governance in Estonia: Intact despite 2007 amendment to Commercial Code

by John JA Burke

The Baltic Times in its 22-28 February 2007 edition published an article entitled "Experts: Estonia to become haven for shady corporations". The charge of attracting disreputable corporations purportedly would result from an amendment to Estonian law relaxing director liability, protecting any decision made in "good faith". Statements from local experts support the stories' spin. The publication and its expert commentary imply that Estonia has reached the bottom of the regulatory arbitrage barrel symbolised by Delaware Corporate Law. That implication does not withstand legal analysis and misrepresents the law of Delaware.

The publication states, "Under the changes, which will come into effect in March [2007, authors' addition], directors and board members cannot be prosecuted if their decisions were made in good faith". The Justice Minister is quoted as saying "the new corporate law was copied from the U.S. state of Delaware and was designed to attract more investment to Estonia". The sweeping statement follows: "Delaware is well known for its lax corporate laws, which allow company directors to absolve themselves of liability for any decisions, including those that adversely affect stock prices or even consumers."

An expert, the Vice-Dean of Business at International University Audentes, claims, "Delaware law brings Estonia into conflict with the European Commission." He elaborates, "Such laws allow boards to remove themselves of any sort of liability. They can hide behind the law in terms of product safety and fiducial (sic) responsibility." The Vice-Dean cites Enron and Worldcom in support of his views, and concludes: "Any place that has this law will be a major attraction, particularly for companies dealing with a product that has the potential to cause harm." Expert practitioners and statements from a Ministry of Justice spokesman fail to add any clarity.

The Delaware legislature adopted Article 102(b)(7) in response to the decision in *Smith v. Van Gorkom* that cracked the citadel of the "business judgment rule" under which directors were liable to shareholders under a theory of breach of due care only in extreme cases of managerial incompetence. The court in *Van Gorkom* required directors to actively acquire information to produce the best premiums for shareholders in connection with a sale of the company. The decision was regarded as applying a full-blooded version of the duty of care and was perceived as a threat to Delaware's reputation as the state of choice of incorporation.

Nevertheless, jurisprudence subsequent to *Van Gorkom*, has developed new doctrines to assess director liability given the diminishment of the duty of care standard. These standards often referred to as enhanced scrutiny for transactional duties are exemplified in decisions such as *Unocal Corp. v. Mesa Petroleum* [formulating standard of review, existing between business judgement rule and entire fairness rule, for action taken to respond to threat of corporate control], *Revlon v. MacAndrews & Forbes Holding, Inc.* [requiring directors to maximize company's value for sale over preservation of corporate entity when sale is a virtual certainty], and *In Re Caremark International, Inc.* [stretching duty of care to include a requirement that directors assure an adequate reporting system of information].

This trend continues unabated, addressing recent events, such as backdating options [*Ryan v. Gifford*, finding that when directors backdate options they cannot meet the busi-

ness judgment rule test thereby exposing them to director liability], and [*In Re Tyson Foods, Inc. Consol. S'holder Litig*, finding that where directors "spring-loaded" options, that is, timed them to take advantage of non-public, material information when granted potentially constitutes a breach of the duty of loyalty, given sufficient proof.

The Baltic Times' claims disintegrate before the facts. Estonia is not analogous to Delaware. The two regimes are the product of entirely different legal traditions, though Estonia may have "sampled" a Delaware provision. It is beyond dispute that Delaware has a court system and jurisprudence on corporate law that is pre-eminent in the world. The same cannot be said for Estonia. In addition, given Delaware's sophisticated jurisprudence, as well as federal and state law applicable to company activity, it is impossible to reduce to a single axiom the scope of director liability.

Consequently, the bald assertion that "Such laws [apparently Article 105(b)(7)] allow boards to remove themselves of any sort of liability" is false. Moreover, the subsequent assertion that "They [directors] can hide behind the law in terms of product safety and fiducial (sic) responsibility ... as long as their decisions were in good faith" is first difficult to interpret as Delaware litigation arises in the context of derivative shareholder suits. Product safety claims would come into play directly only if the company first were found to have violated a law and was ordered to pay damages. Under this scenario, a shareholder filing a derivative lawsuit would have to show oversight failure, a standard that if met exposes directors to potential liability. If the company intentionally violated the law, Article 105(b)(7) provides no protection.

Whether the Estonian amendment contravenes EU policy is a premature question as first the EU has not provided a definitive stance on the issue, and second, legal progress in this area moves with extreme caution. For the record, Enron was incorporated in Oregon and Worldcom was incorporated in Georgia.

More important, legal rules do not solve corporate control problems. It is shareholders that must undertake active roles in selecting directors and voting on management and company issues. This tactic is difficult but not impossible to achieve. In the United States, for example, minority shareholders have managed to place propositions on proxy statements to protect their interests. Even if these propositions fail to pass due to a lack of adequate votes, the fact that some propositions have generated substantial shareholder support sends a clear message to directors and officers: shareholders are watching, ready to act, and intolerant of abuse of authority.

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# Baltic Rim Economies

Estonia – Latvia – Lithuania – Poland – Baltic Russia  
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