Baltic Rim Economies

Estonia - Latvia - Lithuania - Poland - Baltic Russia
Bimonthly Review

Baltic Rim Economies

ISSUE NO. 6, 19 DECEMBER 2008

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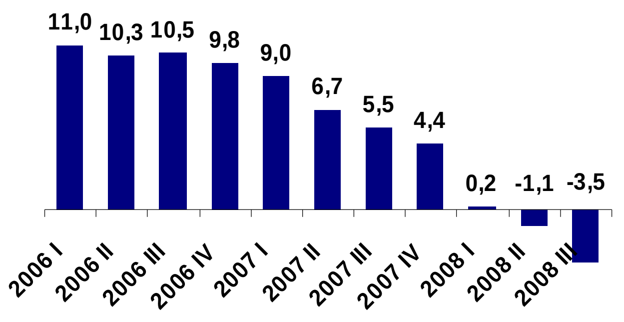
EXPERT ARTICLES CONTINUED:

Estonia

Economy in a slump

According to a preliminary estimate by Statistics Estonia, GDP decreased by 3.5% in the third quarter of 2008 y-o-y. The slump of the Estonian economy continues as GDP continues to decrease for two quarters in a row. Low domestic demand, which decreased by 9.5%, and the decrease in exports of goods and services were the main factors contributing to the decrease of the GDP. One main component of domestic demand, private consumption expenditures, decreased in almost all categories except in expenditures on housing, health, education and recreation.

Real growth rate of GDP in 2006 Q1 - 2008 Q3 (y-o-y, %)



Source: Statistics Estonia

All economic forecasts are now surrounded by vast uncertainty. However, dim prospects for the Estonian economy are more than likely. According to the SEB Nordic Outlook, the Estonian economy will fall by 4.0% next year and by 1.0% even in 2010. Since Estonia's key export markets are also facing difficult times, Estonian exports will most likely stagnate. The forecast of the Estonian treasury is line with SEB in predicting a decline of 3.5% next year. The Bank of Estonia is somewhat more optimistic in predicting a decline of more than 2.0% in 2009. The Central Bank sees pursuing policies of openness, free competition and a well-regulated market economy as answers to avoiding major setbacks in the global economic crisis.

Industrial production plummets by 10%

The data of Statistics Estonia shows that industrial production decreased by 10% in October y-o-y. The decline of industrial production y-o-y begun in March, earlier this year, and has now dropped to its lowest level this year. Manufacturing fell by 10% which was mainly caused by weakening market demand. The decrease in manufacturing was mainly affected, as earlier, by a decrease in the production of food, wood and construction materials. Some export-oriented industry branches still managed to enjoy growth. As in earlier months, the production of metal products, electrical machinery and chemical products grew when compared to October of the previous year.

Inflation still high but diminishing

According to Statistics Estonia the increase in the consumer price index was 8.0% in November y-o-y. The annual index was mainly influenced by the price increases of housing which accounted for a third of the price rise. Rising prices of heat energy was, for the most part, responsible for the price rise in housing. The index decreased -0.3% in November compared to the previous month. This was mainly influenced, among other things, by the price decreases of motor fuel (-10.3%) and vegetables (-4.7%). The price of heat energy, however, continued to increase (5.0%)

According to the Bank of Estonia, it is likely that inflation will continue its gradual decrease and that the Maastricht inflation criteria will be met in 2010. This is supported by the economic downturn and cheapening commodity prices. To support this goal, the government is urged to avoid raising administered prices. The SEB Nordic Outlook also forecasts diminishing inflation due to the increasing unemployment which will ease considerably the pressure of wage increases.

Construction and real-estate in continuous decline

The total production of Estonian construction enterprises in Estonia and abroad decreased by 16% in the third quarter y-o-y Statistics Estonia reports. The slowdown of the construction market started at the beginning of the year after showing only growth figures earlier during this decade. Now the construction market has reached its lowest levels. The production of building materials has been sharply declining by a third in October y-o-y. The future also looks bleak since only approximately 1,000 building permits were issued in the 3rd quarter which is about half less than a year ago.

The Estonian real estate market has been in serious difficulties in 2008. According to Statistics Estonia, in the 3rd quarter the total number of purchase-sale contracts has decreased by more than a fourth y-o-y and by a tenth compared to the previous quarter. In addition, the total value of the contracts has decreased by 35% y-o-y and by almost 20% compared to the previous quarter.

Some business highlights

- Tallink, the Estonian ferry giant and owner of 11 vessels announced a profit of approximately EUR 20 million in the last financial year – a 70% decline y-o-y. According to company representatives, the result was influenced among other things by the late delivery of a new cruise vessel and increasing fuel and interest costs.
- The fast-ferry company SuperSeaCat closed all its operations earlier this autumn. Experts believe that the introduction of new, fast, high-capacity ferries was one major contributor to the downfall of SuperSeaCat.
- The software developer Playtech Estonia has announced plans for hiring 80 employees. The Tartu based company already employs some 330 people in Estonia.

Estonia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	7.9	6.5	8.0	7.2	8.3	10.2	11.2	7.1	-3.5	Q3/2008
Industrial production (y-o-y %-growth)	14.6	8.9	8.2	11.0	10.5	11.0	7.3	6.1	-11.0	10/2008
Inflation (CPI, end of period, y-o-y %-change)	5.0	4.2	3.6	1.3	3.0	4.1	4.4	9.6	8.0	11/2008
General government budget balance (% of GDP)	-0.6	0.3	1.5	2.0	2.3	2.3	3.8	2.8	n/a	1-12/2007
Gross wage (period average, EUR)	314	352	393	430	466	555	596	784	800	Q3/2008
Unemployment (% end of period)	13.9	11.9	11.3	9.3	8.5	7.9	5.9	4.7	6.2	Q3/2008
Exports (EUR million, current prices)	3445	3698	3642	4003	4770	6190	7647	8028	6384	1-9/2008
Imports (EUR million, current prices)	4615	4798	5079	5715	6704	8213	10576	11278	8344	1-9/2008
FDI inflow (EUR million, current prices)	425	603	307	822	775	2255	1341	1817	783	H1/2008
Current account (% of GDP)	-5.5	-5.6	-10.6	-11.6	-12.5	-10.5	-14.8	-17.4	-10.0	Q2/2008

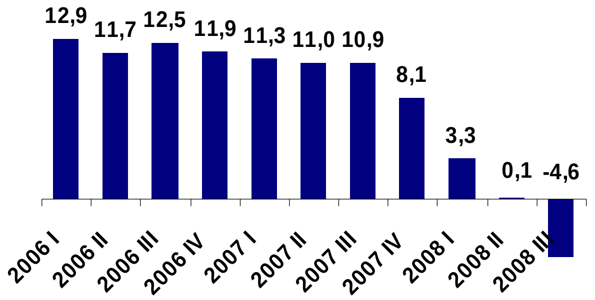
Sources: Statistics Estonia, Bank of Estonia, Eurostat, author's calculations

Latvia

Economy in trouble – GDP decreases

According to the Central Statistical Bureau of Latvia, GDP decreased by -4.6% in the third quarter y-o-y. The Latvian economy is facing major challenges. As the difficulties of the economy have worsened, the country was forced to receive financial aid from the International Monetary Fund (IMF) in November. Major factors contributing to the difficulties are dwindling domestic demand and as a result of the global financial crisis, a decreasing external demand as well.

Real growth rate of GDP in 2006 Q1 - 2008 Q3 (y-o-y, %)



Source: Central Statistical Bureau of Latvia

Forecasts regarding the future of the Latvian economy are bleak. The Central Bank's GDP forecast for 2008 is -2.0% and -5.0% for 2009. The fourth quarter preliminary data shows a rapid decrease in retail turnover in October and worsening consumer confidence indicates a deep downturn. In line with the Central Bank, SEB forecasts in its Nordic Outlook a 5.0% decrease in GDP in 2009 and -1.0% in 2008. Unemployment is expected to rise sharply. In addition, Swedbank has noted that the risk of long-term economic downturn has grown and that the problematic current account deficit is estimated to stay high.

Industrial output dives 9% y-o-y

The data of the Central Statistical Bureau of Latvia shows that industrial production has decreased by 9.0% in October 2008 compared to the corresponding period of the previous year. The downturn was mostly influenced by the decrease in the output of manufacturing (-11.1%) and in electricity and gas supply (-4.8%). Mining and quarrying, however, showed an increase of 16.9%. Compared to the previous month, industrial production has decreased by 3.7%. This was mostly influenced, like on the year-on-year data, by the decrease in the output of manufacturing (-3.2%) and in electricity and gas supply (-5.2%). Mining and quarrying, however, showed an increase of 1.9%.

High inflation continues to diminish

The consumer price level of November 2008 increased by 11.8% compared to November of the previous year the Central Statistical Bureau of Latvia reports. Hence inflation continues its gradual decrease although remaining still at a high level. The price increase of housing, water, electricity, gas (32.4%) was the biggest. Food prices have increased by 11.6%. However, the price level of communication has decreased by 5.3%. The price level in November 2008 compared to the previous month decreased by 0.4%. As in year-on-year data, the price increase of housing, water, electricity, gas (1.6%) was the biggest. However, the price level of transport has decreased by 4.7%

According to the Bank of Latvia, the combination of a downturn of the economy and low demand has caused a rapid decline in inflation. In addition, changes in global food and oil prices have been favorable. The Central Bank projects that the annual inflation rate in December would be around 11%.

Imports decrease almost 10% y-o-y

The value of exports increased by 2.8% and the value of imports decreased by 9.3% in October 2008 y-o-y according to the Central Statistical Bureau of Latvia. The largest increase in commodity exports was in agriculture (up by 35.4%) and in products of chemical and allied industries (up by 31.0%). Exports in wood and wood products went down by 28.7% and in transport vehicles by 18.0%. The largest increase in imports was in mineral products, including among other things oil and oil products, natural gas and electricity with a 55.7% increase. Imports of wood and articles of wood went down by 54.2%, transport vehicles respectively by 44.4%.

Compared to the previous month, exports decreased by 6.9% and imports by 6.6%. The largest increase in commodity exports was in agricultural and food products (up by 20.2%) and textiles and textile articles (up by 10.2%). The largest decrease in exports was in products of base metals and articles of base metals which fell by 24.2%. The largest increase in commodity imports was in agricultural and food products (up by 6.0%). The largest decrease in imports was in products of products of the chemical and allied industries.

Some business highlights

- Riga Airport launched its new EUR 23.5 million runway a while ago. The new runway allows the airport to accommodate any type of plane without limitations which is unique in the Baltic countries.
- Rigas Dzirnavnieks, the Latvian grain processing company, reported a 48% increase in its sales January- September y-o-y. The turnover was EUR 22 million.
- The Latvian authorities have bought a controlling stake in the troubled Parex Banka. The second largest bank in Latvia met overbearing difficulties and was forced to seek assistance from the Latvian state.

Latvia - main economic indicators	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**as of**
GDP (y-o-y %-growth, constant prices)	6.9	8.0	6.5	7.2	8.5	10.6	12.2	10.3	-4.6	Q3/2008
Industrial production (y-o-y %-growth)	3.2	6.9	5.8	6.5	6.0	5.6	4.8	0.5	-9.0	10/2008
Inflation (CPI, end of period, y-o-y %-change)	1.8	3.2	1.4	3.6	7.3	7.0	6.8	14.1	11.8	11/2008
General government budget balance (% of GDP)	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	n/a	1-12/2007
Gross wage (period average, EUR)	268	282	297	298	314	350	430	683	678	9/2008
Unemployment (% end of period)	13.3	12.9	11.6	10.3	10.3	8.7	6.8	5.4	6.3	Q2/2008
Exports (EUR million, current prices)	2020	2232	2416	2559	3204	4085	4594	5727	5331	1-10/2008
Imports (EUR million, current prices)	3453	3910	4284	4634	5671	6879	8828	10986	8989	1-10/2008
FDI inflow (EUR million, current prices)	n/a	n/a	223	248	489	568	1324	1797	1051	1-9/2008
Current account (% of GDP)	-4.8	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-22.8	-15.6	Q2/2008

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

Lithuania

Pessimistic views on the economic situation

According to Statistics Lithuania, the Lithuanian GDP grew 3.1% in the third quarter, compared to the corresponding quarter of the previous year. The quarterly GDP growth rate is the lowest since 2000.

Many concerns have been raised about the economic situation in the Baltic countries. The largest Nordic banks have compared the macroeconomic situation in the Baltics to the situation that led to the financial crisis in the Nordic countries in the beginning of 1990's. Several instances, among others SEB AB and Nordea AB banks, IMF and the European Commission have assessed that Lithuania and the other Baltic States might fall into a protracted economic decline. After a prolonged economic expansion Lithuania will face great challenges due to e.g. a wide current account deficit and a high inflation rate.

Inflation still high

The consumer price level in November 2008 was 9.1% higher as compared with the corresponding month of the previous year. The annual inflation rate was mostly influenced by a price increase of 11.6% for food products and non-alcoholic beverages, 22.6% for housing, water, electricity, gas and other fuels, 15.5% for alcoholic beverages and tobacco products, and a 4.5% decrease in prices for clothing and footwear.

The Lithuanian inflation rate has been falling slightly compared to the 12.5% peak it reached in June. According to Statistics Lithuania, the price level in November 2008 decreased by 0.2%, compared to the previous month. The last time deflation was registered in Lithuania was in September 2006 (0.1%).

Export growth the highest in EU

In January–September 2008, the export of goods increased by 33.8% and imports by 23.6% compared to the corresponding nine months of the previous year, reports Statistics Lithuania. According to Eurostat data, Lithuanian export growth was the highest among the EU countries.

According to Statistics Lithuania, export growth in January-September 2008 was mainly driven by an increase in the export of processed oil lubricants and lubricants received from bitumen minerals (2.4 times), fertilisers (97.9%), and grain (2.6 times). An increase in imports mainly resulted from increases in the import of crude oil and natural gas (2.5 times), railway locomotives, carriages and railcars and their parts (5 times), and fertilisers (2.4 times). In January to September in 2008, Lithuania's main export partners were Russia (15.4%), Latvia (11.5%), Germany (7.2%), and Poland (5.8%) and the main import partners were Russia (31.2%), Germany (11.8%), Poland (9.9%), and Latvia (5.1%). The EU Member States' share of total Lithuanian exports was 61.1%, while imports from EU countries accounted for 56.5% of all Lithuanian imports.

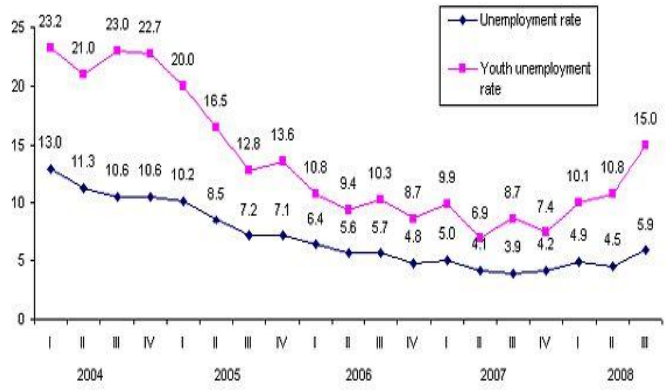
Wages keep on growing

Statistics Lithuania reports that average monthly gross earnings in the whole economy in the third quarter increased 19% compared to the corresponding period in 2007 and amounting to EUR 672. In the public sector the average monthly gross earnings amounted to EUR 692 (increased by 23.1%) and in the private sector EUR 660 (increased by 16.6%).

Youth unemployment rising

According to Statistics Lithuania, the unemployment rate in Lithuania in the third quarter was 5.9%, which is 2 percentage points higher than in the corresponding period in 2007 and 1.4 percentage points higher than in the second quarter of this year. The youth (aged 15–24) unemployment rate is on the increase. In the third quarter the youth unemployment rate was 15%, compared to 8.7% in the corresponding period in 2007.

Unemployment rate 2004–2008 (%)



Source: Statistics Lithuania

Some business highlights

- The Minister of Finance of the new cabinet of Lithuania is Algirdas Semeta, who has been acting as the Incumbent Director of the Statistics Department under the Lithuanian Government.
- After several months of drastic increases in food prices, the costs will be expected to stabilise soon, informs the Lithuanian Retailers' Association.
- Electricity prices in Lithuania will rise 18% in 2009 according to economic analysts of SEB Bankas. The price increase will first and foremost affect businesses whose overheads depend heavily on electricity prices, while households are not likely to see noticeable price rises until the Ignalina nuclear power plant closure at the end of the year 2009.
- The Lithuanian bank Snoras's consolidated net profit for the first three quarters plunged by 38.9% year-on-year. The Snoras sources have said that the bank is not in danger and is even expanding its business.

Lithuania - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	4.1	6.6	6.9	10.3	7.3	7.9	7.7	8.0	3.1	Q3/2008
Industrial production (y-o-y %-growth)	2.2	16.0	3.1	16.1	10.8	7.3	8.9	7.2	-2.5	10/2008
Inflation (CPI, end of period, y-o-y %-change)	1.4	2.0	-1.0	-1.3	2.9	3.0	3.8	8.1	9.1	11/2008
General government budget balance (% of GDP)	-2.5	-2.0	-1.4	-1.3	-1.5	-0.5	-0.3	-1.2	n/a	1-12/2007
Gross wage (period average, EUR)	263	274	293	311	335	421	459	594	672	Q3/2008
Unemployment (% end of period)	16.9	17.9	13.0	11.6	10.6	8.3	5.6	4.2	5.9	Q3/2008
Exports (EUR million, current prices)	3841	4778	5526	6158	7478	9502	11250	12522	12464	1-9/2008
Imports (EUR million, current prices)	5650	6767	7943	8526	9959	12446	15384	14341	16304	1-9/2008
FDI inflow (EUR million, current prices)	439	516	772	160	623	826	1448	1645	741	1-9/2008
Current account (% of GDP)	-5.9	-4.7	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7	-17.0	Q2/2008

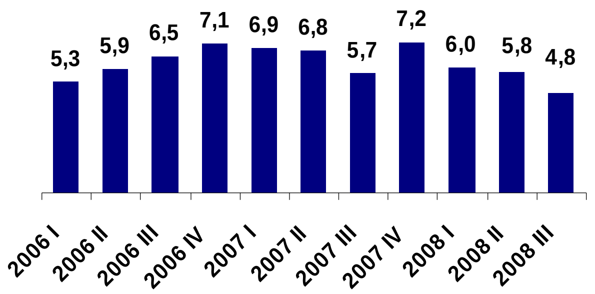
Sources: Statistics Lithuania, Bank of Lithuania, Eurostat, author's calculations

Poland

GDP growth on a subtle diminishing trend

The Polish GDP growth was 4.8% in the third quarter of 2008 y-o-y. The Polish economy continues on a trend of a gradually diminishing GDP growth. However, so far the deceleration has been quite subtle, especially when compared to the Baltic countries.

Real growth rate of GDP in 2006 Q1 - 2008 Q3 (y-o-y, %)



Source: Central Statistical Office

Forecasts predict that the subtle diminishing trend of the Polish GDP growth will continue. The National Bank of Poland sees that economic growth will continue to decrease in the coming quarters. This is mainly attributed to weakening external demand, uncertain future prospects and limitations to credit availability. The OECD predicts that the Polish economy will grow by 5.3% this year and by 3.0% next year. SEB forecasts in its Nordic Outlook a more pessimistic scenario - a 4.9% increase in GDP this year but only 1.0% in 2009.

Inflation continues subtle decrease

The Central Statistical Office reports that the Consumer Price Index increased by 4.2% in October 2008 y-o-y. The gradual deceleration of inflation has continued as expected. As in previous months, the highest price increase was recorded in dwelling (up by 8.8%). Food, all beverages and tobacco products were up by 4.6%. The most notable decrease in prices was still in clothing and footwear which was down by 6.2%. The price level in October compared to the previous month increased slightly by 0.4%. The highest price increase was recorded in dwelling (up by 0.9%) and the highest price decrease was found in transport (down by 1.0%), as earlier.

According to the National Bank of Poland, energy prices and rises in service prices were major factors contributing to the inflation in October y-o-y. The Central Bank forecasts that in the near future inflation will be over 3.5% but in the medium term the global and domestic downturn will ease inflationary pressures.

Industrial output declines to only 0.2%

Industrial production decreased by 0.2% in October 2008 compared to the corresponding period in 2007. This was a significant downturn compared to September when industrial output was up by 6.8% according to the revised data of the Central Statistical Office. The output was up in 13 of the 29 industrial sectors. Manufacturing was the only main sector which grew (up by 1.3%). The highest growth in manufacturing sub-sectors was noted in the production of other transport equipment (up by 56%) and in machinery and equipment (up by 40%). The decline of production was most notable in electricity, gas and water supply (down by 9.7%) and mining and quarrying (down by 8.3%) as in the previous month.

Exports up by 18% in the three first quarters

The Central Statistical Office informs that Polish exports rose in value to almost EUR 88 billion in the three first quarters of 2008. This is 17.7% more compared to the corresponding time of the previous year. This is a bit better than a month ago when the respective figure was approximately 1.5 percent units smaller. Imports rose in value to almost EUR 105 billion in the three first quarters of 2008 which is almost 20% more compared to the corresponding quarter of the previous year.

Some business highlights

- The energy group Tauron Polish Energy is interested in replacing its old generating units with new ones within 12 years. The over EUR 7 billion investment plans are included in the group's development strategy.
- The Infrastructure Ministry has unveiled a new plan for modernising the Polish railways from Warsaw to Poznań and Wrocław. The over EUR 6 billion investment plan includes 540 kilometres of new railway lines and the project should be finished by the year 2020.
- The Lotos Group, Poland's second largest fuel producer, and Norwegian oil producer Statoil Hydro made a deal in which Statoil Hydro will supply oil to Lotos in 2009 should the latter be unable to buy supplies from other sources. Quantities were not revealed by the parties but estimates have been around 1-2 million metric tons.
- Moody's Banking System Outlook for Poland predicts that the fundamental credit outlook for the Polish Banking System is negative. According to the report Polish banks were doing relatively fine in the first half of the year but the second half has not been as good due to, among other things, the global tightening of credit supply.
- The government is considering constructing two nuclear power plants according to Polish Prime Minister Tusk. Decisions have not been made yet regarding the locations of the proposed plants but Mr. Tusk has said that they should be built in the poorest parts of the country with the largest development needs.
- BASF Construction Chemicals is investing in a mortar production plant near Poznań. The investment is worth several million Euros and the plant is planned to produce an output of 45,000 tons per year and to employ 40 people.
- Sea-Invest, a Belgian company, has acquired a controlling stake in Polish Port Północny. The company trans-ships dry bulk cargo in the Gdańsk seaport and employs 250 people.

Poland - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
GDP (y-o-y %-growth, constant prices)	4.2	1.1	1.4	3.8	5.3	3.5	6.1	6.5	4.8	Q3/2008
Industrial production (y-o-y %-growth)	6.7	0.6	1.1	8.3	12.6	4.1	5.7	9.7	0.2	10/2008
Inflation (CPI, end of period, y-o-y %-change)	8.5	3.6	0.8	1.7	4.4	0.7	1.4	4.0	4.2	10/2008
General government budget balance (% of GDP)	-0.7	-3.7	-3.3	-2.9	-3.3	-6.1	-3.9	-2.0	n/a	1-12/2007
Gross wage (period average, EUR)	472	557	544	497	505	591	692	825	794	1-10/2008
Unemployment (% end of period)	16.0	18.5	19.7	19.3	18.0	16.7	12.2	11.4	8.8	10/2008
Exports (EUR billion, current prices)	34.4	40.4	43.4	47.5	59.7	71.4	87.5	101.1	87.8	1-9/2008
Imports (EUR billion, current prices)	53.1	56.2	58.3	60.4	71.4	80.6	100.0	118.8	104.9	1-9/2008
FDI inflow (EUR billion, current prices)	10.3	6.4	4.4	3.7	10.0	8.3	15.1	12.8	9.9	1-9/2008
Current account (% of GDP)	-6.0	-2.9	-2.6	-2.1	-3.5	-1.7	-2.3	-3.7	-5.5	H1/2008

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

St. Petersburg

Economy: crisis has started

The slowdown of St. Petersburg's economy has turned into the deep recession of its key sector, namely industry. Industrial production fell in October 2008 by 8.9% y-o-y, outrunning the unprecedented 8.5% monthly y-o-y fall of August 2008. Service sectors continued to grow, but the growth rates were much lower than a year ago. Retail trade in October 2008 rose by 8.3% y-o-y; and communication grew 16.2% y-o-y. These figures contributed to the aggregate growth of January-October 2008 in trade and communication, which accounted for 13.4% and 15.6% y-o-y, respectively. Nevertheless, the increase was much lower than that of January-October 2007 (17.8% for trade, and 21.1% for communication, y-o-y). Construction experienced slight 4.8% y-o-y growth of monetary output in October 2008, while residential space finalised dropped in the same month by 14.4% y-o-y. The only exception was the transport sector, which rose by 49.6%, y-o-y, in October 2008. Monetary output of the sector was increasing in previous months as well. In January-October 2008 the transport sector grew 44.5% y-o-y. However, the total cargo turnover of regional carriers in the first ten months of 2008 rose by 2.6% y-o-y only. Thus, the only reason for the aforementioned transport's bright performance was the fast increase of transport tariffs, which followed the fuel price rally of spring-summer 2008.

Real estate: prices went down

Construction and real estate sectors felt the influence of decreasing demand already in early September 2008, as the buyers did not show up at the market after the summer holidays. The real estate prices in roubles, however, kept on climbing up. According to BN (*Bulleten' Nedvizhimosti*), the largest regional real estate data portal, in October-November 2008 housing prices in St. Petersburg started to fall, both on primary and secondary markets. Since October 1st till November 30th 2008, the average primary market rouble price fell by 3.3%. On the regional secondary market rouble prices decreased even more significantly: by 4.6%. This was the deepest real estate rouble price reduction in St. Petersburg since March 2006. Price reduction, together with deteriorating demand, struck regional developers heavily. In October Moody's Agency changed the investment rating of the largest regional construction holding, namely the LSR Group, from *stable* to *negative*. To raise current cash-flow, many developers announced various discounts on apartments and houses. In certain cases the sellers offered a discount of 30% and more, while on average the rebate was 15%. Many construction companies expected regional authorities to support them by purchasing apartments for municipal purposes. Indeed, in November St. Petersburg Government announced two tenders, with total budget of EUR 287 million. However, maximum price per metre was set at RUR 47 300, or EUR 1340, which appeared to be 46.8% below the current market price reported by BN.

Regional budget: sequestration

The crisis reminded the officials and the public of budget's sequestration, which was an unpopular measure, used in the 1990's. Budgetary performance in the first three quarters of 2008 was successful enough compared to the corresponding period of 2007: budget's revenues in 2008 reached EUR 6.9 billion, while incomings for the first nine months of 2007 were EUR 5.7 billion. Despite this, in November 2008 the regional authorities admitted that a preliminarily agreed regional budget for 2009 had to be changed, as the revenues might drop down already in the last quarter of 2008. Governor V. Matvienko proposed a 10% reduction of planned expenditures. Her proposal was adopted by the regional Parliament, opposed by its Communist Faction alone.

St. Petersburg's budget for 2009*, selected sectors

	Initially planned expenditures, EUR million	*Reduction, EUR million*
Municipal healthcare	1141.6	28.7
Road maintenance	1219.8	134.3
Municipal construction	1792.2	78.4
Municipal transport	381.3	62.7
Communal utilities	1073.1	69.8

Source: Government of St. Petersburg, 2008
** - calculated from RUR to EUR at current Bank of Russia's rate*

Foreign trade: still stable

Regional foreign trade grew fast in January-September 2008. Exports went up by 60.1% y-o-y, and imports expanded by 38.7% y-o-y. However, the trade remained heavily dependant on the oil price at global markets, as the share of mineral fuel in regional exports exceeded 78%. The rapid decrease of international commodity prices in October-November 2008 would lead to a reduction of export volumes already in the fourth quarter of 2008. On the import side, the situation could be different. In January-September 2008 the top-five of the region's leading import partners were China with 17.9% of total imports; Germany with 12.7%; Finland with 8.8%; USA with 6.2%; and South Korea with 4.1%. Two of those were EU countries, and Euro/Rouble exchange rate in the beginning of 2008 and in the end of November 2008 was almost at the same level, making imports from the EU quite affordable for local buyers. Chinese imports, in turn, fill low-price niches, being therefore less sensitive to economic crisis.

Some business highlights

- KIT Finance, St. Petersburg's fourth largest bank, was acquired by a consortium of two Russian state monopolies, namely RZD (Russian railways) and Alrosa (producer of diamonds). They purchased a 100% stock of KIT Finance for a symbolic sum of 3 euros, in order to prevent its bankruptcy. Amount of the bank's "bad" assets in October 2008 exceeded EUR 2 billion.
- Finnish retailer Kesko officially refused to buy 89% of Lenta, St. Petersburg leading supermarket network, as they failed to reach an agreement with the sellers.
- VTB Asset Management, a subsidiary of VTB, Russia's second largest bank, declined a project for creating a techno-park in Petrodvorets, south of St. Petersburg. Earlier the VTB subsidiary planned to invest EUR 200 million in this project.
- VEFK, a large regional bank, received a EUR 230 million loan from the Bank of Russia. This measure by the Central Bank prevented VEFK from possible bankruptcy

St. Petersburg - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	10.5	4.5	17.7	8.4	7.2	8.4	8.4	9.1	n/a	1-12/2007
Industrial production (y-o-y %-growth)	26.2	0.2	31.4	5.8	14.1	4.2	-7.0	10.0	3.1	1-10/2008
Regional inflation (CPI, y-o-y %-change)	23.5	16.3	16.6	13.0	12.7	12.0	10.0	10.9	15.0	1-10/2008
Gross average wage (monthly, EUR)	n/a	n/a	217	209	285	345	407	510	617	9/2008
Unemployment (% average annual)	7.9	4.4	3.5	4.3	2.8	2.4	2.4	2.0	2.0	H1/2008
Exports (EUR million, current prices)	2736	2134	1839	2429	3210	3954	5499	12978	12678	Q1-Q3/2008
Imports (EUR million, current prices)	2693	4423	5158	5123	5560	8081	10299	15093	12507	Q1-Q3/2008
FDI inflow (EUR million, current prices)	158	127	89	62	90	201	512	567	581	Q1-Q3/2008

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

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

Leningrad region

Economy: sharp braking

The negative influence of economic crisis was observed in Leningrad province in October 2008 already. Several basic sectors of the regional economy either remained stagnant, or moved into recession. Transport had a zero change compared to October 2007; a symbolic 0.5% y-o-y surplus was reported by the consumer services sector. In October 2008 catering decreased by 8.7% y-o-y and construction dropped down by an impressive 13.0%. Relatively stable in this month were industrial production with its 4.6% y-o-y growth, communication with 4.5%, and retail trade with a 5.3% y-o-y increase. Accruing results of January-October 2008 for all sectors of regional economy were still positive, but mostly due to successful pre-crisis development in the first three quarters of 2008. Nevertheless, even the growth leaders of previous years continued to decelerate in January-October 2008. In the first ten months of 2008 trade, transport and communication rose by 6.3%, 3.4%, and 7.0% y-o-y, respectively. These results appeared to be much more moderate, than a year ago, when the corresponding y-o-y increase was 16.0%, 14.2%, and 11.0%. Moreover, in case of transport, the 3.4% growth of its monetary output reflected uprising tariffs only, as the cargo turnover even reported a slight reduction of 0.4%, y-o-y.

Agriculture: unexpected improvement

The sole example of successful performance in October 2008 was given by regional agriculture, which raised its output by 11.1%. This happened partly due to a good harvest, increasing the volumes of grain, produced by beginning of November 2008, by 15% y-o-y. Another reason was the rapid development of hog breeding in the region: hog livestock grew 43% y-o-y by November 2008. Thus, in January-October 2008 regional meat production rose by 26.1% y-o-y, while a year ago the corresponding increase was 3.0%. But the banking crisis and lack of affordable loans might damage this expansion in the nearest future.

Inflation: changing the trend

CPI in October 2008 equalled 1.3%, which meant 16.1% y-o-y. Accruing inflation (prices compared to those of December 2007) was 12.7%, and if this trend continues, then the annual rate for 2008 might exceed 15%. Real incomes of the region's residents continued to decrease: in January-September 2008 they fell by 1.1% y-o-y. This reduction was a consequence of high inflation. Nominal wages, within the same period, rose by 32.4% y-o-y. However, the inflationary trend might change already in the last quarter of 2008. The financial crisis had already caused a certain contraction of prices at regional market. Diesel fuel, one of the key commodities became in October 2008, on average, 1.7% cheaper, than a month before. The corresponding monthly price change for construction concrete was even higher, minus 5.9%. The rouble price for ceramic bricks kept stable from April till October 2008. State regulated tariffs, including communal services and communication, were frozen in October 2008 to prevent further inflation. All these factors together form a basis for decelerating the regional inflation, as CPI is to some extend a derivative of the abovementioned producers' prices.

Foreign investment: the last wave?

Foreign investment in Leningrad province grew 60.2% y-o-y in January-September 2008. The structure of the inflow changed: share of FDI rose to 55.7% of the total in January-September 2008 from 50.8% a year ago; share of other investment decreased to 44.3% from 49.2% correspondingly. One of the biggest receivers of foreign capital in the region, mostly in a form of FDI, was the wood processing industry: it attracted 12.6% of all foreign investment. Another target sector for non-residents in January-September 2008 was real estate and renting. This branch obtained 26.5% of the total, and the bulk of this money was repatriated from offshore states by its Russian owners.

Leading investors to regional economy, by states

	Jan-Sept 2008, foreign investment, EUR million	*Jan-Sept 2008, foreign investment, share in total*
Finland	124.3	26.9
Cyprus	112.8	24.4
Austria	96.8	20.9
Luxembourg	36.9	8.0
Italy	18.5	4.0
Netherlands	16.1	3.5
Great Britain	15.6	3.4
Other	41.8	8.9

Source: Petrostat, 2008

Similar performance was experienced in January-September 2008 by regional foreign trade, as its total turnover increased by 59.8% y-o-y. Exports from Leningrad province rose by 61.0%, and imports grew 50.0% y-o-y. The structure of foreign trade remained stable: 81.4% of exports referred to mineral fuel, and 65.7% of imports belonged to machinery and equipment.

Some business highlights

- The first high-speed Siemens train was delivered to Ust-Luga seaport, Leningrad province. RZD, Russia's railway monopoly, contracted the German company for EUR 600 million to produce eight trains adjusted for Russian rails. RZD plans to launch high-speed railway communication between St. Petersburg and Moscow already in 2009.
- The government of Leningrad province started to prepare a land plot near Vsevolozhsk, Leningrad province, for a new bakery of the Fazer Group, a Finnish food producer. The plot of 20 hectares would be equipped with a separate power supply line and related infrastructure. Fazer intends to invest around EUR 100 million in its new production facility.
- Irish packaging company, namely Smurfit Kappa Group, launched a plant in Vsevolozhsk. The plant would produce bag-in-box packaging for food and beverages; its production capacity is 30 million packages a year. The Irish company invested EUR 3.5 million in this project.
- A cement plant of Evrocement Group, a large Russian cement producer, located in Pikalevo, Leningrad province, announced its plans to fire 700 employees in addition to 200 already retired in August 2008. These plans of a biggest employer in the municipality caused public rioting. The conflict was resolved only by the interference of Valery Serdukov, the Governor. He promised to raise this issue to federal level in order to find support and to secure the jobs.

Leningrad region - main economic indicators	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**as of**
Regional GDP (y-o-y %-growth, constant prices)	12.8	8.5	16.3	14.6	8.8	8.3	8.1	8.5	n/a	1-12/2007
Industrial production (y-o-y %-growth)	26.8	10.7	35.6	20.9	10.3	5.9	26.9	2.6	1.4	1-10/2008
Regional inflation (CPI, y-o-y %-change)	23.5	19.6	14.8	13.0	14.9	12.0	9.9	9.3	15.6	1-10/2008
Gross average wage (monthly, EUR)	106	141	152	173	190	259	324	403	478	9/2008
Unemployment (% average annual)	12.7	10.8	9.6	9.2	7.5	7.8	6.2	3.3	3.1	H1/2008
Exports (EUR million, current prices)	1787	2350	2301	2580	3887	4862	5443	6078	6236	Q1-Q3/2008
Imports (EUR million, current prices)	328	810	939	1061	1372	2561	2858	4759	4545	Q1-Q3/2008
FDI inflow (EUR million, current prices)	222.5	266.0	121.9	104.5	106.6	178.7	288.0	277.0	258.0	Q1-Q3/2008

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

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

Kaliningrad region

Economic crisis strikes the region

Russia's hope to remain a safe haven during the financial and economic crisis that started in 2007 in the United States as a sub-prime credit crisis has all but disappeared in September and October. Although the impact of the crisis on Kaliningrad's economic statistics has been relatively modest so far, a string of disappointing news from the corporate and banking sectors suggest that the full impact of the crisis is yet to be reflected in economic indicators. Still, economic growth in Kaliningrad was slowing down even before September and in the last two months this slowdown became more and more apparent.

Industrial production in October 2008 fell by 7.7% year-on-year (y-o-y) basis. This fall is mainly due to a major slump (–26.5%) in the production and distribution of electricity, gas and water. While this is likely to be a one-off event related to the load of the Kaliningrad power station (CHP-2), output growth in other industries is also slowing: manufacturing production increased in October only by 6.3% y-o-y.

Growth in construction remained strong but significantly slower than in the first half of the year. While construction activity grew 45.7% in January-October, growth in October was 19.4%. Retail sales have not suffered much from the economic crisis so far – they grew by 11.6% in October and by 15.4% in the first ten months of the year – but the retail companies that based their expansion on the availability of easy credit are now facing tough times and have serious difficulties in rolling over their debt.

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

	2008, Jan-Oct	*2007*
Industrial production	4.6	40.3
Mining	-0.7	1.0
Manufacturing	10.4	93.7
Utilities	4.6	0.3
Construction	45.7	9.8
Retail Trade	15.4	17.9

Source: Kaliningradstat (2007, 2008)

Inflation: producer prices decline sharply

Producer prices fell by 6.6% in October (m-o-m). Although a major decline in oil prices was the main reason for this, price growth in the manufacturing sector was also limited this year – in the first ten months manufacturing prices increased by only 1%. On the whole, producer prices in October were only 1.3% higher than a year ago.

Moderation in producer price inflation has not affected growth in consumer prices so far. After a seasonal fall of food prices in July and August they resumed their growth in September. Annual consumer price inflation remained high – at 15.9% in October – but it did not change much for the last three months. The fall in commodity prices and the weakening of consumer demand should help ease inflationary pressure in the near future.

Regional finances

Financial results of the public and private sectors in the first three quarters of the year were quite strong. Revenue of the consolidated (general) regional budget grew by 43% (in current prices) in January-September, y-o-y. This strong performance helped to achieve a budgetary surplus of almost 12% of revenue. Net financial results of the corporate sector (without financial institutions and small businesses) also increased substantially – by 33% in the same period. Although retail trade and real estate operations are among the most vulnerable sectors during the current crisis, their profits grew by factors of 3 and 6 correspondingly in the first three quarters of the year.

Household incomes decline

Real disposable household incomes fell by 1.7% in the first nine months of the year and by 10.1% in September, y-o-y. Given that many companies started to cut their staff in October and plan to reduce annual bonuses it is likely that real incomes will fall for the whole year. After a double digit growth in incomes for the most of the last ten years this fall might be especially painful for the residents of Kaliningrad.

Wages continued to grow albeit more slowly than last year – in September they increased by 8.9% y-o-y. But October was marked by a rapid increase in wage arrears that grew by 25% over the previous months. They are likely to increase even more in the coming months.

Some business highlights

- The financial crisis strongly affected Kaliningrad's companies most dependent on debt financing. KD-Avia, an airline, defaulted on its bonds and its future is in doubt. It has been decided to split the airline and the Kaliningrad airport, Khrabrovo, into separate legal entities.
- Two of Kaliningrad's largest retailers, Viktoria and Vester, struggled to raise financing in order to pay back their short-term debts. They are mothballing their investment projects, delaying payments to suppliers, cutting their staff and selling some of their assets. Their main hope seems to be focused on getting loans from Russian state-owned banks.
- Clients of two small Kaliningrad's banks, BaltKredo Bank and Setevoi Neftyanoi Bank, have been experiencing problems with withdrawing funds from these banks. BaltKrdeo Bank asked the Central Bank of Russia for a bailout.
- Swedish telecommunication company, Tele2, bought a tiny Kaliningrad mobile phone operator, Tsifrovaya Expansia (Digital Expansion), operating a GSM 1800 network in the region for SEK 150 million (EUR 14.6 million).
- Despite the crisis, M-Industriya, started construction of the building materials plant in Gusev. The company is planning to invest RUR 890 million (EUR 25.5 million).
- Avtotor began complete knock-down assembly (that includes welding and painting) of Chevrolet Lacetti cars. It is planning to produce 80,000 cars a year. Investment in the new production facility amounted to EUR 80 million.
- It was announced that the first reactor of the Baltic nuclear power station in Kaliningrad will be brought on-line in 2014, one year earlier than was planned. Total investment in the project, which will include two 1150 MW reactors, are planned at RUR 134.2 billion (EUR 3.8 billion).
- Benefit Engineering, has started a large scale development project in Kaliningrad that should include construction of 350,000 sq. metres of new housing and cost about USD 300 million (EUR 235 million).

Kaliningrad region - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	15.2	3.4	9.5	9.3	12.6	3.6	11.6	24.7	n/a	1-12/2007
Industrial production (y-o-y %-growth)	32.4	12.9	4.2	4.7	22.5	27.4	66.6	40.3	4.6	1-10/2008
Inflation (CPI, end of period, y-o-y %-change)	17.5	21.0	9.8	17.5	11.7	11.1	7.9	11.2	15.9	10/2008
Gross wage (period average, EUR)	67	99	125	137	155	193	285	358	434	Q3/2008
Unemployment (% end of period, LFS data)	15.6	10.6	7.2	7.6	6.5	6.6	4.5	3.4	n/a	Q4/2007
Exports (EUR million, current prices)	514	508	497	507	876	1470	2025	3666	242	H1/2008
Imports (EUR million, current prices)	947	1169	1701	1894	2419	3283	4275	5714	2956	H1/2008
Exports (sales) to Russia (EUR million, current prices)	459	691	802	989	1449	1901	2471	3901	2240	H1/2008
FDI inflow (EUR million, current prices)	7.1	3.6	6.3	12.4	18.0	15.1	16.9	117.9	52.7	H1/2008

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

BONUS project – Baltic countries lead research for better use of the Baltic Sea

By Janez Potočnik

In March 2000, at the Lisbon European Council, the EU Member States endorsed the objective of creating a European Research Area (ERA) in which knowledge can be shared and where researchers can have easier mobility to develop European careers. The ERA also aims at opening and coordinating European, national and regional programmes to support best research throughout Europe to address major challenges while fighting against duplication and dispersion of resources.

Eight years later, the creation of ERA has become a central pillar of the EU Lisbon Strategy for growth and jobs. R&D and innovation are even recognized as key pillars in EU and national recovery plans, as crucial part of the response to the current economic crisis. Realising the fifth freedom, the free circulation of knowledge, in addition to the already four existing ones - the free movement of people, goods, services and capital - has become one of our main goals. We need this freedom now to set free Europe's creativity, our entrepreneurship and our potential to innovate. Knowledge is not only an essential driver for sustaining growth in what is commonly called the real economy; it is also better knowledge and its application that we need in order to face daunting challenges like climate change, energy security, an ageing population or economic recession. We need the best brains from different countries working together and competing to find new solutions.

However, much work remains to be done to reach the ERA objectives, and to overcome the continuing fragmentation of the European public research base and realise the fifth freedom. For this reason, in 2008, the European Commission and the Member States launched five new initiatives on specific areas to re-launch the ERA as a follow-up to a review and a public consultation in 2007 on the ERA Green Paper. These five initiatives cover[1]:

- a "Commission Recommendation on the management of Intellectual Property Rights in knowledge transfer activities and a Code of Practice for universities and other public research organisations";
- a "European Partnership for Researchers", to improve career development and the mobility of European researchers;
- a "Commission proposal for a Council regulation on the Community legal framework for a European Research Infrastructure (ERI)", to support the set up of urgently needed new research infrastructure;
- a "Commission Communication on Joint Programming", a framework for interested Member States to join forces on a voluntary basis to tackle major European societal challenges together, and
- a "Strategic European Framework for International Science and Technology Cooperation", for the Community and Member States to work more productively with third countries and raise attractiveness of Europe for researchers and research investments.

Each of these initiatives is characterised – to a greater or lesser extent - by a focus on a partnership approach; that is, with the full understanding that our aims cannot be realised without the full involvement of all stakeholders in their planning and implementation. These principles have been enshrined in the so-called 'Ljubljana process', which was launched under the Slovenian Presidency. The Ljubljana process aims to steer and stimulate the European Research Area by: working together in partnership with all the Member States, Associated Atates and the Commission, as well as with other stakeholders; agreeing a common long-term vision for the future of ERA as the basis for our future actions and initiatives, and enhancing the governance of ERA, notably with better political steerage at ministerial level. A 'Vision 2020' has been prepared under the French Presidency and endorsed by the recent Competitiveness Council on 2 December 2008. It will help establish targets, indicators, monitoring and evaluation criteria to enable an efficient follow-up of ERA developments.

These new and important initiatives should not mask the achievements realised and the promising actions that have been taken during the last eight years, both at the level of the Community and by the Member States. They include, for instance, actions to develop the coordination of national and regional programmes. An excellent example from the Baltic Sea area is the **ERA-NET "BONUS for the Baltic Sea science – network of funding agencies"** (2003-2008), funded by the Sixth Framework Programme of the European Community (FP6), where BONUS stands for "Baltic Organisations' Network of Funding Science". This project brought together 11 major organisations from all nine Baltic countries involved in the funding and organisation of marine science.

For thousands of years, the Baltic Sea region has been a major focus of human settlements, but today, this ecosystem is seriously impacted by both natural and human phenomena. This has reduced the capacity of the Baltic Sea to provide the goods and services upon which people depend directly and indirectly for social, cultural and economic benefits. Ad hoc policy making for the sustainable development of the Baltic Sea is not possible without a sound knowledge base on the ecosystem.

Most European countries with a coastline have established marine research programmes for addressing better socio-economic needs, while at the same time ensuring high quality scientific research. A BONUS study in 2004 revealed the diversity of concepts and strategies, of legal and administrative procedures, and of the scientific and technical implementation of marine research programmes in the Baltic Sea region.

At the same time, at the level of regional seas in the EU, the Marine Strategy and the Maritime Policy have been introduced to holistically integrate and make more effective a multitude of national and international policies, agreements and regulatory instruments for reducing marine pollution, managing living resources and biodiversity, as well as developing sustainable maritime activities. The final objective is to tackle climate change while ensuring EU competitiveness in the perspective of sustainable development. In the Baltic Sea region, these European policies are implemented through the Baltic Sea Action Plan of the HELCOM, based on continued cooperation between the Baltic Sea countries over three decades already.

Indeed, there is a long history of fruitful cooperation in several fields of activity in the region, including in science, which brings together institutes, universities, scientists, and regulators. But the research funding agencies have been missing from this interplay. There was a lack of corresponding pan-Baltic collaboration for coordinating the funding and the implementation of the research agenda that is needed to effectively address the Baltic Sea's trans-boundary environmental problems.

[1] For more detail see http://ec.europa.eu/research/era/specific-era-initiatives_en.html

To fill in this gap, the key marine research funding organisations from the nine Baltic countries, together with ICES (International Council for the Exploration of the Sea), decided to conduct the ERA-NET BONUS. It aimed at creating conditions for a joint Baltic Sea research programme, which is expected to substantially improve the effectiveness of environmental and sustainable development policies for the entire region.

The first phase of BONUS involved an inventory of the diversity of approaches across the different national programmes to define research priorities, evaluate proposals and execute and evaluate the research. Consequently, BONUS has developed a joint Baltic Sea Science Plan and Implementation Strategy, and a dedicated legal structure for its implementation. This occurred at the same time as four of the Baltic countries became Member States of the European Union - speeding up their integration in the building of the European Research Area. The expected level of coordination to be reached by BONUS partners is high and their objective is to establish a more ambitious durable coordination of research funding in order to support the sustainable development of the Baltic Sea region. Therefore, the eight Baltic Sea States of the European Union together with the Russian Federation and the European Commission have decided to work on a further elaborated proposal for a joint Baltic Sea research programme that could be implemented under Article 169 of the Treaty of the European Community. Such a perspective implies that the different countries involved are working to reach a higher degree of integration with regard to scientific programming, management structure, financing and allocation of appropriate resources to joint programme implementation. In parallel to the elaboration of such a proposal, the funding organisations from the ERA-NET BONUS are currently implementing an ERA-NET Plus action under the Seventh Framework Programme (FP7) during which they will test the joint implementation of a large joint call for proposals based on the Baltic Sea Science Plan set out above.

BONUS has contributed to the structuring of the regional research area by bringing together key research funding organisations and a large population of scientists in developing a Science Plan and Implementation Strategy. In responding to the European Marine Strategy and Maritime Policy it is a demonstration in the development of a joint programme bridging science and policy. Lessons learnt are not only important for other European regional seas but also for any other area, where Member States and their scientific communities get together to jointly address the challenges they are facing.

Janez Potočnik

European Commissioner for Science and Research

Mare nostrum – Sea of Culture

By Stefan Wallin

Following the political changes in the 1990s, the Baltic Sea has become an inland water in the European Union. This *Mare nostrum* unites ten member states and is comparable to the Mediterranean in EU policy. The Directorate General for Regional Policy is currently preparing a Baltic Sea strategy, which is projected to be ready in 2009. The strategy includes a Northern Dimension objective. Finland has stressed the role of culture in the strategy.

The Baltic Sea has always been a route for interaction and trade. For millennia, seafaring has connected its coastal and archipelago cultures. Many skills and methods have spread as export articles. The region has developed a diverse, mutually enriching cultural heritage. Prehistoric and historical trade routes, Viking culture, the Hanseatic alliance, and the era of Sweden as a great power epitomise the cultural forces uniting the region.

The main objective for the *Council of the Baltic Sea States* (CBSS), established in 1992, is to promote security, stability and welfare in the region. The priorities of the countries alternately presiding over it are reflected in the agenda. The Baltic Sea cultural ministers convened in Sweden in 1993 for the first time and have met at a few years' interval ever since.

At their summit in Riga in June 2008, the Baltic Sea Prime Ministers adopted education, culture, including cultural heritage and the promotion of regional identity, as one of the aims in Baltic Sea regional cooperation. Varied cultural activities are considered an inalienable part of people's well-being and civil society in the region.

The ministers of culture have initiated two cooperation networks: Ars Baltica, which promotes regional cultural policy, and the *Monitoring group on cultural heritage*, which advances cultural heritage cooperation in the region.

Ars Baltica is the only cultural cooperation body in the Baltic Sea region with broad representation of both public financing bodies and cultural actors and projects. Ars Baltica assesses the scope and interest of applicant projects in terms of the Baltic Sea region. It awards an Ars Baltica logo, which is subject to certain criteria, notably wide-ranging cooperation within the Baltic Sea region or Europe and enhancement of cultural identity and diversity in the region, as well as high quality. The logoed projects can attend the Ars Baltica Forum, a meeting place for cultural actors and decision-makers.

Examples of Finnish Ars Baltica projects are *Baltic Ring* and *Littera Baltica*, which promote Baltic Sea literature; the *Baltic Sea Residency Network*, which coordinates artist-in-residence activities; *Populism*, a touring exhibition mounted by the Nordic Institute for Contemporary Art; *Rauma Biennale Balticum*, a long-standing joint exhibition of pictorial art; the international *Romani Writer's Congress*; Oulu International Children's Film Festival; and the *Baltic Circle* theatre event.

Ars Baltica is an important element in the international activities of the Arts Council of Finland. It is a means of leading Finland and its neighbouring areas towards wider European networking. The Finnish experience is that, with its light and appropriate structure and budget, Ars Baltica is an effective cooperation network implementing the aim of regional cooperation underscored by the ministers of culture.

The Monitoring Group promotes cultural heritage cooperation amongst the Baltic Sea countries. The scope of its work ranges from maritime archaeology and underwater wrecks and historic towns to cultural heritage education and cultural tourism. A project called *Rutilus*, financed by the Nordic Council of Ministers, has compiled an exhibition of one hundred most important underwater heritage sites in the Baltic Sea. The Monitoring Group also follows a Nordic project appraising the effect of climate change on cultural heritage. The working group on sustainable historic towns bases its work on Nordic cooperation carried out in this area since the 1970s.

Other important cooperation projects include a communication channel for artists and institutions called *Baltic Interface Net*. At their St Petersburg meeting in 2003, the ministers pledged their support to the *Baltic Sea Festival*, which in five years has evolved into a major classical music event. It uses culture-environment cooperation to draw attention to the ecological state of the Baltic Sea.

The Baltic Sea region has been rated as world leader in networking. The *Balticsea.net* portal contains the foremost public administration bodies and networks working in the area. For all of these, culture is one viewpoint and instrument in their work.

Baltic Sea cultural activities can use many international and EU funding programmes and schemes. The Nordic support programme for Baltic Sea civic organisations has advanced multilateral contacts, civil society, welfare and democracy. In 2007 the programme adopted a more flexible and transparent funding structure, in which one requirement is Nordic partners, but which also provides for wider regional networking. There are various funding programmes catering for art and culture, mobility, artists-in-residence, and children's and young people's computer games.

The 2011 European Capitals of Culture, Turku and Tallinn, are both situated on the Baltic Sea coast. Alongside Finnish culture, Turku will present Baltic Sea themes and topical issues to the rest of Europe.

The Baltic Sea ministers of culture met in Riga, Latvia, in October 2008 to discuss the theme *"Future of Culture in the Baltic Sea Region"*. In their Declaration, the ministers focused on improving the structure and content of Baltic Sea cultural cooperation. They also decided to enhance the protection of cultural heritage, with special emphasis on accessibility to cultural heritage, especially for children and young people. Other aims were to promote cultural diversity, intercultural dialogue and exchange, to enhance the contribution of the art and culture sector to the creative economy by mainstreaming culture in all relevant policies, to promote interaction with other regional and international structures.

Mare nostrum has always united the nations around the Baltic Sea, and their history and development have been shaped by cultural exchanges. Now, within the EU, they form a strong Baltic Sea community resting on a value base of respect of human rights, creative power, cultural diversity and tolerance. The Riga Declaration creates a solid basis for proceeding in this direction on the strength of shared aspirations.

It is an age-old tradition here in the North to see access to culture and creativity as everyman's right and cultural rights as pivotal human rights.

Stefan Wallin

Minister of Culture and Sport

Finland

Security challenges in the Baltic Sea Region

By Bogdan Klich

A cooperative spirit, in which the states bordering the Baltic Sea, maintain their mutual relations, makes the region safe and secure, especially when compared to other parts of the world. Not only there is no major territorial dispute, but the existing institutional structures provide for extensive regional collaboration. The objective of the Polish policy towards the Baltic Sea region is to further increase its level of security. To attain it, we strongly support the ongoing regional integration.

A success of the Nordic cooperation was an inspiring example in the early 1990s when the new structures were created to cover the wider region of the Baltic Sea. At the core of this process were initially the activities of the Council of the Baltic Sea States (CBSS), engaging all the countries situated on its shores. The accession of Poland into NATO in 1999 as well as the subsequent accession of Estonia, Lithuania and Latvia in 2004 marked a major geopolitical change not only in the region, but in Europe as such, enhancing both the regional and continental security. The 2004 EU enlargement meant that the two sides of the Baltic shores, from Narva to Szczecin and from Kiel to Helsinki, became part of a singular economic area. The further development of the region is thus becoming more accommodated in the EU's structures. The European Commission is now working out a new strategy for the Baltic Sea region. Poland supports this concept and is looking forward to the adoption of the final document during the Swedish presidency in 2009.

Challenges ahead

The overall security level in the Baltic Sea region is now widely assessed as high. Most of the coastal states are both members of NATO and the European Union and any conflict between them seems unconceivable.

The security enjoyed in the Baltic Sea Region, does not, however, mean that there are no challenges for us to face. While we would like to see the Russian Federation as a constructive partner engaged in both Baltic and wider European cooperation, we are deeply concerned by the recent developments in the Russian foreign policy. The August intervention in Georgia strains the confidence in the Russian government's good will to continue its relations with its neighbours on a friendly basis. The selection of the Baltic Sea as a route for the Nord Stream pipeline can hardly be regarded as an economic decision, having nothing to do with strategic considerations. The most recent declarations on the planned remilitarisation of Kaliningrad Oblast and the earlier suspension of the fulfilling of the CFE Treaty provisions by Russia are both further contributing to the climate of growing mistrust in relations with Moscow.

While the role of Russia in the community of the Baltic Sea states is now a disquieting issue for some of its neighbours, it is not the only challenge we face in the region. Energy security remains a grave concern, especially for those states constituting isolated energy markets. The fragile ecosystem of the Baltic Sea requires action on such problems as eutrophication, overfishing, invasive species, harmful substances and explosive remnants from World War II. The growing maritime traffic and the recent plans for the new capacities in the field of nuclear energy generation, while both desirable, pose new risks as regards maritime and nuclear safety. The long Schengen border, stretching from remote areas of northernmost Norway to eastern Poland, is still vulnerable to illegal migration and smuggling. Organised crime, human trafficking and cybersecurity all add up to the list of challenges we need to face in the Baltic Sea Region.

Polish involvement

The countries bordering the Baltic Sea have already constructed a complex institutional network of productive multi-layered cooperation. In the field of military security, Poland was an initiator and supporter of a common capacity-building. In 1998, defence ministers of Poland, Germany and Denmark decided to establish the Multinational Corps Northeast, with headquarters located in Szczecin, Poland. Seven other countries, including three Baltic Sea states, joined the initiative since then. Currently, Poland is preparing as a lead nation an EU battlegroup that will include also troops from other Baltic Sea states: Germany, Latvia, and Lithuania as well as Slovakia. The group is to be on a standby readiness in the first half of 2010. Polish Navy has already organised various NATO exercises in the Baltic Sea and actively participated in mine-clearing operations, while Polish Air Force contributed to the security of Estonia, Latvia and Lithuania by policing their airspace in 2006 and 2008. Taking into account the variety of regional projects, Poland supported the moves toward their better coordination, such as the Kiel Initiative.

A comprehensive approach to the security of the Baltic Sea region requires action to be taken in many non-military areas as well. As regards region's energy issues, Poland has long advocated, and continues to support, the projects aimed to the construction of interconnections between the national energy systems. Our preference is on the investments justified by financial reasons and, even more importantly, environmental concerns. Due to the latter, Poland is joining its Baltic partners in making the region a model example of state-of-the-art marine environmental management. An ambitious Baltic Sea Action Plan was adopted last year at a ministerial meeting hosted by Poland in Kraków. The innovative management approaches proposed by the document give us a chance to restore good ecological status of the Baltic Sea by 2021.

Conclusions

The Baltic region is still a safe place in today's volatile world. But having in mind the challenges the region faces, we must continue to maintain the Baltic Sea region on NATO agenda to reaffirm our commitment to region's security. We must develop the various initiatives under the CBSS aegis to progress on human development and make the cooperation attractive to Russia. Finally, we must work out a new strategy for the Baltic Sea region within the European Union to provide for its prosperous future.

Bogdan Klich

Minister of National Defence

Poland

Return of the cold war – mis-shapes and mirror images

By Sven Mikser

The cold war shaped the mindsets of its participants for almost half a century. Its reflections can still be observed in many parts of the world today. Today's conflicts have their roots in the cold war, but the similarities between then and now are often superficial or deceptive. The „return of the cold war" – already something of a cliché – nevertheless deserves close analysis.

During a visit to Kabul some years ago I discussed the Soviet invasion of Afghanistan with an Afghani lawmaker. The emotions of Estonians with the regard to that war are not easy to explain. Many young men from occupied Estonia were forcibly recruited to the Soviet army to fight in Afghanistan. We were praying for their safe return. At the same time, we desperately wanted someone to kick the asses of the Soviets. The role of the Afghan debacle in the demise of the Soviet empire cannot be overestimated. To a large measure, the Soviet – Afghan war was also a war by proxy between the Soviets and the West.

Two decades later, as our parliament unanimously votes to extend the mandate of 170 Estonian soldiers deployed to southern Afghanistan to fight the Taliban, we tend to overlook the degree to which the present war echoes back to that cold war clash. But we know that the failure to stabilise Afghanistan might have negative implications to our own security.

It was a historic mistake by the West to abandon Afghanistan after the Soviets departed, as the ensuing civil war resulted in the rise of the Taliban. But an equally huge mistake was made by the West during the Soviet invasion when the so-called Arab Afghans were invited to join the war against the invaders. The diverse extremist groups who arrived in Afghanistan had until then been fighting their own authoritarian governments in various Arab countries. They only created a global network and a global agenda after they were given that opportunity by the Saudis, the Pakistanis and their Western backers.

During the cold war, the Soviets and Westerners alike refused to attribute any independent agenda to their Third world satellites. Mosaddeq was anti-Western and therefore a communist, Zia was anti-communist and thus an agent of Western imperialism. But these leaders did not see themselves as mere pawns in the hands of their megapower benefactors. They tried to forward their own agenda and changed sides when it suited their cause. Bizarrely, we have not learned from that mistake. After the „end of history" we even refused to believe that our former adversaries may have an agenda different from our own.

It is often said that the cold war is over and that Russia is not the Soviet Union. It is true. But it has an important implication that is sometimes ignored. The Soviet expansionism was based theory of Marxist class struggle. Communism was supposed to be a cosmopolitan ideology. Throughout the cold war Moscow tried to export the revolution to capitalist Europe by subversion, propaganda and sponsorship of indigenous communist parties. Some European governments had every reason to be alarmed by the subversive efforts of the Soviets.

Conversely, the Russian expansionism of today lacks a cosmopolitan ideology. Its ideological basis – if there is any – is Russian nationalism. Unlike communism, it cannot have any appeal to the disaffected classes in countries far away. On the other hand, the nations of Russian „near abroad", which in the view of the Kremlin where chopped off from the Russian empire at a moment of its historic weakness, have good reason to be afraid. When Putin called the fall of the Soviet Union the „greatest geopolitical catastrophe of the 20th century", he was not lamenting the failure of communism but the fall of an empire.

Moscow recognises the difference between its position today and twenty-odd years ago, and has adjusted its tactics accordingly. Instead of appealing to the „disaffected masses", the Kremlin is now using petro-dollars to buy up individual Western decision makers. That, when successful, not only bends the European policies to the liking of Moscow, but also erodes the confidence of many Europeans in the solidarity and common values of the West.

Altogether, oil and gas play a major part in the *divide et impera* policies of the newly resurgent Russia. It is the more disturbing as Russia is not playing by the same rules as the rest of Europe when it comes to business practices or environmental standards.

The implications vary a lot for different countries. It is not difficult to see why a country that has power interconnections with Russia capable of carrying less than 20 per cent of the country's peak consumption, tends to see it as an way of diversifying its supply. But if the capacity of the interconnections is two-thirds of the daily peak consumption, there is a real danger of the market being swamped with dirty cheap energy. Here the problem stops being merely environmental. It becomes a security issue.

Threat assessments differ, and with good reason. For example, if Iran ever acquires a nuclear weapon, it will surely not waste its precious bomb on a tiny country such as Estonia where even the closest CNN camera crew is several travel hours away. Therefore one could say that a nuclear-armed Iran is not be a direct threat to Estonian security. That, however, does not mean that we are braver than Americans or that the U.S. is paranoid about Iran. Similarly, resurgent Russian imperialism presents a different degree of threat to Georgia, Estonia, and Finland.

The West emerged victorious in the cold war, because it did not allow economic interest to dominate its core values. But the end of cold war did not bring about the end of history. Even today, our liberal values are not universally accepted, so it is imperative that we guard them against challengers as we are trying to promote prosperity and stability around the world.

Sven Mikser

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Germany and the Baltic Sea cooperation – current common challenges and the Baltic Sea Strategy of the European Union

by Wilfried Grolig

Germany and the Baltic Sea Cooperation
After more than fifty years of politicial divide, the Council of Baltic Sea States belonged to the first initiatives reviving the awareness of our rich historical and cultural heritage in the Baltic Sea Region and to create new bonds of cooperation between the Western and Eastern coast of our common sea. Following the EU enlargement of 2004, all Baltic Sea's littoral states – with the exception of Russia – are now members of the European Union. Against this background, the reasons for Germany´s interest in the Baltic Sea Cooperation are manifold and of continuously gaining relevance. Let me only highlight three of them:

Firstly, there are environmental reasons: The Baltic Sea itself is highly polluted and in strong need for joint protection. There are emminent environmental problems like the fragile ecological state of the Baltic Sea which we will only be able to solve in a common effort and together with the European Union.

Secondly, there are economic reasons: According to the yearly "State of the Region Report" compiled by the Baltic Development Forum, the Baltic Sea Region is one of the most economically dynamic regions worldwide. Nevertheless, there are still economic disparities within the region and the location at Europe's geographical periphery requires continued efforts to preserve and enchance competitiveness.

Thirdly, the Baltic Sea region has a strong and historically well-founded cultural and social common identity which we can now build on.

These and other common interests and challenges lead to Germany's long-standing political commitment to further enhance Baltic Sea cooperation. Germany is an active member in the Council of Baltic Sea States (CBSS), which Germany and Denmark initiated together in 1992. The CBSS Secretariat in Stockholm is currently chaired by a German, Dr. Gabriele Kötschau. Germany has chaired the CBSS in 2000/2001 and will do so again in 2011/2012. The German federal state Schleswig-Holstein is currently chairing Ars Baltica, a network of culture ministries and culture agencies around the Baltic Sea. As regards the subregional cooperation, the city state of Hamburg will take over the chairmanship and secretariat of the Baltic Sea States Subregional Cooperation (BSSSC) in January 2009.

Regarding our common regional identity, Foreign Minister Frank-Walter Steinmeier has proposed at the CBSS summit in June this year to set up a ring of partner schools around the Baltic Sea, with the explicit goal to foster the regional identity. The cultural department of the German Foreign Ministry is currently preparing the implementation of this proposal. Germany considers science, education and innovation to be among the key drivers of the Baltic Sea region's competitiveness.

Germany is also an active member in the Helsinki Commission (HELCOM) and played a strong role in the effort to compile the HELCOM Baltic Sea Action Plan which was adopted in November 2007 and commits all littoral states to return the Baltic Sea to a good ecological status by 2021. The German Environment Ministry last year pledged another 10 Million Euros to the Northern Dimension Environmental Partnership (NDEP). The same Ministry is also leading two new Baltic Sea INTERREG projects which were approved a couple of weeks ago by the responsible international committee, addressing sustainable development issues.

Germany and the EU Baltic Sea Strategy
The ongoing preparations for the EU Baltic Sea Strategy can be considered as the most important development regarding Baltic Sea cooperation in 2008/2009. The European Council in December 2007 invited the Commission to present an EU strategy for the Baltic Sea region by June 2009. Germany fully supports the initiative and is actively taking part in the preparation process. The Strategy itself is representing a political value per se: The Baltic Sea region will gain more attention in Brussels and from other European partners in the coming months. Commission policies and programmes will benefit in terms of coherence and effectiveness. A successful strategy could also set an example for other EU regions.

It will be of utmost importance to seek regional coherence and regional synergies between the existing EU policies, programmes and projects, thus making them more effective while raising their visibility to EU citizens in the region and beyond. While developing the Strategy we should also actively explore possibilities to link EU programmes and projects with funds from regional and international financial institutions.

The environmental status of the Baltic Sea remains a serious concern, as past measures have only been able to slow down the deterioration of its water quality and the degradation of its biodiversity. Two initiatives to reverse these trends have recently been decided on: The EU Marine Strategy Framework Directive and the Baltic Sea Action Plan adopted by the Helsinki Commission in November 2007. The Strategy should build upon them and aim at assisting their implementation.

As regards economic issues, Germany particularly values the focus on an effective functioning of the EU internal market. A uniform, harmonized implementation of EU legislation will be useful for companies in the Baltic Sea region, because our region has many small national markets and is situated on Europe´s geographical periphery.

The European Council in December 2007 stated: „The Northern Dimension framework provides the basis for the external aspects of cooperation in the Baltic Sea region." Some essential parts of the future Strategy will require cooperation with non –EU countries, in particular Russia as a Baltic Sea littoral state and Norway as a like-minded stakeholder in the region. It is therefore advisable to involve this countries, thereby increasing their readiness to assist in later implementation.

Wilfried Grolig

Ambassador of the Federal Republic of Germany in Finland

Foreign investment in the strategic sector of the Russian economy – fundamentals and expectations

By Igor Yurgens

A radical socio-economic transformation has lasted almost twenty years in Russia. This process one can in general describe as successful, but to talk of its completion is currently not possible. However, the current year for us in this respect has been a year of great expectations.

The Russian government has at last grasped why the country needs full-scale strategic modernization, and what such modernization requires from the government itself and from its various offices.

The state – slowly but surely – is changing, reorienting itself toward completely new tasks, and acquiring totally new functions. These are supporting functions, the economic policy of which consists first of all in the creation, support and development of an environment favorable to business.

Russian President Dmitry Medvedev has already more than once declared that the formation of the best conditions for investment – both internal and external – has become one of the primary areas of work of the Russian government. The adoption of the Law on Foreign Investment in the Strategic Sector has confirmed how the preparedness for such work is genuine, but at the same time has shown that the effectiveness of these efforts can be noticeably lowered by certain negative influences.

The myth circulating beyond the borders of Russia that the law contemplates a ban on investment is clearly unfounded. Those with experience in investing in the strategic sector of the Russian economy, together with those who had the intention of doing so, fully understood the necessity of the creation of a statutory document of this sort. The clear and sufficiently transparent procedure for obtaining official permission is much better than numerous informal contacts with uncertain prospects. And strict determination of sizes of portions of shares in an enterprise - requiring sanctioning upon purchase, plus a clear establishing of borders between strategic and non-strategic sectors, represent a much more convenient state of affairs than the duplicated control of particular procedures scattered among separate industry laws. All the new introductions, without a doubt, have improved the investment climate.

There is also the other matter of the idea that the strategic section of the Russian economy, mirrored by the large volume of work on its legislation, has considerably (and, I assume, unjustifiably) expanded. I think that practical experience in introducing laws on foreign investment will help the legislators somehow narrow the sphere of its application.

At the moment, however, to talk of such experience is not possible. No matter how much one improves the investment climate in a particular country, the global economic crisis will nevertheless still have its say, and, at the moment - the final say.

To date, the Commission on Foreign Investments, chaired by the Russian Prime Minister, has not turned down a single transaction falling under its competence. However, those approved number only two: the purchase of 25% of the shares in the Sukhoi civil aircraft manufacturer by a subsidiary of the Italian company Alenia Aeronautica to develop together the Sukhoi SuperJet-100 range; and the acquisition by De Beers of 49.99% of Arkhangelskgeologodobycha shares owned by Lukoil with a view to development of the Verkhotinskaya diamond field. It was also announced that by early 2009 another five large transactions will be reviewed by the Commission. But it is clear that the Russian government is incapable of bucking the general trend: investment activity is falling, especially in big business. And we cannot expect any positive shifts here.

However, the global financial crisis (no matter how deep it gets) does not remove the need to modernize the Russian economy and the whole political and socio-economic system. Nor does the crisis cancel the objective set by Dmitry Medvedev at the Krasnoyarsk Economic Forum in February 2008. The President pointed to the need to concentrate on four main issues in the coming four years: institutions, infrastructure, innovation and investment.

Efforts aimed at enhancement of the investment climate should not depend on how impressive annual economic growth indices are. Contemporary development of the economy, presupposing the creation of optimal conditions for foreign investment, is a long-term project, which does not anticipate any temporary freezing. Indeed, delaying such a project could bring about collapse.

Regardless of certain weak areas, the legislation regulating the pattern of foreign investment into the strategic sectors of the Russian economy became an important step in the context of implementation of the modernization project. The barriers that have been established by the legislators are much more rational than those which they replaced. However, this legislation is by far not the key factor in reflecting the attractiveness of Russian business to foreign investors.

There are a number of restrictions that prevent Russia from securing the kind of investments that would be optimal in terms of both volume and, what is more important, quality. Such restrictions include the following: the inefficiency of the legal system; insufficient protection of private property; widespread assumptions about the absolute power of Russian corruption; the lack of trust in relations of the business community, the state and civil society; the preservation of the raw-material orientation of Russia's export policy; and the growing confrontation between Russia and the US and some European countries resulting from a more active Russian foreign policy.

If the Russian government puts enough effort into solving these problems – and mention has been made of this effort more than once, and initial steps have already been taken – I think that the consequences for the investment climate will be impressive, regardless of the state of the global economy.

Igor Yurgens

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Russia

Significance of Russia's Baltic fleet growing. Will nuclear weapons return to the Baltic Sea?

By Bo Österlund

Citing military sources in mid-August, *The Times*, published in Britain, stated that Russia is considering equipping its Baltic Fleet with nuclear weapons. According to *The Times*, the plan would include the arming of surface vessels, submarines and naval bombers. U.S. NATO ambassador **Kurt Volker** also confirmed that he was aware of these particular plans for arming the fleet.

Jan Leinonhjelm, Director of Russian Research at Sweden's Försvarets Forskningsinstitut (FOI), regards The Times' information as "uncertain" but not unlikely. Leijonhjelm asserts that all signs point to the fact that we are heading towards "colder times". Swedish research interests affirm that the possible nuclear arming of the navy would at least increase the range of Russian nuclear weapons. Behind the measure, the visible political dimension is more important than the military one.

According to the Natural Resources Defence Council (NRDF), Russia possesses 5670 operative nuclear warheads in its active arsenals. According to assessments, 3,339 of these are strategic and 2,330 are tactical. In addition to this, Russia has approximately 9,300 warheads in reserve or for interception. According to NRDF, Russia has a nuclear arsenal totalling over 15,000 warheads.

In the Times article, which cites military sources in Moscow, the navy's armaments build-up scheme is treated as a countermove to NATO's intentions to distribute its missile shield into Europe and, in particular, Russia's former state allies, Poland and the Czech Republic. According to Russian sources, the United States planned missile silos would form strategic targets, draw fire, and in this manner, also be the objects of a nuclear strike by the attacker.

The Baltic Sea makes up, as is well-known, Russia's shortest route to Western Europe and the core area of the European Union. The Baltic has, for centuries, formed the route for Russian trade and cultural exchange.

Russia and its naval forces on the Baltic Sea have, throughout the centuries, influenced the security policies of its neighbouring states in a significant manner. The Baltic was also the object of immense geopolitical change during the entire 1990s.

Russia's Baltic Fleet was, in practice, destroyed during the war with Japan (1904-1905) in the distant Far East during the Battle of Tsushima, May 1905. It should be mentioned that, under the leadership of Admiral **Oskar Wilhelm Enqvist**, the cruiser division to which the Aurora cruiser among others belonged survived that battle. As a result of this defeat, Russia's first revolution erupted. The tsarist state managed to emerge from this crisis and initiated a massive naval programme in addition to building a sizeable chain of fortresses under the name **Peter the Great**, in accordance with a plan approved in 1912. The emphasis behind this chain was on the Gulf of Finland. Russia's October Revolution in 1917 was launched, as we subsequently know quite well, from the Aurora cruiser as a result of its seamen's mutiny.

During the world wars, the Soviet Union's Baltic Fleet did not have a more significant strategic or military role. The Baltic Fleet failed during World War I to stop the transport of German troops to Finland, as was also the case in the artillery attack against Kronstadt by British naval units. During World War II, the Baltic Fleet was confined to the remotest reaches of the Gulf of Finland and to the use of submarine networks and wide-ranging mine explosives. The blockade of the Finnish coast remained non-realized, as was also the case for the invasion plan for Åland formulated in 1941 by Admiral Pantelejev. Russia's navy obtained limited access to the Baltic Sea as of the end of summer, 1943, and as a centre for operations only after the truce agreement in the autumn of 1944.

It is calculated that the Soviet Union's Baltic Fleet together with the naval troops and combined maritime/air force had achieved a fourfold quantitative advantage over NATO by the mid-point of the 1980s with respect to the naval forces situated on the Baltic Sea. A qualitative comparison would, however, certainly require a more precise specification and evaluation.

The Baltic Fleet boasted a total of 23 offensive submarines at the time – i.e., more than all other Baltic coastal states counted together. However, the boats were old diesel-electric Whisky and Foxtrot class models, equipped with torpedoes. As an alternative to torpedoes, the boats could be armed with double the number of mines.

Already in 1976, six older models of Golf-class submarines armed with three nuclear ballistic missiles, the range of which was approximately 1,400 kilometres, were relegated to the Baltic Fleet. With the outset of 1982, two Juliett class submarines also operated in the area, equipped with short-range cruise missiles by which it was possible to affect maritime and land targets. "Weapons collector" **Jari Komulainen** subsequently brought one of these museum submarines for exhibition to Helsinki's Hietalahti district.

During the latter half of the 1980s, the Baltic Fleet boasted a massive maritime invasion force made up of almost 50 assault vessels and a marine brigade that functioned in Baltijsk. At the time, Poland had a division trained for landing that comprised over 8,000 men. It was possible to load, at one time, a landing battalion, 20 tanks and four helicopters into any of the larger ships, such as the Ivan Rogov type of vessels. The prerequisite for the use of naval forces was the construction of a sizeable infrastructure. Shipyards in what was then Leningrad, which were specialized in highly demanding production as well, were included. Missile cruisers and destroyers designed also for use beyond the Baltic were built here, in addition to Victor and Alfa class nuclear submarines and landing vessels. In connection with the shipyards and bases, there were also trial-run operations, experimentation with new weapons systems and, with regard to vessels intended for export, training activities for crews.

Acquiring the domination of the seas was, alongside the protection of their own and allies' coasts, the fleet's most important operative functions. The preservation of a balance of power that was advantageous to the Soviet Union was planned for implementation. This would be achieved by sealing the Danish straits, thereby preventing the arrival of possible additional enemy attack forces on the Baltic Sea. The maintenance of quantitative superiority would have established an advantage in possible maritime conflicts.

With the disintegration of the Soviet Union and the eastern expansion of NATO, Russia's naval forces in the Baltic were forced, in a similar manner to the last wars, to surrender their bases in the Baltic and retreat to the extremity of the Gulf of Finland. The Baltijsk military base, in the area of Kaliningrad Oblast, became a highly important advance outpost.

For Russia and its Baltic Fleet, these historical upheavals meant that the area's allies were lost step-by-step – and, furthermore, to their former opposition. **Vladimir Yegorov**, commander of Russia's naval forces, stated in 1994 that the Baltic Fleet had lost 80% of its military bases, 64% of its shipyards, half of its surface warships and personnel, 60% of its air force, and 30% of its airbases. The share of Russia's naval forces respective to the defence budget declined from its 23% level in 1993 to 9.2% in 1998. In practice, the naval reconstruction programme came to a halt. We recall from those times the explosion that occurred in 1996 on the 'Peter the

Great' missile cruiser, which was being rebuilt and in trial use. This returned the vessel for an extended period to the shipyard.

According to **Felix Gromov**, Admiral in Command of the Russian Navy, the emphasis in naval assignments at the outset of the 1990s was on defence tasks, safeguarding the inviolability of Russian territory, the protection of maritime traffic and the economic zone, maintaining the security of Baltic resources use (exploitation of the oil-find facing Kaliningrad), and fulfilling the obligations established in connection with international assignments. The functions of the Baltic Fleet were designed for implementation primarily in the area of Kaliningrad. Support for other branches of defence was required to come from an area limited to the use of naval forces and without a land link to the motherland.

NATO's eastern expansion affected Russia's security policy-based initiatives in the area at the end of the 1990s. The establishment of a security zone – as with the proposal for the establishment of a nuclear-free zone – were practical measures designed to resist the expanding western alliance. According to the Swedish sources, the placement of tactical armaments in the area of Kaliningrad – in other words, short-range nuclear weapons – had already been introduced at the time. As a response to the war being waged in Kosovo, Russia severed its connections with NATO and interrupted its participation in the western alliance's annual Baltops operations exercise on the Baltic Sea. At the end of the 1990s, the largest military exercise in many years was implemented together with Belarus, named Zapad-99. One theme of the exercise was defence by means of nuclear weapons against an attack on Kaliningrad. The most significant event at the time in the Baltic developments was the significant reduction in the operational area of Russia's Baltic Fleet.

In entering the first decade of the new millennium, President **Vladimir Putin** stressed Russia's strategic interests "on all seas and oceans". At the outset of 2001, one could read from American sources that Russia had clustered tactical nuclear weapons in Kaliningrad. This move was no longer a step observing the spirit of the march towards a nuclear-free zone in the North. Russia's vice-admiral in command of the Baltic Fleet, **Vladimir Valujev**, expressed public regrets in 2002 over NATO increasing its activities facing Kaliningrad, with Poland having joined the western defence alliance.

In President Putin's naval policy-based programme ratified in March 2000, State interests were declared to rest on the safeguarding of the use of the oceans' resources while permitting other states or blocs to dominate maritime areas important for Russia. Achieving this goal requires sufficient resources as well as a navy armed with both regular and nuclear weaponry, developed in a balanced manner. In the maritime doctrine extending to the year 2020, the need to develop the infrastructure of ports is noted with regard to the Baltic – after all, of Russia's foreign trade (import and export), 153 million tonnes already travel thrue the Baltic Sea: already almost 20% of the Baltic's entire sea transport volume – as well as the necessity to modernize and regenerate the merchant fleet and the importance of advancing economic cooperation. The planning work on the gas pipeline proceeding across the Baltic Sea has also necessitated the use of the navy's vessel stock.

After the turn of the new millennium, the Baltic Fleet has also been developed as a result of Russia's increased economic resources. At the same time that Russia's naval forces have been given additional resources as a result of the nation's economic progress, more civilian life-based tasks rather than new allocations, together with increasing numbers of military exercises rather than the same with ship orders, have resulted in insignificant impact on the numerical development of vessel stock. The latter with regard to the Baltic Fleet has not yet achieved the level of the outset of the 1990s and is still, numerically speaking, under-strength by comparison to the German and Polish fleets. Consequently, the average age of the ships is also continuously rising, while their technological standard is aging.

With the outset of the 2000s, Russia's Baltic Fleet is comprised of two destroyers, nine medium-sized vessels of which four are landing crafts, and two diesel-electric submarines. Small-classed ships total 27, of which submarine-defensive craft number 8, missile boats 4, hovercraft 2 and minesweepers 6. According to the Swedish sources, the navy operates 38 vessels altogether, of which 7 are believed to be under repair or in storage. At the end of 1995, the Baltic Fleet still totalled over 150 surface vessels and eight submarines.

As of the beginning of 2005, Russia's Baltic Fleet has been coupled with the Russian-German gas pipeline project. In 2006, President Putin stated:

"This is a major project, very important for the country's economy, and indeed for all Western Europe. And of course we are going to involve and use the opportunities offered by the Navy to resolve environmental, economic and technical problems, because since World War II, no one knows better than seamen how to operate on the bottom of the Baltic Sea. Nobody has similar means to control and check the bottom, nobody can better accomplish the task of ensuring environmental security."

By action of the project management, it has been reported that there shall be a 200-metre plated security zone whose security "shall be enforced" on both sides above the gas pipeline.

In 2006 and 2007, vanguard Russian politicians and military men have dealt with and commented on strategic questions as well as reported on changes in nuclear artillery forces-based doctrines and related engineering. In November 2006, Putin warned about the launch of an arms race in Europe. In July 2007, Russian threatened to abandon the INF agreement, which limits the use of nuclear weapons. The extension of NATO's nuclear shield into new NATO countries resulted in Russia announcing as a countermove that it was directing its nuclear missiles to European targets and planning to situate missiles in Kaliningrad.

With the possible relegation of nuclear arms on Baltic Fleet vessels, Russia may be shuffling its playing cards and seeking better negotiation positions for the future.

The information from August of this year on the change in nuclear weapons policy resulted in **Carl Bildt**, Sweden's Minister of Foreign Affairs, declaring that "the Baltic Sea has nuclear weapons" but "is there some kind of changing trend here? That, I don't really know."

Since the safeguarding of superpower strategic interests is emphasized in the activities of Russia's northern and Pacific fleets on the world's seas, the tasks of the Baltic Fleet tend to be concentrated on the protection of economic interests. The protection of what is important to Russia – the export traffic plying the Baltic Sea, over 135 million tonnes in volume – form, together with the planned and already quite lengthily prepared gas pipeline, the essential core of the country's future. When as much as 67% of Russia's export is oil or oil-based products, this vital logistics chain should be examined also from the perspective of the recipient, or "customer".

Times change and us with them, says the old proverb. Will this fresh information on nuclear weapons launch some sort of process of change in security policy in our immediate vicinity and, if so, in what direction?

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Turku and Tallinn – work together for a better Baltic Sea environment

By Pekka Ruola

The cities of Turku and Tallinn have been named as the European Capitals of Culture for 2011. The Capital of Culture year is a unique opportunity for both cities to present their culture, history, future as well as the cooperation which has lasted for centuries in the Baltic Sea region. In addition, the Baltic Sea has a significant role in the programme of the cities' jubilee year.

Never before in its 20-year history have the cities in two EU countries been located so close to each other as Turku and Tallinn, the Capitals of Culture for 2011. Never before have the cities named as Capitals of Culture shared a similar history, culture and set of values, not to mention a common sea.

The cities of Turku and Tallinn have prepared the Capital of Culture year since the beginning of 2006 – well in advance before any of the two cities were officially named as the European Capital of Culture. The goals of the cities and the countries as well as the European Commission's strategy for the Baltic Sea Region have been taken into consideration in the preparatory work.

The Baltic Sea, the main connecting factor, has been the basis for the preparations – as the Baltic Sea is considered an opportunity as well as a challenge. The common goals of both cities are, in fact, to increase knowledge about the Baltic Sea region, to call attention to the culture of the two cities, to increase well-being, to improve the urban milieu, and to develop creative activities as well as a long-span cooperation.

But how do we achieve the goals? At this stage, concrete examples of cooperation are e.g. the ex-change of artists between the countries in the Baltic Sea region, the network developed for the artists, their work and products in the Baltic Sea region as well as the coordination of various programmes.

A joint marketing is also an essential part of the cooperation. This is carried out e.g. by establishing a Turku information service point in Tallinn and a Tallinn information service point in Turku. The foundations which are preparing the Capital of Culture year have also planned a joint promotion tour in Europe and to unite the efforts to reach more remote countries as well.

Cultural cruises, cultural parks, a common culture, a common memory…

The preparations of a common programme for Turku and Tallinn, the Capitals of Culture for 2011, are in full progress. A cultural cruiser that will cruise across the Baltic Sea during summer 2011 is one of the goals set up in the programme. The purpose is to produce high-level shows taken from the cities' Capital of Culture programmes.

The plans also include the building of central parks for cultural fitness in both cities. The everyday and target-oriented physical exercise, recreational activities, art and history will unite their forces in the parks. For example, utility works of art to be placed by the banks of the Aurajoki River in Turku for climbing and skateboarding, and for fitness training and stretching are planned in cooperation with artists and sports enthusiasts. The fields with works of light-based art for beach volleyball and street basketball tournaments at night time also combine art and sports.

In Tallinn, however, an art and a literature project called Bottled Messages, which is strongly linked to environmental protection and which deals with the pollution problems in the Baltic Sea, will be launched in the beginning of 2009.

A project called Bordering Memories aims at a more extensive cooperation which deals with the relations between the Estonians, the Finnish and the Russians. Today, 40 per cent of Tallinn's population is Russian and the largest immigrant group in Turku is Russian. The foundations are looking for cooperation partners for the project from St. Petersburg.

The opening of the Capital of Culture year will also be celebrated together. The opening will be held on Friday 14 January 2011 in Tallinn. After the festivities, the guests will be transported to Turku where the opening will be held on Saturday 15 January 2011.

The Baltic Sea needs a joint voice

The cities' joint wish to protect the Baltic Sea is also reflected in the Capital of Culture programmes for Turku and Tallinn. Working for a common cause is essential: the countries in the Baltic Sea region must speak in one voice, must act in a joint way and in cooperation to improve the state of the Baltic Sea.

This issue is especially important at the moment, as the Baltic Sea is also the inland sea of the European Union. The opportunities in the region are enormous, since the Baltic Sea is surrounded by the most prosperous and fast-growing economies in Europe. The common challenge in the whole region is indeed the implementation of the economic goals. At the same time, the pressure to protect the Baltic Sea should also be considerable.

The key to solve the conflicts between the environment and the economy is cooperation on the level of local, regional, national and international actors. All the countries in the Baltic Sea region are aware of this and share the concern for the state of the Baltic Sea.

As the Capital of Culture for 2011, Turku will turn the European attention towards the Baltic Sea region and the common goals by means of culture. These goals include the increase of well-being and cooperation, the rise of creative industry and the sustainable development of the Baltic Sea region.

The Baltic Sea will be taken into consideration during the preparatory work of the Capital of Culture year. Responsibility is one of the values of Turku as the European Capital of Culture 2011. Responsibility also means, without question, that the environment will be taken into consideration.

The City of Turku's answer to the combining of economy and environmental protection is the creative industry. Turku 2011 is indeed more than just a year. It is a process which results in Turku being not only a forerunner, but also a significant European supplier of culture and the concentration of creative industry in the year 2016. The various fields of art and culture are in the core of creative industry. The strengthening of the creative industry and the creative environment supports the economic growth in the whole region – with consideration of the environment.

Pekka Ruola

Municipal Councillor

Vice Chairman of the Turku 2011 Foundation

Chairman of the Turku Cultural Board

Finland

Bridge over troubled waters? Managing EU-Russia energy relations

By Torsten Wöllert

Discussions on energy relations between the EU and Russia have changed quite significantly over the last couple of years. From the ambition to establish a "strategic energy partnership" when then-Presidents Putin, Chirac and Prodi agreed to launch an energy dialogue at the EU-Russia Summit in Paris in autumn 2000, focus has more and more shifted towards issues of energy security, reliability, etc. This illustrates decreasing levels of trust and ambition on the political level.

This shift is part of a general trend of increasing "resource nationalism" and the perceived need for higher levels of security (of supplies, of access to markets, of conducting energy business in general). One main driver for this shift is the increasing consolidation of the energy sector in Russia in the hands of the state, which aims to control the "commanding heights of the economy", and therefore the strengthened link between energy and politics. Another important driver is the increasing urgency felt in the EU to create a common EU energy market out of the inherited patchwork of 27 national markets – some of them historically and technically very closely linked to Russia.

As none of these key drivers is likely to disappear any time soon, the challenge for policy makers in EU-Russia energy relations will be to try to keep the necessary adaptation process as transparent and cooperative as possible. This requires continued balancing of political and economic interests on both sides – a complicated, sometimes tedious process with no quick rewards in sight. However, due to the objective inter-dependency between Russia and the EU in the energy sector, other options sometimes advanced on both sides (boiling down to energy flows from Russia to the EU being interrupted or strongly diminished) would have severe negative economic, and certainly also political, consequences.

Against this political background, practical cooperation between EU and Russian companies in the energy sector is not at its full potential but has fared much better than the frequent, mostly negative, headlines may lead to believe. Energy is so far the only sector where signs of increased interaction between EU and Russian players on a reciprocal basis are visible, by EU investments in Russia, by Russian investments in the EU, and by joint projects. This is due to the relative strength of Russian energy companies compared to other branches of the Russian economy and to the currently high energy prices which provide a stimulus for investments.

In particular, EU companies have invested multi-billion Euro amounts into the Russian energy sector and thereby shown a significant degree of confidence in the stability and fairness of the Russian market. While initially investments were concentrated on high-profit, short-return projects, recent investments (and further multi-billion Euro commitments) went into Russia's so far low-profit or partly even negative-profit, if capex for necessary modernization is taken into account, electricity sector. This creates a significant long-term commitment that goes beyond the concrete companies or projects involved.

Because of their huge scale and comparatively low profitability, these projects are particularly vulnerable to unfair or abusive practices and are therefore a good indicator whether Russia's energy sector is moving towards "civilized" business practices. They will simply not be able to bear the burden of interference by "administrative resources" or payments for "political gifts", as they will not be able to pass the associated cost on to the final electricity consumers in the long run.

A failure of these investments would not only indicate that Russia's declared policy of modernizing and diversifying its economy is not being implemented, for the EU this would additionally imply that Russian energy companies are not operating in a fair market. As a spill-over of their domestic business practices, in particular their use of political leverage (in Russian "administrative resources"), to their operations abroad is more than likely, their existing and potential investments in the EU would be subject of increased scrutiny. This process has already begun in the gas sector, where there is currently no fair market to speak of in Russia.

A success of these investments, however, would be a very strong signal that, despite political problems, which may occur, there is a strong basis for a gradual convergence of EU and Russian energy markets. An increased take-up of renewable energies and energy efficiency measures in Russia and related successful investments by EU companies, which are usually much smaller and even more vulnerable, would further reinforce this positive picture.

Only time will tell how Russia's energy sector will look like in, say, five years. But it is safe to say that developments in Russia will have a significant influence on the emerging EU energy market. Interestingly, the opposite is true as well. Therefore it is very important to closely monitor related developments, entertain close communication and cooperation channels between the EU and Russia at multiple levels, and to systematically promote cooperation efforts where and when politically feasible.

At the same time, as the energy inter-dependency has come under political strain, it is prudent policy for both the EU and for Russia to develop alternatives for the medium to long term. This should not be only or foremost the search of other energy suppliers (for the EU) and other energy markets (for Russia). The successful implementation of the declared policies on economic diversification in Russia and on the energy market in the EU (including demand management, renewables, infrastructure, research) will have a much bigger and lasting impact – and will in the end also ease the current strain on EU-Russia energy relations.

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The views expressed in this article are those of the author and do not necessarily reflect those of the European Commission.

The Baltic Sea as the most important corridor for Russia's oil exports

By Agata Łoskot-Strachota

Energy relations between Russia and the EU have recently been dominated by discussions about gas, the routes for and security of gas supplies. Oil issues have been receiving less attention, although Russia is also an important supplier of oil to Europe, and even the only source in the case of some EU states. It has been providing stable supplies to the European market for the last few decades, and the disturbances of recent years have concerned quantities which were relatively small on the EU scale, and have usually been temporary; this was the case for example, of diminishing supplies to the Czech Republic this summer. Longer-term problems have affected Lithuania (the suspension in July 2006 of Russian oil supplies and transit via the pipeline branching off the Druzhba system has forced Lithuania to import its oil by sea). Along with other steps, such as the discontinuation of Russian oil exports via Latvia's Ventspils terminal, these problems are part of a more general tendency. It appears that in recent years Russia has been changing the shape of its export links with EU countries which had operated for decades: Moscow is gradually limiting the role of the Druzhba, which has been the main oil export route until recently, in favour of independent transport via third countries, the Baltic Pipeline System (BPS) and maritime transport via the Baltic Sea. The plans to further increase the role of the Baltic in Russia's oil trade, confirmed by the decision of Russian government from December the 1st on building Baltic Pipeline System 2, will have consequences for both EU buyers of oil (Poland, Germany), and the intensity of maritime transport on the Baltic. Consequently, it may become an important context for the policies pursued by the EU and individual member states in the region, including the EU Baltic Sea Strategy currently being developed.

The Baltic Pipeline System

The volume of Russian oil exports transported by the Druzhba pipelines connecting the Western Siberian fields with European consumers is decreasing: while the Druzhba was still the most important oil export route in 2005, in 2007 the BPS and the Primorsk terminal had already replaced it in the lead position, as the route for 36% of Transneft's total oil exports (compared to around 31% transported by the Druzhba). At the same time a new Baltic route, the Baltic Pipeline System 2 (BPS 2) has become one of the key new oil export projects in Russia's energy strategy. The BPS 2 would branch off from the Druzhba system in Unecha and run to Ust-Luga on Russia's Baltic coast, and it would allow the export potential of Russia's Baltic terminals to be expanded from the current 75 million tons to 125-150 million tons. Even though it is not completely certain that the project will be implemented, and many details still remain unclear (for instance, no feasibility study has been performed), the decision of Russian government, statements by top-ranking politicians (including PM Putin and deputy PM Igor Sechin) and the Transneft chief suggest that the project to build the BPS 2 is to be pushed foreward at both the political and business levels. In the light of the global financial crisis and the declining oil prices, it is becoming more difficult to find financing for the project (the cost of which is estimated at around US$2 billion). However, in all probability these factors will only delay the start of work on the route and the date on which it will be put into operation (at present the first phase is expected to be completed in 2012).

Consequences for Europe

Since, according to current projections, the volume of Russia's oil production and exports will remain at a more less stable level (or, according to pessimist scenarios, even decrease, cf. IEA WEO 2007, Russia's Energy Strategy to 2020, adopted in 2003), the Druzhba will be used less and less if a new pipeline is put into operation, and this will most probably mainly concern the northern branch from Russia via Belarus to Poland and Germany. Consequently, Belarus, Poland and Germany may end up having to import oil for their refineries by sea, which, in turn, would require investments in infrastructure development (in particular, the Rostock and Gdańsk terminals, as well as the pipeline connections). Oil purchased in this way would probably be more expensive than oil transported from Russia by land, although it is unlikely that the price difference would be big enough to make oil imports from other suppliers more profitable. The change in the geography of export connections would also probably entail some reshuffles among the intermediary companies trading Russian oil. Gunvor (one of the companies building the oil terminal in Ust-Luga) would probably gain even more importance, at the expense of the current main intermediaries such as J&S and Sunimex.

Another consequence of the construction of BPS 2 would be a substantial increase in tanker traffic on the Baltic Sea. This would boost the Baltic's economic importance, although at the same time it would create environmental risks (such as oil spills). More intensive maritime transport might also cause disturbances in the existing system of connections, and hamper plans to develop alternative transport (such as the projected LNG supplies).

On the other hand, the prospect of a substantial reduction in the volume of oil transports via the Druzhba (or even the complete disconnection of the northern branch) might stimulate projects concerning alternative supply routes. Latvia and Belarus are already holding talks concerning the possible construction of an oil terminal in Riga, which would permit oil supplies to Belarus. This would make it more economically-justified to extend the Odessa-Brody pipeline to Płock, and possibly on to Germany, and would make the project more attractive to both European oil buyers and potential Caspian suppliers.

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Eclipse of export-led growth?

By Dan Steinbock

Since early fall, the Nordic and Baltic economies have no longer been unaffected by the global financial crisis. The impact is not just cyclical. Nor is the crisis just a 'particularly severe recession.' It reflects structural transition of the global economy as the growth drivers are shifting from the West to the East. It may also herald the eclipse of export-driven growth strategies.

Impact of Global Financial Crisis

Until recently, real GDP growth in the Baltic Sea Region was significantly above the level in the EU-15 and began to outperform both the NAFTA region and the world economy overall. Today, the region is struggling with global forces that have a potential to reverse much of the past progress.

"For a decade, efforts at truly integrated European markets and monetary union felt like running in quick sand," said a high-level representative of a major Nordic business association in early fall. "Now integration has new momentum and everybody would like to be part of euro." In the long term, that is a promising trend. In the short term, it is too little too late.

The good news is that, after the severe recessions in the early 1990s, the banking systems are more solid. The bad news is that, since early fall, all countries in the region have been coping with a major slowdown, while some – particularly Iceland – have been devastated.

In Sweden, the newly attractive euro environment is expected to become an issue in the 2010 elections. Due to its surplus, EU and EMU membership, Finland is now better positioned to cope with the crisis. In Denmark, many believe that the EU membership and a reassessment of the EMU would have ensured access to financial support (ECB) and better currency stability (euro); hence, the Danes' new interest in a referendum. Due to its oil, Norway has been less interested in the euro and European monetary policy; it needs high interest rates to prevent its economy from overheating, while other European countries need low interest rates. In Iceland, banks and business tycoons took huge risks, while citizens borrowed to the hilt, and now the country is paying the price.

As Germany, Eastern Europe's largest trade partner, fell into recession, demand for Eastern Europe's exports is contracting and FDI inflows – the drivers of regional growth – are decreasing. In the Baltic states, EMU is now seen as a safe haven. In the absence of a real push toward euro, they are not likely to be able to join the euro zone by the target date of 2011.

Due to their relatively small capital markets and low levels of public debt, the Baltics have not been hit very hard yet. However, large current-account deficits, high external debt and excessive lending growth reflect growing risks. Further, deficits mean vulnerability to credit tightening and reversals of capital flows. Countries that are highly dependent on foreign capital inflows have been shaken dramatically by the crisis and the ensuing decline of oil price – even Russia.

In the past, the Baltics openness contributed to their rapid growth; now it will render them increasingly vulnerable to global turmoil.

From Global Growth to Regional Integration

In the past, developing countries that could create competitive export industries have enjoyed extraordinary growth rates, particularly in East Asia – from Japan to the 'tiger economies' and, more recently, China and Vietnam. This growth, however, has been predicated on the ability of the global economy to absorb the exports.

Since the 1990s, many countries in the Baltic Sea Region have emulated aspects of the East Asian growth model. They are characterized by relatively high trade openness, as measured by exports plus imports of GDP. In these terms, the Nordic countries are two-to-three times as open as Japan or the United States while the Baltic States have been far more open than the Nordic economies.

It is their inherent smallness and openness that allows these countries to benefit from global growth but also makes them vulnerable to rapid fluctuations in external markets. Now the glory days of export-driven growth are fading. The new global environment may not prove as favorable to export-led strategies in the near-term.

As the G7 economies have been swept by recessionary conditions, deflationary pressures hamper usual monetary and fiscal remedies. Despite interest rate cuts in Europe and the U.S., advanced economies are struggling to stay afloat. In the past, the current-account deficits in the U.S. and other advanced economies sustained the growth miracle in the East and Northern Europe. In the future, this pattern will be a lot harder to sustain. The current turmoil would become far more severe, if economic agony in the advanced economies is allowed to evolve into isolationism and protectionism – as happened in the 1930s.

With the Hanse legacy, the Baltic Sea Region has promoted integration through centuries. In the Cold War era, cooperation in the region was hindered, but when the Berlin Wall fell in 1989, new strong ties re-emerged. Today, Northern Europe comprises not just the Nordic and the Baltic states, but the entire Baltic Sea Region, including northern Germany and Poland, as well as Northwest Russia. Many observers see Northern Europe as a potentially strong regional player in the politically fragmented Europe. This perception has not yet been matched by appropriate regional aspirations.

Despite legacies of historical division, many Asian nations are now developing bilateral and multilateral free trade agreements. Accelerating integration stimulates multi-level regional integration and compensates for decreases in external demand. These efforts offer great lessons for other regions as well.

Strong regions are better positioned to cope with global crises.

Dan Steinbock

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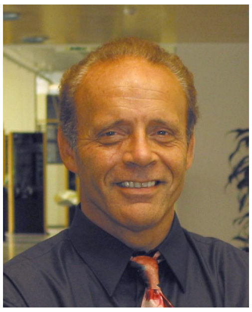

Rouble devaluation – pros et contras

By Sergey M. Drobyshevsky

Several last years the Russian rouble was considered by many experts and analysts as one of the most stable and attractive currencies. Backed by huge foreign reserves of the Bank of Russia (Number 3 in the world), which have been formed at expense of outstanding positive trade balance as well as of positive capital account balance (in 2006-2007), the Russian national currency steadily appreciated against both the US dollar and euro. By mid-2008 the real effective rouble exchange rate was approximately 20% higher than on the eve of 1998 crisis, though that time the rouble seemed to be overvalued. Tremendous shifts occurred as well in attitude of the Russian economic agents to rouble: through 1999 to 2008 the share of private deposits in foreign currencies declined from 44% to 15% of the total amount of private deposits, virtually all prices started to be nominated in roubles (including cars and real estate).

The slump of oil prices, political events (the Mechel case and Caucasian war) as well as bursting out the global financial crisis change the situation completely. Rouble turned to be under a serious pressure – the international investors started withdrawing capital from the Russian assets, the Russian banks and companies – accumulating of currency for coming repayments of their external debt, but the population renewed dollarisation of its savings.

Facing all challenges, the Central bank of Russia pursued a policy aimed at smoothing of rouble to bi-currency basket (55% - US dollar, 45% - euro) exchange rate, preventing notable rouble's devaluation. The policy was based on the volume of foreign reserves. For the period between August 8 and the end of November the foreign reserves of the Bank of Russia shrank by approximately 25% ($150 bln.! – from $600 bln. to $450 bln.)[1] , but the rouble to bi-currency basket exchange rate fell by more than 5%. Taking into account the growth of US dollar at Forex, rouble fell against US dollars by more than 25%.

Analysing the most probable scenarios of development of the Russian economy in 2009 (characterized by a falling oil prices in the world market – up to 30-40 $/bbl, weak state of other markets for main Russian exports, lack of refinancing of private external debt, stable high inflationary background), we see that the Russian balance of payments could be restored and the foreign reserves of the Bank of Russia could be saved at most at half of the initial volume ($300 bln.) only along with a 30-60% devaluation of rouble against the bi-currency basket. Under a very favourable circumstances (e.g., regaining of the level of 60-80 $/bbl. by oil prices, return of international capital to emerging markets) a 10-15% devaluation could be enough.

Therefore, the Russian Central Bank's policy should consider a set of pros and contras of rouble devaluation:

«Pro»:

- A very negative macroeconomic forecast – the devaluation is actually unavoidable.
- During last half-year (since the trends at Forex were broken) rouble has fallen against the US dollar at relatively a smaller value, than currencies of other emerging economies (Korea, Mexico, Poland, Brazil etc.) Hence, rouble seems to be overvalued against other currencies of emerging economies.
- The policy of bi-currency basket pegging, not a single currency, gives the Bank odf Russia a chance to devaluate without serious negative effects on economic agents' expectations. Though the majority of economic agents (the population, in the first line) put their attention to the rouble/US dollar exchange rate, a decline of rouble /bi-currency basket exchange rate at the time of US dollar weakening at Forex could make an illusion of no-devaluation of rouble, but the problem of balance of payment deterioration would be solved.
- A further decline in foreign reserves is fraught with self-fulfilling attack against rouble.

The «Contras» could be named as fallows:

- Limited potential of speculative game on rouble decline (international investors are busy with problems in the financial sector of the developed countries, but the Russian banks are exposed to a strict control and liquidity is concentrated at only a few banks).
- If the rouble devaluation against the bi-currency basket occurs at the moment of US dollar strengthening at Fores, the population expectations can be extremely negative and stimulate a bank run.
- High external indebtedness of private sector.
- Due to lower internal demand and investment activity in Russia we expect a sharp decline in import (the foreign trade statistics for the first month of crisis – October – will be published in by the end of the second decade of December). Thus, it is possible improvement of the Russia's balance of payment and at low oil prices too.
- Highly negative political and image consequences for the Russian Government and the Central bank.

Summing up, we strongly convinced that now is a right time for a rather apprehensible decline in the rouble to bi-currency basket exchange rate. Persuading of current policy (devaluation of rouble by 0,5-1% a week) can lead to further losses of foreign reserves, but a devaluation by 10-15% allows positively change the state of the currency market in Russia, limits, by the way, the probability of a new attack against rouble (under the current deficit of free liquidity).

In the future, depending on the situation in the global economy and the state of Russian export the rouble exchange rate will call for a new devaluation, or will appreciate again. This perspective testifies to a possible way for the Russian Central Bank to be more independent from the external conditions and to a new pre-conditions for switching to a rouble free float.

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[1] $40-50 bln. accounts for a pure statistical reduction in reserves at expense of exchange rates volatility (approximately 55-60% of the Central Bank of Russia foreign reserves are in euro and other currencies, which has fallen against the US dollar that time).

How to restore confidence and allow the rouble to weaken

By Lars Tranberg Rasmussen

It's all about restoring confidence:
The outlook for the Russian rouble (RUB) has certainly changed in recent months. Whereas the expectation had been for the rouble to appreciate to bring down inflation, most RUB watchers now expect it to depreciate in the coming year to adjust to a lower oil price and weaker external balances. Expectations of a weaker rouble amid declining oil prices created a lot of tension in the Russian financial markets and have caused a spike in the risk premiums that investors pay to hedge RUB exposure. Russian authorities took steps to alleviate the stress in the financial markets, but investor confidence has still not been restored and net capital flows remain negative as foreign investors reduce exposure to Russian markets. Going forward it is of great importance for the authorities to restore confidence in order to avoid a hard landing for the economy. We argue that allowing for a more freely floating rouble could support this.

Central bank keeping a tight grip:
The Russian central bank (CBR) keeps a fairly tight grip on the RUB, which is "pegged" against a basket of EUR 45% and USD 55%. On a day-to-day basis, the CBR intervenes to keep the rouble within a relatively narrow trading band against its basket. Rising oil prices, which drove the C/A surplus to record highs – peaking above 10% of GDP in 2006 – and rapidly rising capital inflows following the liberalisation of Russian capital markets in 2006 meant pressure on the rouble to appreciate was strong in 2006-07. However, the CBR allowed only a mild appreciation against the basket by attempting to reduce bets on a stronger rouble, which would only increase the upward pressure on inflation.

Instead, the strong external balance position led to a swift build-up of foreign currency reserves in 2006-08, peaking at around USD 600bn in August 2008. As capital inflows were only partially sterilised in recent years, domestic money supply grew much faster than nominal GDP. Abundant liquidity created rising inflationary pressures and kept local interest rates extraordinarily low. This combination of negative real interest rates and high economic growth created little incentive for the private sector to save, while at the same time it induced high private spending and rapid credit expansion. Thus imports accelerated and external debt levels in the private sector rose swiftly. However, these increasing imbalances were partially hidden when global liquidity was rich, oil prices were rising and the external environment was generally benign.

Risk premiums through the roof
Things have certainly changed in the past year. Oil prices plunging 70% since peaking in July, the ongoing global credit crunch and rising political risks following the Caucasus crisis shifted sentiment towards Russian and highlighted its vulnerabilities. Net capital flows turned negative and may total USD 100bn in 2008 as foreign investors decrease exposure to Russia amid tighter global liquidity and fears of devaluation that have forced the CBR to sell foreign currency reserves to keep the rouble stable. FX reserves have dropped by 25% – or almost USD 150bn – since August 2008, and the liquidity situation in Russia has worsened rapidly, pushing up yields in Russian money and fixed income markets to exorbitant levels.

Higher funding costs and lower oil prices have been a toxic cocktail for many Russian companies, which are often highly leveraged and largely dependant on oil revenues. According to the Russian central bank, gross external debt in the private sector amounted to USD 490bn at end-H1 08 – or more than 30% of GDP. Further, almost USD 100bn has to be refinanced in H2 08 along with another USD 59bn in H1 09. This has caused immense worries among market observers given the global credit crunch, and has increased the sell-off of Russian assets. The CBR deposited USD 50bn from its FX reserves in VEB – a large state-owned bank – to help troubled Russian companies refinance their external liabilities. The authorities have also implemented large-scale liquidity measures to ease market tensions, but with limited success so far.

Overall, Russian markets have sold off massively and risk premiums have spiked at very high levels in recent months, which has fed speculation about massive rouble devaluations. The CBR is up against the wall and there is no easy way out right now. Until mid-November the CBR declined to widen the rouble's trading band, instead selling foreign currency to defend the currency. This accelerated the drain of FX reserves and caused short-end RUB rates to spike above 100% – very toxic for the economy. The CBR recently allowed the trading band to widen – a de facto RUB devaluation – and the rouble weakened 4% against its basket. This reduced risk premiums somewhat, but the market is still priced for a major RUB devaluation and the CBR is still being forced to sell foreign currency to defend the rouble.

Moving towards a freer floating rouble
FX reserves currently roughly correspond to the private sector's gross external liabilities, and a further draining would jeopardise the creditworthiness of the Russian economy. Indeed, Standard & Poor's downgraded Russian sovereign debt one notch in December and kept a negative outlook on the back on these credit issues. Hence, further negative rating action is likely. In our view it would thus make sense to speed up the widening of the trading band and let the market help find a reasonable level for the RUB, thus avoiding draining FX reserves excessively. There are no easy solutions to the current situation, but a swift rouble devaluation could probably alleviate the current economic slowdown, as it could bring some relief to the money markets. The CBR indicated in early 2008 that it was moving towards a freely floating rouble and shifting focus to inflation-targeting instead in the next two years – a process that it might usefully speed up.

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Double environmental dividend – combining actions against climate change and pollution of the Baltic Sea

By Lassi Linnanen

The agricultural sector is a key contributor to the pollution of the Baltic Sea. Excess loads of nutrients lead to eutrophication with excessive algae blooms - with toxic blue-green algae as a consequence. This is the core of the environmental issues addressed within the HELCOM Baltic Sea Action Program.

In the Leningrad region, Russia, there are 17 farms with a total of 18 million birds excreting over 600,000 tonnes of manure. This manure is spread on farm land in the vicinity of these farms, causing leaching of nitrogen and run-offs of phosphorus into the rivers, Lake Ladoga and Baltic Sea. Improvement of the manure handling in these poultry farms is, according to the present knowledge, the most cost-efficient measure to reduce eutrophication of the Baltic Sea.

Several reasons exist for why chicken farms could take part in projects that help to replace the traditional dispensing of manure. Key action to drive change in the Leningrad region would include encouraging regulators to use taxes and subsidies but also communicating successfulness of pilots to convince other farmers to consider similar solution. An environmental tax of 15 EUR/ton exists for improper land filling of the manure but enforcement is lacking. Going forward, Russia needs to increase the enforcement of the taxes to encourage farms to not dump the manure on fields in such excessive quantities.

Second, environmentally friendly image is increasing in importance. Chicken farms are supplying products to large international multinationals (e.g., McDonalds) and thus stringent quality and process requirements are needed to secure contracts. Consumers are increasingly becoming more environmentally conscious and such environmental activities can be used as a value proposition enhancement. Third, the manure treatment installations help to replace old heating systems. Chicken farms need to heat up the farm facilities and thus manure incineration solution helps to reduce dependency on gas and coal fired heat power plants.

A practical aspect to be solved is that planned capacity does not meet peak energy demand in winter using manure alone and is underutilized during summer. During peak demand, natural gas is needed to meet high energy needs. On the other hand, there is excess manure production during warmer periods if manure is only burnt to satisfy heat needs. Therefore, there is a need to find solution on how to capture value from capacity during warmer months. Of the various options to solve this energy balance issue, burning manure according to heat needs and producing pelletized fertilizer from unburnt manure is most feasible. Given that ash contains valuable substances, it has value in itself in case these substances can be utilized in economically feasible manner.

To be able to best capture the value from generated ash, it is essential to identify the most suitable method to utilize its substances. In Finland, using chicken manure as fertilizer is not approved yet but in case it would be allowed, demand would exist for the end product. Approval process is ongoing but as approval requires creating a new type name group, it may take up to one year. Furthermore, to get the product approved as fertilizer in Russia may take up to 2-3 years. As fertilizer prices have been increasing very rapidly, farmers are continuously searching for alternative options.

In general, chicken manure ash should be a relatively safe product and rejection is unlikely. Several possible end-uses have been identified for the ash, which contains 8% of phosphor and 12% of potassium. Main the possibilities are grain fields, where nitrogen could be added separately, and greenhouses, which grow high nutrition-consuming vegetables, such as cabbage and lettuce.

The key issue in the chicken manure incineration is that while fighting against a huge and global problem, climate change, you can at the same time affect on something that you can really see and what is very close to you - the most polluted sea in the world, the Baltic Sea. Chicken manure case is one of the pilot projects promoted by Baltic Sea Action Group (BSAG). BSAG is a Finnish foundation that operates within the whole Baltic Sea with a holistic overview and well targeted concrete actions. Our cross-board environmental work is advised by International Advisory Board of highest level.

BSAG acts as a catalyst in the project and combines forces in order to speed up the actions and positive outcomes. We rely on public private-partnership, and we have wide range of modes of operation from lobbying in to turn key project management. We identify the problem; analyze the best ways to solve it and act. Acting quickly is possible with the support from private sector. People as well as companies are utterly willing to participate in solving both local and global environmental problem.

BSAG's operation methods are innovative, aimed towards concrete solutions and based on extensive co-operation. The foundation acts as an initiator and/or a catalyst in parallel and concrete projects. We have a wide variety of tools in use: political forces regardless of political views or ambitions, heads of states from the entire Baltic Sea area, civil servants and authorities, NGOs, private citizens, companies and prestigious business executives. The positive co-operation in the environmental matters is particularly important and strengthens the relations of the states in general: it is of everyone's interest that the Baltic Sea is maintained healthy, peaceful and secure.

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Reduction of nutrient discharges will turn the trend towards a cleaner Baltic Sea

By Martti Lariola

The collapse of the Soviet Union in 1991 was great news for the Baltic Sea environment. Hundreds of polluting factories on the eastern shores of the Baltic Sea came to a permanent standstill. The Baltic countries and Poland adopted European environmental standards of municipal and industrial effluents. The World Bank and the European Bank for Reconstruction and Development prepared and financed – complemented with bilateral grants from the Nordic countries and local financing from government sources - municipal investments in wastewater treatment in cities that HELCOM had identified as "hot spots". After this first wave of investments, the environmental agenda was extended to medium-sized municipalities.

Before and after the accession of the Baltic countries and Poland into EU in 2004, generous financing was made available for environmental investments in the new member countries. Poland prepared projects for wastewater treatment in 1734 wastewater treatment plants with a total budget of over 12 billion EUR. This investment programme, called KPOSK and funded from EU and local sources, is now under implementation and expected to be completed in 2010 in cities over 100,000 citizens, and gradually by 2015 in medium-sized and smaller cities.

As Poland represents nearly half of the population in the Baltic Sea catchment area, and about 40 % of phosphorus and nitrogen discharges, the current investment programme will have a decisive impact on the eutrophication of the Baltic Sea. While we wait for comprehensive statistical data on actual nutrient inflows, examples of leading Polish cities will demonstrate actual developments.

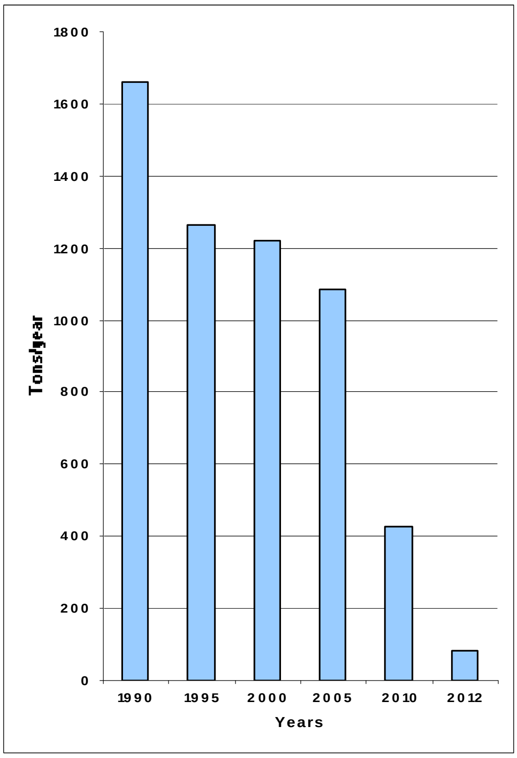


Table 1: Phosphorus discharges in Warsaw 1990 – 2012 (ton)

The City of Warsaw represents more than 5 % of all urban population in Poland. In 1990, all wastewater from Warsaw entered untreated to the Baltic Sea. It contained about 1600 tons of phosphorus annually (Table 1). As a result of about 800 million EUR investments in wastewater treatment, the current (year 2008) phosphorus discharges amount to about 550 tons – more than 1000 tons reduction. After the investment project has been fully implemented and all wastewaters connected to the treatment plants in 2011-2012, the annual phosphorus discharges are expected to drop to 160 tons. This corresponds to the current legal EU requirement of 1 mg phosphorus/litre of effluent.

If the environmental performance of Warsaw is representative of the whole country, Poland will be a star performer in phosphorus removal. However, there is a wide agreement in the scientific community that the current universal EU requirement of 1 mg phosphorus/litre of effluent is not sufficient to save the sea.

Therefore, additional measures are required to bring the phosphorus discharges to the level of 0.5 mg/litre of effluent, which is the level recommended by HELCOM in order to reverse the alarming trend of eutrophication. Only then can we confidently look forward to a cleaner sea.

The good news is that the additional measures required to cut the phosphorus discharges to half, from 1.0 mg/litre to 0.5 mg/litre, can be implemented with minor additional investments and a marginal increase in operating costs. The solution is intensified chemical treatment of wastewater through adjustments in wastewater treatment processes, taking advantage of the investments made.

The John Nurminen Foundation of Finland and Baltic Sea 2020 of Sweden have approached the City of Warsaw, signed a Letter of Intent for accelerated phosphorus removal and implemented a Technical Audit to specify the detailed techniques and costs for reducing phosphorus effluents from Warsaw's wastewater from 1.0 mg/litre to 0.5 mg/litre. This translates into annual reduction of remaining phosphorus discharges from 160 tons (1.0 mg/litre) to 80 tons (0.5 mg/litre; see Table 1). The foundations plan to accomplish this by the end of 2012.

The estimated additional cost of intensified phosphorus removal to achieve the 0.5 mg/litre level means only 0.2 % increase to the total operation and maintenance cost of a wastewater utility. In some cases, minor investments may be needed for the improvement of monitoring and reporting systems.

The consumer of water and wastewater services can easily afford the additional cost of improved phosphorus removal. The additional annual cost per person is less than one Polish zloty in a year – equal to the cost of about one cup of coffee. This is a small price to be paid for the decisive improvement in the quality of water in the rivers and waterways of Poland, and ultimately in the Baltic Sea.

What is the legacy that we plan to leave to our children? This is the fundamental question that we all need to ask ourselves. It is the duty of our generation to fix the problem that we have created. The positive impact of our accelerated actions will be visible in the recipient rivers and in the Baltic Sea water within the coming decades. The Baltic Sea deserves good news for a change.

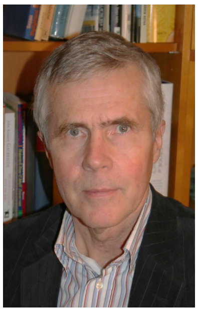
Martti Lariola

Project Director

Clean Baltic Sea Poland

John Nurminen Foundation

Finland



Key figures on maritime transports and cargoes handled in the Baltic Sea ports in 2007, compiled by the Baltic Port List

By Antti Saurama

Collecting unified, detailed and extensive transport data from ports in different countries and making comparisons between ports in the Baltic Sea Region is not always easy. This is due to differing practices in collecting and compiling statistics, at both country and port level. The statistics are fragmented, sometimes hard to access and may only cover the major ports. But access to comparable, reliable and easily obtained data on small ports is also considered important by many parties handling information on seaports. More importantly, the compilation of an extensive data bank specifically on port level offers a range of opportunities to monitor maritime traffic in the Baltic Sea Region as a whole at a very detailed level.

To fill some of the gaps between the information needed and what is readily available, the Centre for Maritime Studies of the University of Turku has introduced a continuous series of annual market reports to monitor cargo traffic development in the Baltic Sea Region. The *Baltic Port List* was first published in July 2008, providing key cargo and traffic figures regarding the year 2006. As part of this continuous series of reports, the CMS has now, in late 2008, produced the second report: the Baltic Port List 2007. The report covers virtually all seaports in the Baltic Sea Region that operated internationally and handled more than 50 000 tonnes of cargo in 2007. This extensive report covers 209 ports in the Baltic Sea Region whose aggregate cargo volume totals 99.1 per cent of all cargoes handled in the region.

To summarise the key figures for 2007, Baltic Sea ports handled a total of 826 million tonnes of cargo in 2007. This volume includes all seaports in Estonia, Finland, Latvia, Lithuania, Poland, Sweden and the Baltic coast ports of Denmark, Germany and Russia. Equally, this figure represents the gross volume of maritime transports in the Baltic Sea in 2007. The total volume increased from 2006 to 2007 by 4.1 per cent (or 32 million tonnes). This increase equals the total cargo turnover of the port of Ventspils in Latvia or three times that of the ports of Malmö in Sweden in 2007. In absolute terms, the annual increase was greatest in Russia (+19.8 million tonnes), Sweden (+4.6 million tonnes) and Finland (+4.6 million tonnes), while the fall was greatest in Estonia (-5.0 million tonnes).

Measured in total cargo volumes, Sweden remained the leading country in the Baltic Sea region, with a share of 22.4 per cent of total traffic in 2007. Sweden's share of total BSR volumes fell by 0.3 per cent points. Sweden was closely followed by Russia, raising its share to 21.1 per cent (+1.5 per cent points) during 2007. Finland was the third biggest country in handling cargoes in the Baltic Sea region, with a share of 14.0 per cent (+0.0 per cent points).

A moderate annual increase of 1.6 per cent was identified in exports (+7.4 million tonnes), while imports grew faster, by 7.9 per cent (+20.9 million tonnes). At state level, the largest increases in exports in absolute terms occurred in Russia (+16.3 million tonnes), Latvia (+2.1 million tonnes) and Finland (+0.9 million tonnes). At the same time, decreases were identified in Poland (-6.7 million tonnes) and Estonia (-6.6 million tonnes). Imports grew fastest in Poland (+6.3), Finland (+4.6) and Russia (+3.0 million tonnes). Falls in imports occurred only in Denmark (-348 000 tonnes). In four countries – Finland, Germany, Denmark and Sweden – the volume of imported goods exceeded exported goods.

In the report, international cargo traffic is divided into three groups: dry bulk, liquid bulk and other dry cargo. Of these, liquid bulk cargoes formed the largest share of international cargo traffic in the Baltic Sea, at 39 per cent, amounting to 292 million tonnes in 2007. Annual growth was negative, at almost one per cent. However, in Russia, where over 37 per cent of liquid bulk cargoes were handled, annual growth reached 6.5 per cent. Other dry cargo was the fastest growing cargo type in the Baltic Sea, amounting to an annual increase of almost 10 per cent. Ports with total cargo volumes of more than 10 million tonnes achieved an even greater annual growth of almost 16 per cent.

At port level, the top 20 ports measured by total cargo volumes handled 504 million tonnes of cargoes, accounting for 61 per cent of total cargo traffic (market share +0.5 percentage points). The two biggest ports, namely Primorsk and Saint Petersburg, managed to increase their market share most (0.7% points and 0.4% points) as well as growing fastest in absolute terms (+8.1 million tonnes and +5.3 million tonnes). Major growers among the top 20 ports, in relative terms, were Gdynia (+21.5%), Vysotsk (+19.7%) and Malmö (+18.5%).

Ports handling more than 10 million tonnes of cargo dominated international liquid bulk traffic in particular, with a share of 85 per cent, but they also had the largest share of international other dry cargoes (61%). In addition, for example, international container traffic was highly concentrated. Of the total 7.4 million TEU of containers handled in the Baltic Sea, 93.1 per cent (+0.6% points) passed through top 20 container ports in 2007. The handling of containers grew most, in absolute terms, in Saint Petersburg (+248 000 TEU), Gdynia (+158 000 TEU) and Kotka (+111 000 TEU). In addition to the port of Gothenburg, these three ports numbered among the major container ports in the Baltic Sea.

The selection of information above plus a detailed catalogue of port-specific traffic figures and information on market shares are included in the Baltic Port List 2007. The Centre for Maritime Studies sincerely hopes that, in a number of ways, the Baltic Port List serves the professional interests of various stakeholders in the fields of port operations, shipping, logistics and public administration now and in the future. The Centre for Maritime Studies warmly welcomes all feedback from users of the report.

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The Baltic Port List 2007 can be purchased from the Centre for Maritime Studies (CMS) from the beginning of December 2008. For further information and subscriptions, see http://mkk.utu.fi.

Containerized cargo market of the Baltic Sea and future of Mother Russia

By Kirsi-Maarit Poljatschenko

Stakeholders of the cargo market in our region would agree that the Baltic Sea cargo market is and will be driven by Russia and Russian consumers. Soft market analysis shows that 75% of all containerized loads into Russia pass through the Baltic Sea ports, which is natural and justified simply by geographic reasons. For the Baltic Sea Region, St. Petersburg is the only metropolis and North-West Russia is a permanent trendsetter – and not only for the cargo market. Those of us that make strategic decisions regarding market positioning or investments in the cargo market would need to foresee the future of Russia in order to outperform competition. We use time series methods and past performance numbers in our forecasts; on a lucky day we get it right.

What if we all in our respective industries systematically prepared ourselves for *alternative futures* instead of one growth curve or linear prediction? Element of imagination might facilitate creative debate, flexibility and in best case agility when unexpected events and dramatic changes occur. Can we afford not to expand our thinking in 2009? Global market environment requires new understanding of complexity. It is about time to change our forecasting practice and expand horizon because everything else has changed already. Planning for the future is of equal importance for small and large businesses. Multinational corporate can dedicate more resources in futures committees but writer would like to argue that small businesses can think big and run faster.

Scenario thinkers are enthusiastic about *what if*-questions. Firstly they define the scope of research and secondly they evaluate drivers and trends which seem to have most impact on events and development within the scope. Meantime, they capture weak signals which for them indicate ongoing evolution or change, yet unrecognized by the large audience. They are also interested in wild cards which are improbable events that could have great impact on area of scope. Thirdly, they work with these components in different combinations and volumes - and imagine different futures. Purpose of scenario stories is not to predict the future but to trigger creative and open debate regarding consequences of each alternative. It is easy to get attracted to scenarios because the process of creating scenarios can be both fun and eye-opening. Scenario process reveals key uncertainties and creates possible outcomes which together shape the future.

Writer of this article is interested in evolution of the containerized cargo market across the Baltic Sea. I have collected facts and beliefs from stakeholders, decision makers and media sources and as result I composed four alternative stories which describe Russian Federation in 2014 – the year of Sochi Olympics. Kindly fasten your seat belts when reading the following Russian stories. I have not used my Tarot-card deck here: a common PEST-approach was firstly used to understand political, economical, social and technological environment of the Russian Federation today. PEST-categories assisted in figuring out which drivers and uncertainties of Russia have most impact on containerized cargo market of the Baltic Sea. Different outcomes of today's uncertainties were then used as ingredients for four narratives which might be (very) unlikely to happen, but they sure could. What do you think about following?

My first future scenario is called *Cold War II*. In 2014 oil income continues to boost GDP growth of the Russian Federation at 5-6% annual rate but the national prosperity has not contributed for well-being of population –national investment scheme has supported oil and gas related technology and wealth of the Kremlin's preferential oligarchs. Political statements and undiplomatic behavior have caused isolation of Russia. Relations with both EU and USA are cold but Moscow and Beijing are better connected. Consumer buying power has increased in larger cities of European Russia to extent which still attracts multi-national retailers – provided that they can play ball with authorities and bureaucracy. Olympic Games are jeopardized by possible absence of the USA team and some of its allies. NATO has reacted strongly against the latest neighbor conflict of Russia.

Investment Magnet is the second scenario: innovative Russia welcomes multinationals to invest in real estate, land and resources in order to facilitate integration with world economy. EU neighbors enjoy business opportunities and strong demand for developed logistics services of the new WTO member. President of Russia has become a media-popular leader across Europe due to his diplomatic approach and activity in environmental politics. Russia has made serious effort to imitate, learn and innovate. Visa-free travel of Russian citizens within EU contributes for integration. Labor costs have risen but productivity has room for improvement. GDP has reached 9% growth rate after slow down of 2009-2011 and Russian middle class consumers have more opportunities for consumption and investments than before.

Mother Russia is the third scenario: nationalist and protective approach rules in international business relations. Other WTO member countries do not appreciate Moscow version of capitalism which continue to limit foreigners' business opportunities. Russia plays ball with mitigated WTO rules and the external world tries to deal with it without open conflicts for sake of some degree of integration with Russia. Moderate growth of GDP is driven by oil income but not adequate for the middle class to improve its living standards. Authorities apply penalties and additional taxes for transit cargoes in order to support inbound flow into Russian ports directly. Bureaucracy and addiction with paper documents has not disappeared.

Fourth scenario is called *Wild East*. Grey economy rules in 2014 and business opportunities are ambitious but risky. The marionette president is under control of the Duma which is entrepreneurial but compromises national interest and welfare issues. Lack of transparency leaves room for malpractices of authorities. Citizens of Russia struggle with practical problems and pay in cash. Russian transportation and logistics business suffers from image problem due to its risky nature but the Baltic Sea is busier than ever. Russia has detached from dialog regarding security and anti-pollution. Business environment is confusing for EU which continues to compromise with Russia. Spill-over of grey economy is of special concern in Finland and the Baltic countries. Foreign small and mid-size companies appear to be prosperous in the Russian market due to their agility and simple business plan. Multinationals are challenged by bureaucracy and credit worthiness issues.

Needless to say that writer is indemnified, should any of above ever happen. Each scenario case would carry its consequences for the containerized cargo market across the Baltic Sea. In order to fight against complexity of unpredictable business environment we might learn to keep four alternative futures on table at all times. Static forecasts belong to history. The essence of foreseeing is the power question 'what if?'

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Author has been involved in container shipping in Finland and the Baltic countries since 1991; primary experience in general management and sales.

EU and Russia – are there limits to "common values"?

By Wolfram Schrettl

When browsing through documents produced in Brussels on the topic of Russia, it's not hard to encounter the notion of "common values" – i.e. values supposedly shared by Russia and the EU. That is no less true for the attitudes harbored by the German government in its bilateral dealings with Moscow. Just take a look at any speech of Frank-Walter Steinmeier, Germany's foreign minister, on the relations between his country and Russia, and it's easy to see that he is routinely reiterating the mantra of "common values". As to Russia itself, President Dmitri Medvedev, in a recent speech also elaborated at length on the theme, with democracy figuring prominently as "the way forward", and with a number of other values, to which both Brussels and Berlin would subscribe, added.

Unfortunately, reality in Russia is brimming with evidence that clearly demonstrates the country's ubiquitous difficulties in living up to those high standards. More often than not, however, those difficulties are dismissed, in Russia as well as abroad, as being of a transitory nature ("birth pangs"). Russia, so it is said, just needs to be given a fair opportunity to straighten things out, i.e. time and patience are all that is required.

It may be appropriate to ask whether such an optimistic view is really justified, even more so as a puzzle comes in its way: Why is it, so one may ask, that the Russian regime, as represented by both Prime Minister Putin and President Medvedev who are both enjoying, according to all available opinion polls, unprecedentedly high popularity ratings (still further increased in the wake of the Georgia expedition), seems to take an ever more authoritarian turn. One would be inclined to expect the opposite, i.e. that the increased popularity would allow the regime to feel a little more comfortable and self-confident and, therefore, to relax somewhat, to loosen its grip on society. The unpleasant reality is that the regime seems to be quite disinclined to follow such a path.

What could be the reason(s) for the seemingly contradictory development? One conceivable explanation might be found in the regime's expectation that the windfall gains from the recent run-up in energy prices may not last forever. Therefore, the authoritarian tightening would have to be interpreted as a precautionary measure aimed at warding off possible difficulties, social disruptions and the like, if and when the economy takes a nasty turn. In retrospect, this argument does not seem to be entirely misplaced. It rather suggests that the regime's inner circle is dominated by quite realistic minds, not dreamers or anything similar. If correct, then this version would meet the expectations held by most observers after all. But energy prices will most likely rise again eventually, so the whole argument may not be valid in the long run after all.

A second conceivable factor that might help to explain the authoritarian turn is less dependent on the business cycle nor, more specifically, on the price of crude oil. It is rather of a more long-run, if not permanent, nature. Let us first recall that Vladimir Putin, when still President, saw in the disintegration of the Soviet Union "the greatest geopolitical disaster of the 20th century". He, together with practically all other representatives of the regime, left no doubt that such a "disaster" would not be allowed to repeat itself with respect to the Russian Federation. Indeed, the degree of internal heterogeneity – ethnic, cultural, religious, to name just the most important aspects – within the Russian Federation is such that aspirations towards independence do not come as much of a surprise.

Now, the strengthening of "vertical power" within the Federation can be seen as precisely one key instrument intended to suppress all rumblings in the direction of independence or separatism. Of course, "vertical power" as interpreted and implemented in Russia is quite at odds with the notion of democracy as understood by those Western politicians who are invoking a solid base, in the form of "common values", for EU-Russian relations. Moreover, the key factor preventing Russia from living up to the standards implied in the western concept of democracy, i.e. the internal heterogeneity of the Russian Federation and thus the challenges to its territorial integrity, will not go away in the foreseeable future or, more precisely, as long as the Russian Federation exists in its present form.

Thus, to sum up, we offer the following proposition: As long as the Russian Federation exists in its presents form, it will, due to its sheer size and, more importantly, heterogeneity, face considerable challenges to its "territorial integrity". At the same time, Russian authorities are united in their determination not to let the Russian Federation disintegrate in the same way as happened to the Soviet Union or, earlier, the "Eastern bloc" (Council of Mutual Economic Aid etc.). In view of that goal, it appears only logical for authorities to keep democratic developments within narrow enough bounds so as to nip any aspiring independence or separatist movements in the bud. Thus, for example, the Russian Federation is quite unlikely ever to tolerate aspirations towards putting the independence of some of its constituent parts up to a popular vote, such as Canada is experiencing every once in a while in the case of Quebec. Therefore, while Russia may go a long way in the direction of democracy, there continue to exist, even in the long run, some clear limitations, "objective" limitations, as some of our Russian friends would call them, to the aspired "common values". These limitations are unlikely to be overcome, no matter how much "patience" the West may decide to extend. Nevertheless, they do not seem to bother the romantic speech writers both in Brussels and in Berlin very much. This could be because they are just naive or because they are very diplomatic and polite. Whatever it may be, let us hope that the continued, yet in a key respect rather futile, insistence on common values, does not matter much in practice.

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Why are economies of Estonia and Iceland different?

By Urmas Varblane

During the last quarters of global financial turmoil Iceland has been in the middle of attention. Pressure in international markets and the loss of confidence in Iceland's financial system caused nearly collapse of its banking system in October 2008. Difficulties of Iceland provoked also interest of world press and economic analysts to the other small and open emerging economies. Baltic countries were rapidly taken as the target of close attention in order to find similarities with Iceland and forecast rapid deterioration of Baltic economies up to the devaluation of their currencies. Therefore current article is going to analyse similarities and differences between economies of Iceland and Estonia in order to evaluate how reasonable is to treat those economies facing same economic problems.

The size and importance of the banking sector in the economy. The Estonian banking system comprises four large Scandinavian groups (Swedbank, SEB, Nordea, Danske Bank). Their combined market share amounts to 95% in respect of both the bank loans and customer deposits. The Estonian banking sector is thus closely integrated into the Scandinavian and European markets and the responsibility for the banking sector viability is a joint effort of Scandinavian and Estonian authorities. Estonian Bank has set high reserve requirement (15% of total liabilities), which commercial banks should keep by Estonian bank. It is significantly higher than requested in EU or Iceland. This policy has created sizable domestic liquidity buffer of the banking system, which amounts to nearly 30% of customers' deposits (Estonian, 2008). In Estonian case the total external indebtedness (including household, firms, public and banking sector) has reached to level of around 110 percent of GDP in 2008. Iceland allowed to develop the banking system, which was far too big relative to the size of the economy. After the completion of the banking sector privatization in 2003, the Icelandic banks relied on the availability of ample foreign funding to rapidly expand abroad and increased their assets from around 100 percent of GDP to being worth close to 1000 percent of GDP in mid 2008. At the same time, gross external indebtedness reached 730 percent of GDP in the first half of 2008, largely on account of the banks.

The exchange rate systems. Estonia has used fixed exchange rate system - initially toward German mark and to euro after creation of EMU, since the monetary reform in 1992. Estonia is using currency board arrangement, which reminds in some sense gold standard. The principal features of the Estonian currency board are 100% backing of base money with foreign reserves, fixed exchange rate regime toward euro and complete convertibility of Estonian kroon. According to the legislation, the Bank of Estonia has no power to devalue the Estonian kroon. Any change in the exchange rate of the kroon leading to devaluation against the euro must first be approved by the Parliament. Therefore in Estonian case the devaluation could never used suddenly. Iceland is using flexible exchange rate system and therefore in the current crisis the devaluation of krona started immediately. Within a week after the collapse of three major commercial banks of Iceland (Glitnir, Landsbanki,Kaupthing) the króna devalued over 70 percent. Fighting against devaluation is costly and for the Icelandic small central bank almost impossible to execute alone. It requires extraordinary measures like the restrictions on capital outflows.

Public debt and stabilization reserves. Estonian government has followed extremely conservative policy concerning public debt creation. The external debt of Estonian government sector is only 3.5 % of GDP, which is the smallest in EU. Within the last seven years state budget has been in surplus, which was used in order to create significant reserves in various forms: stabilization reserve deposited abroad, pension and health insurance reserves, unemployment support funds etc. The total volume of public sector reserves are 25-27 bn. EEK or around 11 % of GDP. Reserves allow Estonian government to cover budget deficit, which is unavoidable in 2008 and 2009 due to the rapid weakening of demand at home and by all major trading partners. Important support between 2007 and 2013 are investments from the EU structural funds in total volume of around 3.6 bn. EUR into Estonian infrastructure, education, retraining of labour etc. This is very important fiscal stimulus, which helps Estonian economy to come back into growth track earlier. Icelandic government has been also quite conservative in public debt formation. Between 2005 and 2007 public budget was in surplus and government succeeded to reduce debt. But due to the mismanagement of banking sector Iceland is facing need to execute one of the most expensive bank restructuring that the world has ever seen relative to the size of the economy. Extremely large budgetary cost will be related to the need to fulfil the deposit insurance obligations to depositors in foreign branches of Icelandic banks. According to the recent expectations around 85 % of GDP of Iceland is needed. Public deficit is rising from about 3.5 percent of GDP in 2008 to about 8.7 percent of GDP in 2009 (Andersen, 2008). In short run Icelandic government was supported by the IMF Stand-By Arrangement. But in the medium run it is unavoidable to increase taxes in order to finance rapidly growing public debt.

As a conclusion several points could be outlined, which are supporting idea that economies of Iceland and Estonia are with different degree of financial stability. Estonia has been much more conservative in banking sector management. Additional support creates deep integration into Scandinavian financial market through foreign owned banks. Following fixed exchange rate to euro and using currency board system defends Estonian currency from speculative attacks. Problems of Estonian economy are located in the real economy, which is going through the next round of restructuring. In this framework the key issue is how flexible is Estonian real sector to adjust to the changes in the marketplace.

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Priorities of business for the EU's Baltic Sea Strategy

By Filip Hamro-Drotz

The Baltic Sea Region and cooperation within this area are particularly relevant issues right now. In addition to the traditional cooperation between Baltic Sea States, the European Union is preparing its own Baltic Sea Strategy. This strategy will be highly significant, as it will further anchor regional co-operation within Northern Europe to the European Union.

For business it is important that a strategy is formulated that is both clear and focused, and that it is applied during 2009. The main goals of the EU's Baltic Sea Strategy should include **improving competitiveness in the region**. This aspect would spur EU's efforts to successfully implement the Lisbon strategy aiming to a better competitiveness of Europe globally. According to analysis by Mr Timo Laukkanen, an expert at the Confederation of Finnish Industries EK, improving competitiveness can be enhanced in the following ways.

Business-friendly administration

Companies require clear regulations and official guidelines that understand the needs of business. They also require better customer-focused consultation and accurate information in advance about is-sues such as customs, competition, taxation and the environment. Electronic services should be further developed in the areas of financial reporting, employer responsibilities, the application of environmental legislation and the protection of immaterial rights and patents.

The costs and benefits of regulations affecting business must be carefully assessed. In many cases self-regulation, such as Corporate Governance recommendations, could be used instead of judicial acts. The legal system must also be able to resolve disputes rapidly and efficiently.

Freedom of trade and investments

The freedom and effectiveness of imports, exports, subcontracting and investments are important success factors for companies operating in the Baltic Sea Region. The trade policies of Baltic Sea States should be based on a consistent commitment to actively promoting the freedom of trade and investments.

Identification and removal of restrictions to trade and investments

The Business Advisory Committee of the Council of the Baltic Sea States (CBSS) has proposed that the CBSS appoint a broadly recognised person or persons to clarify existing restrictions to trade and investments in the Baltic Sea States to draw up proposals for removing these restrictions. The Nordic countries successfully implemented a similar programme in 2003-2005 under the leadership of former Danish Prime Minister Poul Schlüter.

Economic integration with Russia

When preparing the EU's Baltic Sea Strategy care must be taken to ensure that the project does not alienate Russia from Baltic Sea co-operation or even erode the benefits of tighter economic cooperation between the EU and Russia in the Baltic Sea Region.

It is therefore important to connect the new Baltic Sea Strategy to the Northern Dimension that was renewed in 2006 and to recognise Russia in other ways. It is also natural that cooperation with Norway is recognised.

Sensible economic policy and a common currency

Weakening economic growth and high inflation highlight the importance of a sensible economic and stable currency policy. The expansion of the eurozone within the Baltic Sea Region has not proceeded as could have been expected. Especially in the Baltic countries, companies have to pay serious attention to the stability of their currencies and managing risks, which creates uncertainty and increases costs.

Functional labour markets

Ensuring the availability of labour requires a rapid strengthening of work-based immigration policies in the entire Baltic Sea Region. This holds true even in the current situation whereby the deceleration of economic growth is increasing the availability of labour.

At the same time, the relationship between work and workers should be further facilitated. A lot of work has to be done to abolish incentive traps, or disincentives to work, as well as to ease domestic and international migration and increase the production of reasonably priced housing.

Extension of free competition to traditional public sector tasks

The extension of free competition to tasks that have traditionally been handled by the public sector has become increasingly important. The experiences that have already been gained in this area demonstrate that the use of private sector services offers plenty of opportunities to improve the efficiency of these tasks. At the same time, tendering services requires increased expertise among purchasers, and this should be focused on sufficiently.

Modern infrastructure as a key to success

Long distances require a strong focus on improving infrastructure and reducing logistics costs, which in the Baltic Sea Region are high compared to elsewhere in the world. For example, the logistics costs of Finnish industry are one-third higher than those of companies in Central Europe.

The Baltic Sea States should increase cooperation in order to accelerate the implementation of TEN and other key transport corridor projects. It is also important to speed up the implementation of lower-cost improvements, such as improving maritime safety and electronic customs clearance for Russian transports.

Reasonable sustainable development

The protection of the Baltic Sea requires more action in areas such as reducing agricultural emissions. Special conditions for reducing air emissions from ships in the Baltic Sea must not create unreasonable extra costs for companies in the Baltic Sea Region.

Pioneering work that has been carried out by Finland before other EU States to protect the climate has partially turned against us. Efforts must be made to ensure that unreasonable costs are not created for industry due to demands for even further reductions in emissions. In addition, the availability of reasonably priced energy must be safeguarded before new industrial investments can be made.

Ensuring high levels of expertise

In order to strengthen existing clusters and to promote new business activities, the Baltic Sea States should improve cooperation in the sphere of education in order to ensure the availability of more competitive experts. The methods for identifying and acknowledging unique areas of expertise in different countries must be improved to facilitate the free movement of labour.

Student, teacher and research exchanges between universities are a natural form of cooperation. In Finland the Ministry of Education is currently preparing an internationalisation strategy for universities. Many other projects within the EU are also promoting the internationalisation of education and increase of cross-border cooperation.

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Estonia's economic development – trends, practices and sources

By Rünno Lumiste, Robert Pefferly and Alari Purju

The article is an overview of the case study written for the Commission of Growth and Development, formed in the framework of the World Bank. The Commission on Growth and Development was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth, and second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. To help explore the state of knowledge, the Commission invited academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

A case study of Estonia looked to uncover the causes that have created a development pattern based on very open and liberal economic policy arrangement. Another research topic of the case study concerns the role of external anchors upon economic development; that is, mandates that reflect the values, objectives and aims of a socio-economic alliance, and which also framed Estonia's economic policy.

Estonia is an example of an open economy whose development and growth is based largely on foreign trade and FDI. Analysis of economic growth, the role of the FDI in capital accumulation, and the role of foreign trade in expanding the markets and internationalizing economic activities demonstrated the close and important linkages between them. In addition, a feeling of stability is required for FDI to be a continuous flow instead of shocking increases and decreases, and that is where external anchors assist the market—by providing stability.

Estonia's transition to a market economy has been enhanced by integration with the EU. This was very important in the evolution of institutions in the decade before Estonia joined the EU in 2004. After accession, Estonia became a participant in the general deepening and widening process of the EU, which included development of more integrated markets and associated institutions in the country, and improved capacity of economic agents for adjusting to market competition.

The EU integration process, membership in the WTO, and cooperation with the other international organizations such as the World Bank and IMF played an important role in creating and supporting a private sector–based, liberal market economy. Implementation of the rules, standards, and norms of the Single Market helped to increase the competitiveness of Estonian companies by removal of cost-creating barriers and thus improving market access. These international agents certainly functioned as external anchors.

Those trends were related to institutional and structural changes as well as true restructuring of the infrastructure of the economy. Rapid but positive and proactive change with a determined government bred opportunity, and institutional changes ensured access to new markets. With free trade agreements, active relations with new foreign trade partners, the implementation of quality control systems, and enhanced production methods acceptable in foreign markets, structural changes were manifested in the adoption and formation of companies producing high-quality goods and services that could be marketed despite increased domestic production costs.

Estonia is still a middle-income country. For future development and reduction of the income gap with high-income countries, further structural changes are necessary. To that end, what new activities could help create economic growth? The ITC sector and new services associated with the sector could be one source of growth. This invites wider questions: are values related to high-tech industries and the results of information-based innovation external anchors? A critical factor for future development and structural change is moving from a transition economy to an innovation economy.

To help answer these questions the development of Skype and its applications from an Estonian perspective is an interesting topic for discussion. Skype is telecommunication technology that also makes possible a much wider impact of new telecommunication technology on society. It is too early comprehensively assesses the impact, but new telecommunications technology has definitely influenced the preferences of the younger generation regarding societal behavior and working habits and tools. That could change the economy and society just as when the train and car allowed for fast, low-cost, and on-demand personal transportation. And economic knock-on effects—such as the liberalization of data to a cheap, mobile, and immediate medium—will have unknown economic and social consequences.

As with most economic evolutions, establishing a linear cause-effect relationship is moot given the interconnectivity between human behavior and economic development. That said, there is clear empirical evidence that location, production, technology, and timing along with external anchors are catalysts for change. Yet, just as a chemist creates a complicated solution by mixing and stirring chemicals, if the necessity ingredients are not present in their proper proportions at the proper time, then results strongly vary. For example, Skype would not have been possible just a few years ago even with similar circumstances in Estonia. Without powerful computers of the required world-wide infrastructure to transfer large amounts of data as well as the lessons learned from Kazaa, another Voice over Internet Protocol (VoIP) from another country would have been the success story of choice.

Like a pendulum, economic forces oscillate, but regardless of the situation, economic fundamentals are as important, such as "being in the right place at the right time." External anchors are an important catalyst to this process, but as a catalyst, a reaction requires the necessary ingredients in place.

All the papers of the Commission on the Growth and Development are available on the address http://www.growthcommission.org.

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Virtual Baltic Development Agency – a network for international links and investment spillovers in BSR[1]

By Jacek Batóg

The development of the Baltic Sea Region is suffering from large economic and social differences, cultural barriers, different languages and different business structures. Therefore there is a need for activities which are directly focusing on overcoming some of these differences by close cross-national cooperation between three sectors important for sustainable spatial development: business schools (universities), regional development agencies (RDAs) and small and medium-sized enterprises (SMEs).

The main problems related to such a triple helix include among others:

- how to attract the firms in the BSR to do more transnational business?
- how to encourage the BSR national business support organizations to form clusters for the exchange of knowledge and information?
- how to consider new and specific market integration problems between Eastern and Western Europe related to the promotion of exports and imports?
- how to organize specific training for SME's employees in the areas of entrepreneurship/management, development of venture/risk capital mechanism and international network building?

The Virtual Baltic Development Agency (VBDA), established in the Baltic Business Development Network (BBDN) project carried out in the years 2005-2007 by 15 institutions (universities, business schools, RDAs, chambers of commerce) from 8 countries from the Baltic Sea Region: Denmark, Estonia, Finland, Lithuania, Latvia, Germany, Poland and Sweden (Lead Partner), is a good example of networking of the institutions promoting international cooperation oriented at attracting foreign investment and the development of international commerce. The project was realized within the INTERREG BSR III B Initiative and consisted of 5 working packages:

1. WP1 (implementation of the VBDA structure and its presentation).
2. WP2 (preparation of the organizational structure of Baltic Business Service Centres – main parts of the VBDA - and development of their services offered to SMEs).
3. WP3 (creation of internal business processes within the VBDA as well as common standards for the BSR marketing and business plans).
4. WP4 (development of a CBT-course "Business Guide to the Baltic Sea Region" as background information about business structures in the BSR).
5. WP5 (a comparative study of the regional business structures and their links within the BSR).

The project's objectives were to promote a closer cooperation among BSR countries, both traditional market economies and emerging transition economies, to strengthen the competitiveness of the SME sector. The major objective was to establish a Virtual Baltic Development Agency based on the cross border network linking together different institutions from partner countries. The task of the VBDA was to promote the BSR among institutions and companies outside the BSR in order to attract foreign investments but mainly to support the transnational and trans regional entrepreneurship within the BSR. Nowadays, the Agency can offer a wide array of services to SMEs in regional access points called Baltic Business Service Centres. These Centres are run by the RDAs in cooperation with business schools (universities), enabling the SMEs to communicate in their own language and in their regional environment. The regional BBSCs are linked via the BBDN network and the necessary information is tunneled to the target region using the IT-infrastructure and templates available in English. This new network provides also training schemes for students valid in the whole BSR, building up equal knowledge about business structures and rules.

Baltic Business Service Centres operate in 6 countries: Estonia, Finland, Latvia, Germany, Poland and Sweden. BBSCs provide among others information about the political, economical, legislative and cultural environment in the BSR, ways of doing business, market structure and practices, product guidance and support regarding technical requirements as well as questions related to protection of products' patterns and designs. In this range of advisory services they offer market, demand and competitor analyse, as well as partner, subcontractor or supplier matching.

In order to be competitive in the market and to have the ability to adjust the strategy and profile in the fast-changing economic environment, it has become vital for companies to provide a new knowledge for their employees. Therefore the CBT-course developed by WP4 provides the practical information to optimize the international business activities of a company. Furthermore, the CBT-course is intended to be a self-study product allowing especially employees to improve their skills and knowledge. It was designed in a way that each of the topics represents a separate and independent learning unit. The idea behind that was to formulate modules that can be independently implemented in different seminars.

Since the research and activities undertaken within the framework of the project point out significant needs of firms for international services it seems that in the future the VBDA could become the essential element of creating of the cooperation between firms in the Baltic Sea Region. It is worth to mention here that the project activities were accompanied by additional synergy effects. Among these effects one could name international conferences on "Baltic Business Social and Economic Development" (BBSED) organized by four partners in Wismar, Szczecin, Tallinn and Riga. The organization of this type of events is a very good example of a positive influence of the European Union programs (for example the INTERREG Initiative), within the range of creation of international research and business connections raising the competitiveness of the European Union economies.

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[1] Some parts of this text are taken from project website and project application form.

Paul Krugman and the Baltic Rim

By Mika Widgrén

Perhaps the main reason why this year's Nobel prize in economics was awarded to Paul Krugman, currently at Princeton University, is the development of the so-called 'new trade theory' in the early 1980s. Although 'new trade' is not a teen-ager anymore, it still has in its various extensions the major role in international trade theory. It also plays a key role in the Baltic Sea Region.

The 'old trade' á la Ricardo and Heckscher & Ohlin is based on the idea of comparative advantage. It means that countries specialize in goods that they are able to produce relatively productively. If a country is relatively efficient in producing a group of goods there must another group of goods in which the country is relatively inefficient and other countries, on the other hand, relatively efficient. Efficiency indicates specialization which, in turn, net exports. The major implication is that trade takes place between different countries that are good in different things.

But, a quick look at trade statistics already some 40 years ago revealed something else. The bulk of world trade took and takes place between very similar countries with relatively similar income levels and industry structures. Consequently, the major part of world trade is intra-industry, not inter-industry, trade. This contradicts with the 'old trade theory'. Forty years ago there was simply no theoretical explanation for this phenomenon. Paul Krugman invented that.

The idea is simple. Firms differentiate their goods since doing so they can avoid competition. The other side of the coin is, however, that consumers love variety, which limits firm ability to gain from differentiation. Moreover, the number of varieties is limited with market-size. As consumers are better-off with greater number of varieties – love variety – the bigger the market even more the consumers are better-off.

This is bad news for Baltic Rim if we take the area simply in isolation of global economy or the EU's Internal Market. Of course, the Baltic Rim is not in isolation of the rest of the EU but, still, it is a peripheral area. Distance matters even in globalized world economy since it induces trade costs, no matter how big or small. Due to trade costs it is profitable for firms to locate their supply close to demand. This is again bad news for the peripheral Baltic Sea Region.

This example also leads us to second major contribution of Paul Krugman that made him Nobel Laureate in economic science in 2008, namely the new economic geography. Above illustration is an example of the so-called core-periphery model. Suppose that the Baltic Rim plays the role of the periphery and the big Central-European EU countries the role of the core.

The logic of the core-periphery model roughly states that as far as there are trade costs that agglomerate firms and economic activity to the core since it is cheaper to sell to the home market than to export. When trade costs vanish location becomes less and less important since home market sales and exports are at equal footing. This makes peripheral areas more attractive since firms face less fierce competition there without suffering from export costs to the core. In particular, this means that deep economic integration benefits peripheral areas like the Baltic Rim.

New economic geography does not only look at the Baltic Rim as a peripheral region in world economy. It also gives tools to analyze the links between the firms within the region. These ideas also stem from 'new trade' and, in fact, formalize the old idea of the pin-factory á la Adam Smith. A pin as a final good consists of several intermediates that can be produced in one or several locations. The exact location of producing particular intermediate depends on costs and productivity. It is highly unlikely that one location could, in terms of efficiency, beat the other possible locations in producing all intermediates. Therefore intermediates' production tends to spread to several locations.

But distance matters. Therefore, intermediates' producers have incentives to be located close to the final good producers since they form their demand. This is often referred to as 'forward linkage'. On the other hand, final good producers have incentives to be located close to intermediates' producers since they form their supply. This is referred to as 'backward linkage'. The linkages tend to strengthen each other and this has significant impact on industry location. It also has an interesting and maybe surprising implication to the structure of trade: the bulk of world trade is trade in intermediates, not final goods.

Baltic Rim is full of these linkages. A good example is production of components to Nokia mobile phones in Estonia but there are others too. This strengthens the Baltic Rim as a true economic area that works like this years' Nobel Laureate in economics has theoretized.

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