Baltic Rim Economies

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

ISSUE NO. 1, 27 FEBRUARY 2009

ECONOMIC REVIEWS:

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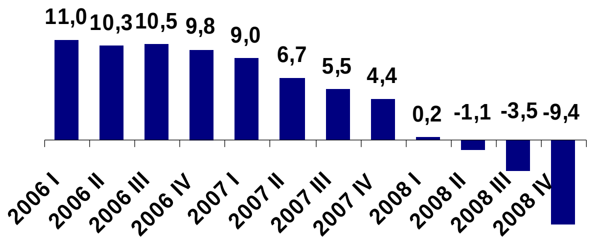
Estonia

Economic crisis steepens

GDP decreased by an astounding 9.4% in the last quarter of 2008 y-o-y according to flash estimations by Statistics Estonia, The Estonian economy has thus suffered a decrease in its GDP for three quarters in a row now and the fall is getting steeper every quarter. The main cause for the decrease of GDP was due to the steep decrease in the value added of economic activities of the industrial sector, particularly manufacturing. This was caused by small domestic demand as well as the decrease in exports of manufactured products. In addition, for the third quarter in a row, the decrease in the value added of financial intermediation accelerated.

Real growth rate of GDP by quarters in 2006- 2008 (y-o-y, %)



Source: Statistics Estonia

Despite common uncertainty, the outlook for the Estonian economy is still gloomy. The Bank of Estonia predicts a decrease of 5.5% in 2009. However, depending on the economic situation of Estonia's trading partners, the fall might even be 9%. Nordea bank, in turn, forecasts a decrease of 4.5% in GDP in 2009 and a continuing downtrend in 2010.

The data of Statistics Estonia shows that industrial production decreased by a total of 6.5% in 2008 compared to 2007. The decline of industrial production y-o-y began in March earlier that year and was steepest during the last quarter of 2008. Industrial production fell by 12% in October, by 17% in November and by 21% in December. The steepest production fall in 2008 was in building materials (-28%).

The decrease in GDP and industrial production has influenced the unemployment figures and public sentiment. The unemployment rate, which had remained on a 4%-level for the first half of the year, increased with great speed in the second half of the year rising to the highest level in the fourth quarter, 7.6%. The economic downturn has had a grim impact on public sentiment as well. A survey conducted among Estonians in November showed that 80% of the respondents thought that the economic situation had worsened notably or at least, to some degree.

Real-estate transactions still decreasing

The Estonian real estate market has been in serious trouble in 2008 and according to Statistics Estonia, the problems have persisted in the 4th quarter of 2008. The total number of purchase-sale contracts has decreased by more than a third y-o-y and by 13% compared to the previous quarter. In addition, the total value of the contracts has decreased by almost a stunning 50% y-o-y and by over 20 % compared to the previous quarter.

Inflation decreases sharply

The increase in the consumer price index was 4.1% in January y-o-y according to Statistics Estonia. The annual index was mainly influenced by the price increases of housing which accounted for a half of the price rise. As earlier, the rising prices of heating energy were, for the most part, responsible for the price rise in housing. The index was also strongly influenced by price increases in alcohol and tobacco and by the price of motor fuel which has decreased significantly since January 2008.

The index decreased -0.6% in January compared to the previous month. Some major contributing factors to the decrease were the price decreases of transport (-4.1%) and clothing and footwear (-5.0%). The long risen food prices stayed at the same level as in December (0.0%).

Change of the consumer price index in selected commodity groups in January 2009 (y-o-y, %)

Commodity group	*y-o-y*	*Previous month*
Food and non-alcoholic beverages	2.8	0.0
Clothing and footwear	0.5	-5.0
Housing	13.3	0.4
Transport	-9.8	-4.1
Hotels, cafés and restaurants	7.8	0.0
TOTAL	4.1	-0.6

Source: Statistics Estonia

According to the Bank of Estonia, it is likely that inflation will continue its strong decrease. This is supported by the decline in domestic demand and the steep fall in food and oil prices. The Central Bank is forecasting in its base scenario a very moderate inflation rate for this year (2.0%) and next year (0.3%)

Some business highlights

- Airline company SAS announced its plans to focus on the Nordic market and sell several of its subsidiaries. SAS has already sold its stake in airBaltic and has announced that Estonian Air is also for sale.
- Energy company Eesti Energia's profits were up by over 20% during the first 9 months of the financial year 2008/2009. The net profit was EUR 49 million and the operating income for the same time period equalled EUR 485 million.

Estonia - main economic indicators	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**as of**
GDP (y-o-y %-growth, constant prices)	6.5	8.0	7.2	8.3	10.2	11.2	7.1	-9.4	n/a	Q4/2008
Industrial production (y-o-y %-growth)	8.9	8.2	11.0	10.5	11.0	7.3	6.1	-6.5	n/a	1-12/2008
Inflation (CPI, end of period, y-o-y %-change)	4.2	3.6	1.3	3.0	4.1	4.4	9.6	10.4	4.1	1/2009
General government budget balance (% of GDP)	0.3	1.5	2.0	2.3	2.3	3.8	2.8	n/a	n/a	1-12/2007
Gross wage (period average, EUR)	352	393	430	466	555	596	784	838	n/a	Q4/2008
Unemployment (% end of period)	11.9	11.3	9.3	8.5	7.9	5.9	4.7	5.5	n/a	1-12/2008
Exports (EUR million, current prices)	3698	3642	4003	4770	6190	7647	8028	8454	n/a	1-12/2008
Imports (EUR million, current prices)	4798	5079	5715	6704	8213	10576	11278	10872	n/a	1-12/2008
FDI inflow (EUR million, current prices)	603	307	822	775	2255	1341	1817	783	n/a	H1/2008
Current account (% of GDP)	-5.6	-10.6	-11.6	-12.5	-10.5	-14.8	-17.4	-7.5	n/a	Q3/2008

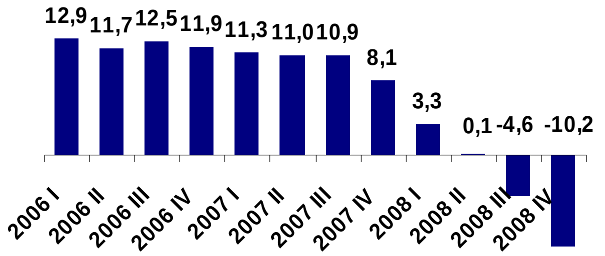
Sources: Statistics Estonia, Bank of Estonia, Eurostat, author's calculations

Latvia

Crisis deepens - GDP decreases over 10%

The Latvian GDP decreased by -10.2% in the last quarter of 2008 y-o-y according to the Central Statistical Bureau of Latvia. The Latvian GDP is now decreasing roughly at the same pace as it increased during earlier years and is now also suffering from a worse GDP decrease than its Baltic counterparts Estonia and Lithuania.

Real growth rate of GDP by quarters in 2006 – 2008 (y-o-y, %)



Source: Central Statistical Bureau of Latvia

Projections regarding the future of the Latvian economy are both grim and uncertain. The Central Bank's GDP forecast for 2009 is still -5.0%. Factors behind the projection are, among other things, weakening consumption and investments and worsening confidence as well as uncertainty regarding the global economy. However, these projections might very easily be revised downwards. In line with the Central Bank, Nordea bank forecasts a similar decrease of 6.0% in GDP in 2009 and a continuing downtrend in 2010.

Industrial output decreased by almost 7% in 2008

The data of the Central Statistical Bureau of Latvia shows that industrial production decreased by 6.5% in 2008 compared to 2007. The decrease was mostly caused by the decrease in the output of manufacturing (-11.1%). The most significant decreases in manufacturing sub-sectors were found in the manufacturing of furniture (-29.8%), the manufacturing of machinery, mechanisms and equipment (-16.5%) and thirdly, the manufacture of rubber and plastic products (-15.9%). Mining and quarrying, however, showed an increase of 2.4% on a yearly basis.

Imports diminish 15% in December

The value of exports increased by 11.1% and the value of imports decreased by 15.2% in December 2008 y-o-y according to the Central Statistical Bureau of Latvia. The largest increase in commodity exports was, as in November, in agriculture (35.1%) and in products of chemical and allied industries (19.1%). Exports in wood and wood products still decreased and went down by 39.3%. Exports in base metals and articles of base metals fell by 39.0%. The largest increase in imports was in products of the chemical and allied industries (12.0%). The decrease in imports of wood and articles of wood (-63.0%) and transport vehicles (-43.7%) continued.

In December 2008 compared to the previous month, exports decreased by 4.6%. However, imports rose by 0.4%. The largest increase in commodity exports was in agricultural and food products (17.6%) and products of the chemical and allied industries (10.2%). The largest decrease in exports was in wood and wood products which fell by 24.2%. The largest increase in commodity imports was in base metals and articles of base metals (22.8%). The largest decrease in imports was in textiles and textile articles (-17.2%).

High inflation continues to diminish

The Central Statistical Bureau of Latvia reports that the consumer price level in January 2008 increased by 9.8% compared to January of the previous year. As in previous months inflation continues its gradual decrease although still remaining at a high level. The price increase of housing, water, electricity, gas (35.9%) was still the biggest. Education has increased by 23.1%. However, the price level of communication has decreased by 5.3% and transport by 5.2%. The price level in January compared to the previous month increased by 2.2%. The price increase of alcoholic beverages and tobacco (4.9%) was the biggest. However, the price level of clothing and footwear has decreased by 5.8% and transport by 0.5%

According to the Bank of Latvia forecast in January, weakening demand lower energy prices will contribute to a further decline in inflation. The Central Bank projects that the Latvian inflation rate could be close to the current low inflation level of Western Europe by the end of this year. Thus, from an inflation point of view, introduction of the Euro might be possible as early as in 2011.

Some business highlights

- Scandinavian Airlines (SAS) has continued the sale of its subsidiaries by selling its share in airBaltic. The 47.2% stake was sold to the Executive Director of airBaltic but the exact sum has not been made public. The Latvian government still owns a 52.6% share of the company.
- The amount of bank loans has decreasing in Latvia. The total loan balance decreased by 1.1% from November to December totalling EUR 27 billion.

Latvia - main economic indicators	2001	2002	2003	2004	2005	2006	2007	2008	2009	as of
GDP (y-o-y %-growth, constant prices)	8.0	6.5	7.2	8.5	10.6	12.2	10.3	-10.4	n/a	Q4/2008
Industrial production (y-o-y %-growth)	6.9	5.8	6.5	6.0	5.6	4.8	0.5	-6.7	n/a	1-12/2008
Inflation (CPI, end of period, y-o-y %-change)	3.2	1.4	3.6	7.3	7.0	6.8	14.1	15.4	9.8	1/2009
General government budget balance (% of GDP)	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	n/a	n/a	1-12/2007
Gross wage (period average, EUR)	282	297	298	314	350	430	683	678	n/a	9/2008
Unemployment (% end of period)	12.9	11.6	10.3	10.3	8.7	6.8	5.4	6.3	n/a	Q2/2008
Exports (EUR million, current prices)	2232	2416	2559	3204	4085	4594	5727	6202	n/a	1-12/2008
Imports (EUR million, current prices)	3910	4284	4634	5671	6879	8828	10986	10534	n/a	1-12/2008
FDI inflow (EUR million, current prices)	n/a	223	248	489	568	1324	1797	1177	n/a	1-11/2008
Current account (% of GDP)	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-22.8	-12.6	n/a	Q3/2008

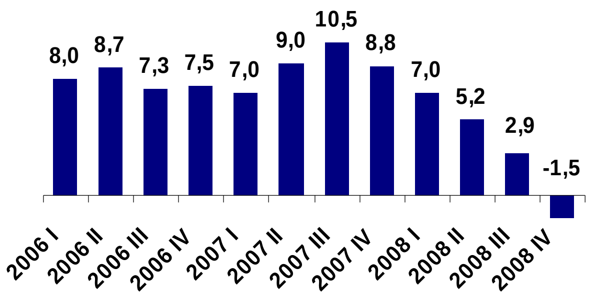
Sources: Central Statistical Bureau of Latvia, Bank of Latvia, Eurostat, author's calculations

Lithuania

GDP decreases now in all the Baltic countries

According to the first estimate by Statistics Lithuania, the GDP in 2008 increased by 3.2% compared to 2007. However, the fourth quarter GDP growth decreased by 1.5% compared to the corresponding quarter of the previous year. In the fourth quarter gross value added was recorded only in construction and other services. Thus Lithuania is following other Baltic countries with a decreasing GDP in the second half of 2008 and having a contracting economy for the first time for almost a decade.

Real growth rate of GDP by quarters in 2006 – 2008 (y-o-y, %)



The Central Bank of Lithuania has in February adjusted its forecasts to a more unfavorable direction when compared to the projections made in October. Now GDP is expected to decrease by 4.9% this year (earlier forecast was +1.2%) and by 3.9% next year. In addition, the Central Bank also projects that domestic demand will continue it's slowing down. However, it is also projected that both inflation and the current account deficit will fall rapidly. Both imports and exports are expected to decrease but the decrease in imports is expected to be more pronounced. Nordea bank, in turn, has forecasted a decrease of 3.0% in GDP in 2009 and a continuing downtrend in 2010.

Foreign trade decreases in late 2008

The value of Lithuanian exports rose in 2008 by 28.4% compared to 2007, according to the non-final data of Statistics Lithuania. The total value of exports during that same time period was over EUR 16 billion. Respectively, the value of imports rose by 18.0% to EUR 21 billion. The foreign trade deficit was almost 7% smaller than in 2007 y-o-y.

Growth in exports in 2008 was mostly influenced by the increase in petroleum oils and oils obtained from bituminous minerals which rose by 2.5 times and by fertilizers (65.1%). The imports of crude oil and natural gas rose by 2.4 times and natural calcium phosphates and crude sulfur rose by 3.8 times. If mineral products are excluded, growth in exports diminishes strongly to little less than 12% and growth in imports diminishes to almost zero. However, in December 2008 y-o-y, exports decreased by 3.2% (4.0% excluding mineral products) and imports by 8.8% (17.4% excluding mineral products).

Inflation soars high

According to Statistics Lithuania the consumer price level in January 2009 increased by 9.6% compared to the January of the previous year. Thus the Lithuanian inflation is roughly on the same level as the Latvian inflation (9.8%) but significantly higher than the Estonian (4.1%). The price increase of housing, water, electricity, gas etc. (22.9%) as well as hotels, cafés and restaurants (14.7%) were the biggest. However, the price level of clothing and footwear (-6.0%) decreased. The rise in the price level in January compared to the previous month was 1.7%. The price increase of transport (8.2%) as well as housing, water, electricity, gas etc. (4.5%) were the largest. However, the price level of clothing and footwear (-5.3%) decreased.

The Central Bank of Lithuania has forecasted in February a diminishing inflation for 2009 and 2010. External factors such as the fall in oil prices and a globally weaker demand for energy and internal factors such as subdued domestic demand are contributing to a more moderate inflation development.

Change of the consumer price index in selected commodity groups in January 2009 (%)

Commodity group	*y-o-y*	*Previous month*
Food and non-alcoholic beverages	10.7	1.7
Clothing and footwear	-6.0	-5.3
Housing, water, electricity, gas etc.	22.9	4.5
Transport	0.4	8.2
Hotels, cafés and restaurants	14.7	1.2
TOTAL	9.6	0.5

Source: Statistics Lithuania

Some business highlights

- Swedish Foreign Minister Carl Bildt has estimated in February that a cable linking Swedish and Baltic energy grids could be a reality within 10 years. In the current situation Lithuania and Latvia have been competing for the underwater cable link from Sweden. For the time being, the Estlink cable between Finland and Estonia is the only major connection between the Nordic and Baltic grids.
- The United Kingdom authorities have barred Snoras, one of Lithuania's largest banks, from opening a branch in the country. The British authorities' were not satisfied with the level of cooperation with the Lithuanian bank.

Lithuania - main economic indicators	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**as of**
GDP (y-o-y %-growth, constant prices)	6.6	6.9	10.3	7.3	7.9	7.7	8.0	3.2	n/a	1-12/2008
Industrial production (y-o-y %-growth)	16.0	3.1	16.1	10.8	7.3	8.9	7.2	2.7	n/a	1-12/2008
Inflation (CPI, end of period, y-o-y %-change)	2.0	-1.0	-1.3	2.9	3.0	3.8	8.1	10.9	9.6	1/2009
General government budget balance (% of GDP)	-2.0	-1.4	-1.3	-1.5	-0.5	-0.3	-1.2	n/a	n/a	1-12/2007
Gross wage (period average, EUR)	274	293	311	335	421	459	594	672	n/a	Q3/2008
Unemployment (% end of period)	17.9	13.0	11.6	10.6	8.3	5.6	4.2	5.9	n/a	Q3/2008
Exports (EUR million, current prices)	4778	5526	6158	7478	9502	11250	12522	16074	n/a	1-12/2008
Imports (EUR million, current prices)	6767	7943	8526	9959	12446	15384	14341	21026	n/a	1-12/2008
FDI inflow (EUR million, current prices)	516	772	160	623	826	1448	1645	1025	n/a	1-11/2008
Current account (% of GDP)	-4.7	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7	-9.4	n/a	Q3/2008

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

Poland

January inflation decreased to 3%

The Consumer Price Index increased by 3.1% in January 2009 y-o-y according to the Central Statistical Office. As expected, the gradual deceleration of inflation has continued. The highest price increase was recorded, as in earlier months, in dwelling (up by 9.3%). Food, all beverages and tobacco products were up by 3.9%. The most notable decrease in prices was in clothing and footwear which were down by 7.0%. The price level in January compared to the previous month increased somewhat (by 0.5%). The highest price increase was recorded in dwelling (up by 1.9%) and the highest price decrease was found in clothing and footwear (down by 3.4%).

Change of the Consumer Price Index in selected commodity groups in January 2009 (%)

Commodity group	*y-o-y*	*Previous month*
Food, all beverages and tobacco	3.9	0.8
Clothing and footwear	-7.0	-3.4
Dwelling	9.3	1.9
Transport	-8.5	-2.7
TOTAL	3.1	0.5

Source: Central Statistical Office

According to the National Bank of Poland, the consumer price index has fallen a bit faster than expected in December. The decrease in inflation has been mainly caused by falling fuel prices although core inflation has also declined. The Central Bank forecasts that in the coming months inflation should gradually decline to the inflation target of 2.5%. However, the weakening value of the Zloty and possible further rises in administered prices could be conducive to price increases.

Exports up by 13% in 2008

Polish exports rose in value to almost EUR 115 billion in 2008 which is 12.5% more compared to 2007 the Central Statistical Office informs. Imports rose in value to almost EUR 140 billion in 2008 which is almost 16% more compared to 2007. Thus the trade balance deficit was some EUR 25 billion. Germany is still the most important trade partner for Poland despite a slight decrease in exports (share of all exports 25%) and imports (23%). France narrowly bypassed Italy as the second most important export country with a share of 6%. Russia held its position as the second most important country of imports with a share of 10%, up by one percent unit since 2007.

Economic growth still slowing down

The National Bank of Poland sees that there are factors contributing to a faster than previously expected slowdown in the GDP growth. These factors include weakening external demand on major Polish export markets such as the Euro area. There have also been indicators of deteriorating export markets in the results business climate surveys by the National Bank. The economic slowdown might contribute to a decrease in domestic demand by limiting household's consumption and possibly by reducing general government expenditure.

The industrial output figures for the year 2008 and the latest data on January 2009 form a downward trend. According to the data of the Central Statistical Office, industrial production increased by 3.5% in 2008 compared to 2007. This was a significantly lower than in 2007 when industrial output was up by 9.7%. Year 2002 was the last time when the increase in industrial output (1.1%) has been lower than in 2008.

However, in January 2009 y-o-y industrial production fell by 14.9%. The worst decline in the main sectors was in mining and quarrying which was down by 17%. The output was down in 26 of 34 industrial sectors. Manufacturing decreased by 15%. Particularly bad figures found in manufacturing sub-sectors were noted in basic metals (down by 40%) and in motor vehicles (down by 36%). On the other hand, some good performers were to be found as well, such as pharmaceuticals which were up by over 13% y-o-y.

Some business highlights

- Polska Grupa Energetycna (PEG), Poland's largest energy group, has published more details of its plans to build two nuclear power plants in Poland, one in the Northern and one in the Eastern part of the country. According to PEG, the planned capacity of the power plants would be up to 3,000 MW each and the goal would be to launch the first power plant by 2020. The estimated value of the planned project is in the range of EUR 15-18 billion.
- Poland's largest fuel company PKN Orlen has decided to decrease its investment plan for the following four years. The company is now planning to invest some EUR 2.7 billion during that time, which is approximately EUR 1.7 billion less than in the previous plans made a year ago.
- The Swedish furniture retailer IKEA has released more details regarding the plans to construct a new factory making wooden boards in Eastern Poland. The investment is expected to create 2,000 jobs directly and another 2,000 for suppliers. Poland is already the home for 14 IKEA factories and the company has recently stated that it plans to invest EUR 1.3 billion in Poland over the course of the following eight years.
- BOT Górnitwco I Eneregyteka, a Łódź-based electricity producer, is planning to construct three offshore wind farms on the Baltic. The combined capacity for the turbines is planned to be 900 MW and the project is estimated to cost roughly EUR 1 billion.
- The Puławy Nitrogen Plant of Eastern Poland and the Swedish energy corporation Vattenfall have agreed to jointly build a conventional coal-fired power-plant with a capacity of 1,400 MW. Both partners would have a 50% stake in the joint-venture company carrying out the project.

Poland - main economic indicators	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**as of**
GDP (y-o-y %-growth, constant prices)	1.1	1.4	3.8	5.3	3.5	6.1	6.5	4.8	n/a	Q3/2008
Industrial production (y-o-y %-growth)	0.6	1.1	8.3	12.6	4.1	5.7	9.7	3.5	-14.9	1/2009
Inflation (CPI, end of period, y-o-y %-change)	3.6	0.8	1.7	4.4	0.7	1.4	4.0	4.2	3.1	1/2009
General government budget balance (% of GDP)	-3.7	-3.3	-2.9	-3.3	-6.1	-3.9	-2.0	-2.7	n/a	1-12/2008
Gross wage (period average, EUR)	557	544	497	505	591	692	825	821	n/a	Q4/2008
Unemployment (% end of period)	18.5	19.7	19.3	18.0	16.7	12.2	11.4	9.5	n/a	12/2008
Exports (EUR billion, current prices)	40.4	43.4	47.5	59.7	71.4	87.5	101.1	114.6	n/a	1-12/2008
Imports (EUR billion, current prices)	56.2	58.3	60.4	71.4	80.6	100.0	118.8	139.3	n/a	1-12/2008
FDI inflow (EUR billion, current prices)	6.4	4.4	3.7	10.0	8.3	15.1	12.8	11.2	n/a	1-12/2008
Current account (% of GDP)	-2.9	-2.6	-2.1	-3.5	-1.7	-2.3	-3.7	-5.2	n/a	1-9/2008

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

St. Petersburg

Economy: the top-year is behind

Despite the first strike of economic crisis being perceived by St. Petersburg's economy already in September 2008, the whole year's economic performance remained quite successful. In fact, the non-financial sector of the regional economy experienced their first significant difficulties in the last quarter of 2008, while January-August and especially the first half of year 2008 were positive enough. This was almost due to fact that Russia's economy, as well as the economies of its regions, remained heavily dependant on world prices for oil and metals, and St. Petersburg was no exception. Nevertheless, some slowdown already happened in the third quarter of 2008. The GRP of St. Petersburg, yet not available for the whole year, grew in the third quarter of 2008 by 3.8% y-o-y only. This figure is less than a half of the city's GRP growth in 2007, which means a deceleration of St. Petersburg's GRP in the second half of 2008. Another negative result was inflation, rising in 2008 to almost 15%, thus reflecting the overheating of the regional economy.

All the basic sectors of the regional economy in January-December 2008, bar transport, showed much lower results, than a year ago. Transport raised its output by 45.5% y-o-y, but mostly due to increasing tariffs, as the physical volumes of carried cargoes remained exactly the same as in 2007. Communication and retail trade were the other two sectors which in 2008 kept y-o-y growth rates higher than 10%: their output increased by 15.1% and 11.2% y-o-y respectively. Industrial production and construction raised their annual output in 2008 by 4.1% and 2.0% correspondingly. In spite of the crisis trends, there were some positive results for 2008. For example, the production of optical and electronic devices expanded by 45.1% y-o-y in 2008.

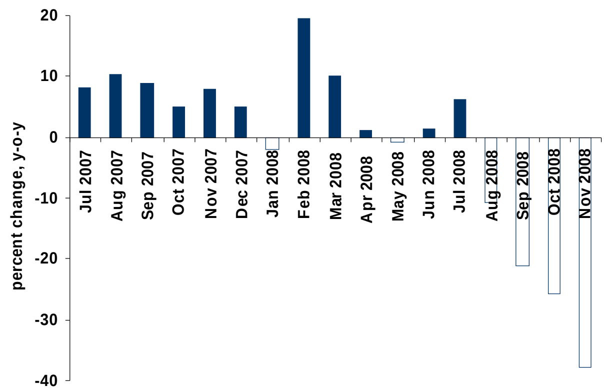
Construction: the fall

The biggest decrease caused by the current economic crisis was experienced by regional real estate and construction sectors. In fact, the first negative trends emerged in this sphere several months prior to the stock market's collapse of September-October 2008. However, the regional real estate market continued to grow until September 2008, regardless of deteriorating demand and increasing interest rates on mortgage loans. Since October 2008 real estate prices started to fall. The sharp devaluation of the rouble conducted in December 2008 - January 2009 led to the shifting of sellers towards prices nominated in US dollars. This traditional payment unit of the regional housing market was substituted by a strengthening rouble in 2006-2008. But recent devaluation of the national currency returned US dollar pricing back to the market. For example, LenSpetsSMU, a leading regional developer, shifted to the almost forgotten "standard units" in calculating the prices for its apartments built in St. Petersburg. One "unit" is equal to RUR 32, which is quite close to current USD/RUR exchange rate. In fact, since the first day of pre-crisis August 2008 till February, 1, 2009, the average dollar price of one square metre of dwelling space in St. Petersburg fell by nearly 37% on the primary market, and by 38% on the secondary market. The corresponding reductions of euro-nominated prices were 24% and 25%. In these circumstances regional developers were unable to sell built apartments and houses, as the buyers were expecting the prices to fall further. This was reflected by a sharp decrease in construction activity at the end of 2008. In December 2008 the volume of construction services in St. Petersburg region dropped by 30.0% y-o-y. Despite this, the total amount of residential apartments finalised in 2008 grew 26.3% compared to 2007. This was, of course, the result of the construction boom of 2006-2008, when all these building projects were launched.

Incomes started to decrease

One of the most visible signs of the economic crisis of 2008 was the downturn of income trend in the end of 2008.

Real incomes of St. Petersburg's residents (y-o-y, % change)



Source: Petrostat, 2008, 2009

The sharp decline started in September-October 2008, with the first mass retirements, first in banking and later in non-financial sectors. Another serious change happened with the structure of people's expenditures. The share of incomes invested in hard currency cash rose from 15.7% in August up to 37.9% in November 2008. At the same time account holders were withdrawing money from bank deposits and investing them into hard currencies and durables.

Some business highlights

- Lenenergo, the region's energy monopoly, sequestrated its investment programme for 2008. Instead of their planned EUR 600 million expenditures on energy network development, Lenenergo had spent only EUR 270 million in 2008. The investment programme for 2009 should be sequestrated as well, down to EUR 140 million.
- Russian Federal Service for Environmental Monitoring signed a contract with St. Petersburg's leading shipyards, namely Admiraltejskije Verfi, on building a scientific marine ice-breaker. The contract's value is EUR 140 million, and it would be the first marine vessel of this type constructed in Russia.

St. Petersburg - main economic indicators	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	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)	0.2	31.4	5.8	14.1	4.2	-7.0	10.0	4.1	1-12/2008
Regional inflation (CPI, y-o-y %-change)	16.3	16.6	13.0	12.7	12.0	10.0	10.9	14.9	1-12/2008
Gross average wage (monthly, EUR)	n/a	217	209	285	345	407	510	667	11/2008
Unemployment (% average annual)	4.4	3.5	4.3	2.8	2.4	2.4	2.0	2.0	1-12/2008
Exports (EUR million, current prices)	2134	1839	2429	3210	3954	5499	12978	12678	Q1-Q3/2008
Imports (EUR million, current prices)	4423	5158	5123	5560	8081	10299	15093	12507	Q1-Q3/2008
FDI inflow (EUR million, current prices)	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: almost stagnant

The economic performance of Leningrad province in 2008 in general was much less impressive, than in the previous 8 years. Despite the GRP data for the whole year not being reported yet, the basic sectors of the regional economy experienced a comparatively small y-o-y increase. In fact, the contraction of growth rates in Leningrad province was less dependent on the effects of global crisis, as this process started earlier. Development of the province's economy has a cyclical trend, and the low point of its cycle coincided with the current crisis. Thus the annual increase of industrial production, the region's basic sector, was 1.0%, y-o-y. Construction grew 1.8% y-o-y, and transport expanded by 3.4% y-o-y. Agriculture raised its annual output by 3.0% y-o-y. This was, however, quite a good result for a traditionally depressive sector of the regional economy. Communication and trade retained their positions as growth-leaders of the region. However, even these two sectors experienced a significant reduction of growth rate: they increased in 2008 by 7.4% and 5.3% y-o-y respectively (while in 2007 the corresponding figures were 12.3% for communication and 17.5% for trade, y-o-y). Inflation from January-December 2008 was very high, reflecting the pre-crisis overheating of the economy and a 12.5% increase of real wages in the region.

Construction: the neighbour's impact

The regional construction sector expanded by 6.2% y-o-y in October 2008 and by 9.3% y-o-y in November 2008, being resistant to crisis. But in December 2008 the credit crunch led to a sharp 45.2% y-o-y decrease of construction activity. Another problem was the slump of St. Petersburg's real estate market, which influenced many construction companies located in Leningrad province. This might lead to higher unemployment in several towns of the Leningrad province, namely in Pikalevo, Gatchina, and Sertolovo. Nevertheless, the province's Vice-Governor Grigori Dvas doubted any possibility of supporting these companies using the resources of the regional budget.

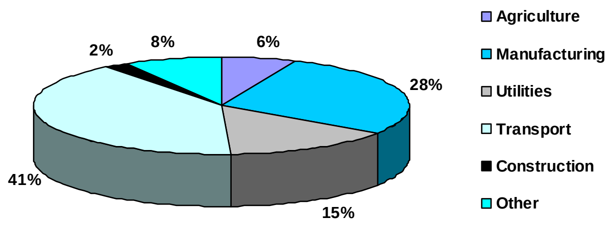
Agriculture: the change

The role of agriculture, both in Leningrad province and in Russia as a whole, increased in 2008. Prices on agricultural goods were comparatively high, and even the decline at the end of the year was not as deep as for many other commodities. Moreover, the devaluation of the rouble led to a bigger demand for domestic food, substituting for imports. The economic crisis did not have a significant negative impact on agriculture, as food normally has a low price elasticity of demand. As a result, all branches of the regional agricultural sector increased their output. Grain producers raised their output in 2008 by 15.0% y-o-y due to the good harvest of the summer season; vegetable crops grew 9.1% y-o-y in 2008. Hog stock went up by 38.2% and poultry stock by 3.0% y-o-y. In 2008 annual output in the region grew up: of meat by 24.2%; of eggs by 5.0%; of milk by 0.2%, y-o-y. These figures outlined a first-ever balanced positive performance of the whole agricultural sector of Leningrad province. Certain problems, however, might emerge in the very near future, as successful development of the sector is dependant on bank loan accessibility.

Investment: basis for future recovery

The influence of the global economic crisis is still unpredictable. But regardless of its duration present investment builds a basis for future revival. In Leningrad province investment in real assets in 2008 grew 10.0% y-o-y. A natural reason for that might be approaching a new growth cycle, which might be now postponed due to the crisis. But it is quite likely that investment-driven sectors would develop faster than the others.

Investment in regional economy in 2008, by sector



Source: Petrostat, 2009

The bulk of investment was received by two sectors, namely transport and manufacturing. Utilities attracted 14.7% of total investment due to the large infrastructural expenditures of Lenenergo, the regional power monopoly. The contribution of agriculture was only 6.4%, but this business field attracted 21.9% more investment in 2008 than a year ago. Construction gained a comparatively small share of capital in 2008, and investment inflow in the sector decreased by 15.2% in comparison to year 2007.

Some business highlights

- Transneft, Russia's state owned pipeline monopoly sequestrated its investment budget from an initial EUR 6.3 billion to EUR 5.1 billion. Nevertheless, it still intends to implement one of the high priority projects, namely BTS-2. In the framework of BTS-2 Transneft plans to create a pipeline linking the Ust-Luga seaport to its oil-transporting infrastructure. Thus Ust-Luga might become an oil-exporting seaport, doubling the already functioning Primorsk port.
- Russian company IST Group confirmed its plans to build a carriage producing plant in Tikhvin, Leningrad province. Despite the crisis, the company managed to attract a EUR 430 million loan, needed to start the project. The volume of total required investment is EUR 600 million.
- Government of Leningrad province plans to sign in 2009 a co-operation agreement with Gazpromneft, a Russian fuel industry giant. According to this agreement Leningrad province prepares a large land plot near the town of Tosno for a petroleum storage depot, which would belong to Gazpromneft. In addition to this, the regional Government allots 32 smaller land plots for building Gazpromneft's fuel filling stations.
- Administration of Leningrad province announced its project to create in 2009-2010 a business incubator, which would be located in the Tosno district. The business park would be focused on agricultural and biotechnologies. The region plans to become a co-owner of this incubator.

Leningrad region - main economic indicators	2001	2002	2003	2004	2005	2006	2007	2008	as of
Regional GDP (y-o-y %-growth, constant prices)	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)	10.7	35.6	20.9	10.3	5.9	26.9	2.6	1.0	1-12/2008
Regional inflation (CPI, y-o-y %-change)	19.6	14.8	13.0	14.9	12.0	9.9	9.3	15.5	1-12/2008
Gross average wage (monthly, EUR)	141	152	173	190	259	324	403	492	11/2008
Unemployment (% average annual)	10.8	9.6	9.2	7.5	7.8	6.2	3.3	3.2	1-12/2008
Exports (EUR million, current prices)	2350	2301	2580	3887	4862	5443	6088	6236	Q1-Q3/2008
Imports (EUR million, current prices)	810	939	1061	1372	2561	2858	4759	4545	Q1-Q3/2008
FDI inflow (EUR million, current prices)	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

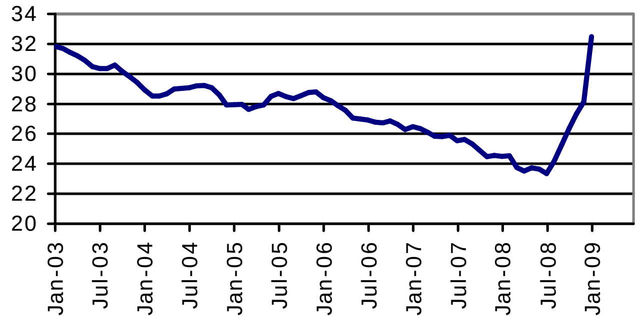
Kaliningrad region

Economy starts contracting in the wake of global downturn

The real impact of the global financial crisis on Kaliningrad's economy became apparent in the last two months of 2008: almost all indicators of economic activity in Kaliningrad were contracting on a y-o-y basis. Sharply lower commodity prices and a reversal of capital flows have strongly affected Russia's economy. The latest forecast from the IMF suggests that Russia's GDP will contract by 0.7% in 2009. Kaliningrad's economy is quite sensitive to changes in the economic activity in Russia and generally follows trends in Russia's GDP but with a higher magnitude: Kaliningrad's GRP is likely to decline by 5-6% if the above forecast proves to be close to the actual data.

A substantial depreciation of the rouble since July is one of the factors that have had a negative impact on Kaliningrad's industry. Devaluation raises the cost of goods produced by Kaliningrad's import-processing companies and decreases their competitiveness on the Russian market. Kaliningrad's manufacturing output in November and December was approximately 15% lower than in the previous year. Whilst manufacturing grew 5.5% in 2008 as a whole, this growth is due to the relatively strong performance in the first half of the year.

Exchange rate RUR/USD (average monthly data)



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

	2008	2007
Industrial production	2.5	40.3
Mining	-0.7	1.0
Manufacturing	5.5	93.7
Utilities	2.9	0.3
Construction	34.9	9.8
Retail trade	12.1	17.9

Source: Kaliningradstat (2007-2009)

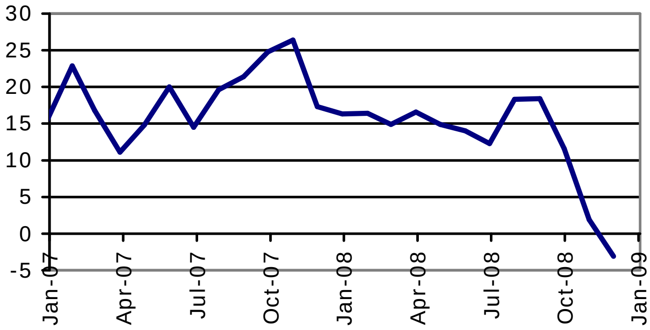
Investment and construction – a bright spot

Construction activity remained one of few bright spots in the economic picture – it grew 34.9% in 2008 y-o-y. While residential construction was slowing down – its output increased by 6.2% (in terms of the total area of completed dwellings), non-residential construction activity was strong. Growth in non-residential construction was fueled by large investments made by Russian and foreign investors in Kaliningrad. Latest available data show that in January-September the investment in fixed assets increased by 49.8% and FDI inflow by – 129% (in US dollars). However, prospects for investments in the next year are gloomy.

Consumer demand weakening

Retail sales have been growing steadily until October but then also suffered from the economic downturn – in December they declined by 3.1%. Real disposable household income started to fall even earlier – since May – and dropped by 4% in January-November of 2008.

Retail Sales, % change y-o-y



Inflation moderates

Consumer price growth has moderated in December: prices grew by 0.6% m-o-m and annual inflation declined to 15.2% y-o-y. Since reaching its peak at 17.4% in June annual consumer inflation has been weakening. However, the devaluation of the rouble will limit further declines in inflation. In Kaliningrad this factor plays a more important role than elsewhere in Russia because of a higher share of imports on Kaliningrad's consumer market.

Industrial producer prices declined by 2% in 2008 pushed down by a substantial drop in the prices of oil and oil products in the second half of the year.

Some business highlights

- The Central Bank of the Russia revoked the banking licences of two Kaliningrad's banks, BaltKredo Bank and Setevoi Neftyanoi Bank, which fell victim to the current financial crisis.
- The Bank St. Petersburg took management control of Kaliningrad's airline, KD-Avia, that earlier defaulted on its bonds. The bank is the largest creditor of the airline.
- Kaliningrad agricultural producer, Sodruzestvo, is going to construct a soybean oil plant near Grodno, Belarus. The company will invest $150 mln in the project.
- KoenigInterBalt, was registered as 56th SEZ resident in Kaliningrad. The company will invest approximately 1 billion roubles in a new hotel and SPA centre in Svetlogorsk on the Baltic Sea coast.
- One of Kaliningrad's largest retailers, Vester, raised a 1.5 billion rouble loan from banks that should allow it to continue the construction of new trade centres that it started before the crisis.

Kaliningrad region - main economic indicators	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**as of**
Regional GDP (y-o-y %-growth, constant prices)	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)	12.9	4.2	4.7	22.5	27.4	66.6	34.8	2.5	1-12/2008
Inflation (CPI, end of period, y-o-y %-change)	21.0	9.8	17.5	11.7	11.1	7.9	11.2	15.2	12/2008
Gross wage (period average, EUR)	99	125	137	155	193	285	358	423	1-11/2008
Unemployment (% end of period, LFS data)	10.6	7.2	7.6	6.5	6.6	4.5	3.4	n/a	Q4/2007
Exports (EUR million, current prices)	508	497	507	876	1470	2025	3666	340	1-9/2008
Imports (EUR million, current prices)	1169	1701	1894	2419	3283	4275	5714	4770	1-9/2008
Exports (sales) to Russia (EUR million, current prices)	691	802	989	1449	1901	2471	3901	2240	H1/2008
FDI inflow (EUR million, current prices)	3.6	6.3	12.4	18.0	15.1	16.9	117.9	89.2	1-9/2008

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

Fighting fraud and corruption – the EU experience

By Siim Kallas

The European Commission needs to fight not only corruption but also the suspicion of corruption. In this regard, transparency is a win – win for the administrations and the public alike. I firmly believe transparency to be the key-tool in fighting this double battle.

Fraud with the EU budget is more than stealing money. The fraudster stealing EU funds also "steals" the success of a policy or a project; prevents people from being trained; innovative companies and researchers from receiving support; cross-national connections from being established; to give just a few examples. At times it seems as if the EU budget belonged to no one; as if fraud with European funds only meant taking a bit of money from an anonymous bottomless money pit. This is frightening and entirely un-acceptable.

Fraud is a criminal act and unfortunately can never be prevented a 100%. So there need to be effective procedures to minimize the risk of fraud, to prevent any abuse and effective tools to detect and investigate it and to sanction it convincingly. The EU budget amounts to around 120 billion euros annually, spent all over the world. For the biggest spending blocks — agriculture and regional aid covering together over 80% of the budget — some 0.2% is estimated to be affected by fraud, but as this is followed-up closely, most of it will be recovered. Experts see no reason to believe fraud and corruption is more widespread in the EU Institutions than anywhere else. For example, the British House of Lords concluded in a special report that there was no evidence of widespread corruption within the Commission and that the level of fraud against the EU budget is no higher than in comparable public spending programmes, including in Great Britain.

When reflecting on this issue, we see that this high level of suspicion is, however, not surprising. First, to a large extent it relates to the unique governance structure and complexity of the EU.

- Compared to a national budget, much of which goes to paying directly for pensions and public services, the EU-budget is almost entirely composed of subsidies, and those are known to be more prone to fraud than other types of expenditure.

- European Union's decision-making processes are multi-layered and complex. They are different from what citizens are used to at national levels. This can be criticised, but the system has been developed to include checks and balances, balancing genuine EU concerns with important national interests.

- Given the Council of Ministers taking decisions behind closed doors or the obscure mass of 15 000 lobbyists operating to defend particular interests vis-à-vis the Institutions in Brussels, it is understandable the citizens are mistrustful.

- This complex governance structure provides convenient space for anti-EU rhetoric, not least in the form of national authorities blaming unpleasant decisions on Brussels. This all undermines the credibility of the EU.

A further cause of suspicion has been past high profile cases created the impression of significant corruption in the EU Institutions. Here I am referring to the events in 1999 leading to the resignation of the Santer Commission, and more recently (2004) problems in the Commission statistical office, Eurostat.

The fight against corruption and fraud within the EU Institutions and bodies has become an absolute priority for the EU. We have a zero tolerance policy and a fully independent Anti-Fraud Service, OLAF that is in charge not only of investigating fraud with EU money, but also any wrongdoing or professional misconduct in the EU Institutions. We have an independent Internal Audit Service, a disciplinary office, tough rules on awarding of contracts and subsidies and whistleblower rules.

Over the past 5 years, we have also stressed transparency in decision-making processes and allocation of funds. Transparency plays a huge role in promoting a EU open to its citizens and therewith helps to increase public trust towards the Institutions. The EU needs the latter as it helps to focus discussion on real issues to be resolved at the European level. Transparency also helps to both fight corruption and correct the image of European Institutions as being corrupt.

In particular, over the past 4 years we have worked with the Member States to ensure that the end beneficiaries of all Community aid schemes are publicly disclosed – this includes the Common Agricultural Policy and the Structural and Cohesion Funds. Since the beneficiaries are now public, it is much easier for the public to detect false claims, and alert the authorities.

Increasing the transparency of lobby activities towards the EU Institutions has also been a key objective. Here, we now have an albeit voluntary register of over 900 lobbyists, who disclose for whom they are lobbying and roughly how much it costs. They also agree to abide by a code of conduct.

Since March last year, we have also been looking again at ethics of our 24,000 Commission Staff. I am convinced that one problem we face is that ignorance and distrust of the Commission means that any individual problem here is seen not as an isolated incident – a “bad apple”, but rather as symptomatic of the whole organisation. I am sure that the great majority of Commission staff want to uphold high ethical standards – but we need to give them the advice and tools needed to achieve this.

The Commission is now finalising a statement of ethical principles for staff – we have adopted a bottom-up approach, whereby staff are invited to comment on different options, to ensure that the final version has strong support across the Commission – and thus that peer pressure will make it to some degree self policing. Work is also continuing on up-dating rules conflict of interest, and on acceptance of gifts and hospitality. Our objective is to allow the informal contacts of officials with the professional world or civil society, which are vital if we are properly to understand the concern of all stakeholders, while ensuring these contacts in no way compromise the integrity or independence of staff. There is never an easy balance here.

Integrity is a matter for all of us, and not the legislator or the administration alone. Member states and European citizens must develop more sense of ownership for EU money. Fraud with EU funds is not only a problem for the Commission. It is taxpayers' money, it comes out of all our pockets, and we therefore encourage the Member States and national authorities to gain and present assurance for the management of EU funds at all levels.

For a complex governance system like the European Union's, transparency is a win–win situation: it is beneficial for the administration and the public alike. Transparency plays an enormous role in promoting a more citizen-friendly EU and thereby helps to gain public trust in the institutions. The EU needs the latter to dispel misperceptions and focus the discussion on the real issues to be resolved at the European level.

Siim Kallas

Vice-President for Administrative Affairs, Audit and Anti-Fraud

European Commission

Baltic Sea Cooperation towards 2020 – serious challenges but bright opportunities

By Alexander Stubb

In the midst of the economic downturn we must look ahead and keep in sight the long-term challenges for the Baltic Sea region. At the initiative of the European Parliament and supported by the Member States in the region the European Union is currently in a process of producing a strategy for the Baltic Sea. The European Commission will present to the European Council of June 2009 a communication on the Baltic Sea Strategy. The strategy is coming with proposals for action on four areas: the environment, prosperity, accessibility and safety and security.

Finland has been contributing to the drafting process in many ways. Our proposals for measures to be taken within the new framework concern the eutrophication of the sea, maritime safety, innovation policies and safety and security. Finland is looking forward for a speedy start of implementation of the Baltic Sea Strategy of the Union and supporting the incoming Swedish EU Presidency in putting the strategy high on the agenda of the Union during autumn 2009.

We are confronted with an economic downturn that is both sharp and unprecedented in its global reach. We are all in it together also in the Baltic Sea Region. The disparities of our economies have not been a hindrance to cooperation, but have instead contributed to growth by offering good business opportunities. Let us not turn back this opening of the markets by giving way to protectionist measures. The expansion of the "home market" to cover the Baltic as well as the Nordic states has meant a lot to growth prospects of many SME's. I hope that despite downscaling, many of those are able to keep their foothold in the regional market.

It is worth considering that since we are seeing a global downturn, the competition between growth regions for a pole position in the global recovery will be fierce. In the Baltic Sea Region we should keep a calm head and continue to invest in the strenghts that we have. The success of our region depends on how we are getting most out of the educated work force, investments in research and development, well functioning public services and infrastructure that is for the most in good shape.

Hard economic times require an ability to cooperate and pool resources. It is not for the governments to choose which are the businessess that will flourish. Some areas where there could be a bright future and even world class excellence for the Baltic Sea region, have been identified by the real actors, namely biotechnology, environmental and energy technologies, maritime sector, tourism and creative industries to name but a few sectors. We should aim at using also EU instruments in the best possible way to foster innovation collaboration and cluster building in sectors like these.

Public finances will be squeezed in the next coming years.This poses a challenge for the financing of environmental protection. But the Baltic Sea can't wait. I would urge for a cost-benefit analysis of the proposed measures needed for the implementation of HELCOM's Baltic Sea Action Plan and for risk assessment on maritime safety. On the basis of careful analysis we should push towards implementation of the most urgent measures. With the HELCOM BSAP and the EU's strategy there is now a momentum for intensified efforts to save the Baltic Sea.

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Although the EU Strategy for the Baltic Sea Region will be an internal Strategy of the Union, we need to co-operate with all the coastal states of the Baltic Sea to ensure its success on the regional level. The fact that the EU is paying an increased attention to the Baltic Sea and other northern regions is an opportunity for all the countries of the region, including the non-EU ones.

The European Council conclusions from December 2007 define the Northern Dimension (ND) to be the framework that provides the basis for the external aspects of co-operation in the Baltic Sea region. Northern Dimension is a common policy between the EU, Norway, Russia and Iceland and the ND area covers both the Baltic Sea and Barents regions. The ND can be described as the regional leg of the EU-Russia co-operation. Russia is a neighbour and a strategic partner.

As to the agenda, the ND is a true reflection of the Peoples Europe. In the Northern Dimension Ministerial Meeting in St. Petersburg in October 2008 we discussed issues that really affect our everyday lives and where we need to co-operate with our neighbours. For instance, a well known fact is that environmental pollution does not recognise any state borders, (or EU ones!) The Northern Dimension Environmental Partnership has carried out large waste water treatment projects in the St. Petersburg area. When the final projects are finished, St. Petersburg will be removed from the HELCOM hot-spots list.

Now when expecting harsh economical times ahead of us, we must constantly keep our head up and look forward. New ideas and new impetus to reinforce our regional identity are needed in order to maintain the unique dynamism, which has marked our region during the past years.

First and foremost, in difficult economic times it is even more important that the Governments do their utmost to create the conditions and necessary prerequisites for economic upturn. I am convinced that the new ND Partnership on Transport and Logistics currently under preparation will have a significant impact on the economic development of the region. .

Secondly, it is my firm opinion that we should try to extend the benefits of regional co-operation to an as wide geographical region as possible. I proposed in St Petersburg ND ministerial meeting, that we should engage Belarus to the Baltic Sea co-operation by including it to the ND partnerships. My proposal was well received - it is also worth noting that when the Foreign ministers of the Council of the Baltic Sea States (CBSS) meet in Denmark this June, we will most probably make a decision to grant an observer status to Belarus to the CBSS.

Thirdly, in order to make the best use of untapped potential of the Baltic Sea Region we should have a critical look at the regional co-operation architecture. There are a number of different co-operation structures, which all have their special missions and fields of excellence. Profound changes have taken place on the Baltic Sea region in the past ten years, and I believe strongly, that we should initiate a process of streamlining and sharpening of the mandates and agendas of these regional co-operation structures. I hope that the EU Baltic Sea Region Strategy will for its own part will give a push to this work by helping to focus our internal thinking and enabling us to set joint objectives for these organisations. This work should of course be conducted in a very close co-operation with the non-EU ND partners, which should not be considered as "objectives" of EU actions, but as equal partners.

The CBSS, like the other Northern regional councils, may have their own role in making our visions for the Baltic Sea a reality. Prime Minister of Finland, Mr. Matti Vanhanen at the 7th Baltic Sea States Summit in Riga in 2008 called for a Baltic Sea 2020 vision to be adopted in the next CBSS summit (Vilnius 2010) This vision should comprise issues like the environment and the ecological protection of the Baltic Sea and how to improve the different energy and transport networks in order to create a prosperous and dynamic economic environment. It is for the current and incoming CBSS Presidencies, Denmark and Lithuania, to decide how to proceed with this idea. The next CBSS Foreign ministers meeting in Elsinore in Denmark next June will time wise be a good opportunity to discuss the role of the CBSS in this context.

Alexander Stubb

Minister for Foreign Affairs

Finland

Baltic Sea maintenance and budgetary control

By Ville Itälä

As we all have learned by now due to the ongoing discussions regarding the Baltic Sea and the gas pipes, the Baltic Sea is quite central and necessary for the European Union. However, as any resource, the Baltic Sea cannot be properly maintained without a proper budget and strategy. Last year the European Parliament budget committee tried out an experimental 5, 5 million euro "one-off" for three different projects regarding the Baltic Sea. Finally, after a few years of pursuing the attempt to gain a budget solely for the maintenance of the Baltic Sea, the European Parliament budget committee now has nominated one for the year 2009. Although the monetary value for this budget strategy has not been determined yet, the nomination alone is a huge step forward. The important thing to concentrate on now is to get the European commission's priorities right, and find a clear focus so that the money can be channelled towards useful projects.

Previous actions prove that improvement is possible, as in the past few years the security and pollution problems have made a change for the better. The Mediterranean Sea annually gets over 150million Euros from the EU budget, surely the Baltic Sea is worth at least as much. Hopefully when the budget amount for the Baltic Sea strategy is being determined this will be taken into account.

There already is a remarkable amount of individuals, private companies, and foundations that willingly put in their efforts in order to help save the Baltic Sea, which still is one of the most polluted seas in the world. One of the main problems still are the industrial ships that dump their bilge water into the Baltic Sea, since as these are amongst the most difficult to control. Just as an example, the chicken production houses in St Petersburg alone dump an incredible amount of phosphor pollution into the Baltic Sea. Even though individual charities do on their part as much as they can in trying to lessen the pollution and make the Baltic Sea more economically sound, the projects and charities lack a common denominator. If the individuals were monitored or looked over by one common project or company, it would be easier to deal with the EU-bureaucracies and also channel the funds more effectively towards a common goal.

As well as trying to get the funding for the proper maintenance of the Baltic Sea, I believe that Russia should be coerced into making a deal that on their side promises to try and control the pollution going into the sea in exchange for letting them build the gas pipe under the Baltic Sea. The gas pipe has been the topic of many heated discussion for quite a while now. It has not been confirmed as of yet whether the German company Nord Stream will be allowed to move forward with the building of the pipe line, as the investigations on the safety and the environmental impacts are still up in the air, but just the possibility of the project moving forward has the people up in arms. As much as 70% of the Swedish MP's are against the project. Sweden and Germany so far are the only countries to receive the permission application from Nord Stream, and Finland and other countries involved will receive theirs during April -09. Even though the company is so optimistic about the project moving forward, that they have already ordered the actual pipes, worries about the environmental and safety implications has the nations involved worried. Hopefully the project will not be realized, but if it is, Russia definitely needs to make a firm promise to do their part in the sustainability of the Baltic Sea. Even though Russia is still at the moment one of the main contributors of the pollution in the Baltic Sea, we cannot forget the areas such as Ukraine and Belarus, that indirectly affect the Baltic Sea pollution levels as well.

Some tangible examples of things already being done for the Baltic Sea, include the HELCOM's Baltic Sea Action plan. HELCOM is a somewhat ambitious program to restore the good ecological status of the Baltic marine environment by 2021, and the plan includes realizing an emissions limit for all the countries involved in polluting the sea. In theory we have the plans needed for action, now we just need to actually make things happen. Each and every one of us is in part responsible for the state of the Baltic Sea, as it is so essential to so many of the European states, now we just need to get everyone to pull their own weight.

Ville Itälä

Member

European Parliament

Finland

Baltic cooperation needs freshening

By Antti Kaikkonen

The Baltic Sea has effectively become the sea of European union and Russia. The European integration and opening up of Russia has steadily built up the regional economy. Connections between the countries have intensified. Transport links are stronger and more plentiful than ever. Budget airlines and affordable ferry connections have enabled both workers and leisure travelers to travel beyond their home countries in large numbers.

The current financial crisis is another example of the importance of regional and global cooperation to solve problems. There simply has to be better collaboration between our countries. Otherwise we might face serious humanitarian and security problems between and inside the countries, also in the Baltic Sea region.

The Baltic Sea is an area of deepening economic cooperation. This should be accompanied by deepening political one. There is an urgent need for the EU members and Russia to solve environmental, energy and traffic questions together. The discussion about the Nord Stream gas pipeline in the Baltic Sea states has shown the interdependence of politics and security and environmental matters.

If the Nord Stream project is realised, the Baltic Sea will become an important transfer route for energy, effectively creating a very strong energy link between the EU and Russia. It is of utmost importance that the Baltic Sea states can develop cooperation beyond the existing ways in the spirit of confidentiality. In the light of recent events in Georgia and the widely varied views toward Russia within the EU, it will not be easy. Moreover, the EU and Russia are tied together by their energy needs. However, this interdependency should not be used as a justification to avoid the difficult problems and sore points of the EU-Russia relationship.

From this perspective, the Swedish decision to select the Baltic Sea as one of the priorities for their oncoming EU presidency is a wise one. The non-paper "A Healthy and Prosperous Baltic Sea Region" assesses the possibilities and challenges for a common EU strategy for the region. The challenge of the strategy is to find the ways of cooperation that will work for both Russia and the EU member states. In this work, we should utilize the experiences gained through the Barcelona Process, and also not to forget the possibilities of the Northern Dimension.

The Baltic Sea region is not lacking in common forums and organisations that facilitate cooperation. The alphabet soup consists of BASREC, BSSSC, CBBS, CCB, HELCOM and UBC to name but a few. However, due to the multitude of actors, initiatives and programmes, there is a need for greater coordination and effectiveness. The problem is one of too much overlapping work and too few concrete results. I think that the cooperation should be reorganised on a new platform. A working title could be the Baltic Sea Union. It could be formed by developing the existing Baltic Sea Parliamentary Conference. We need fewer organisations but more results.

The Baltic Sea Union would create a permanent and functional model for equal cooperation between the EU and Russia. It would also emphasize the equality of the southern and northern EU regions after the establishment of the Union for the Mediterranean. The Baltic Sea and the Mediterranean Unions would be complementary regional structures for cooperation inside the EU and also permanent instruments for external policy. The challenge is to develop tools that do not create new and cumbersome bureaucracy but are effective and flexible.

The council of Europe has recently named me to draft a report on the economic potential of the the Baltic Sea region. The work has begun and the aim is to finish the report by 2010 at the latest. The Baltic Sea states are in widely varying situations but untapped resources do exist. The resources can best be used by cooperation.

Baltic Sea cooperation cannot only be examined from an economic viewpoint, though the economic and employment issues are particularly topical. The ecological and social perspectives should also be taken into consideration.

A central part of the report will be a visit of the economic committee of the Council of Europe to Finland in May 2009. There will be a high level seminar on the Baltic Sea cooperation at the Finnish Parliament. At the same time, the first 60 years of the Council and Finland's 20 years as a member will be celebrated. It is excellent that the Baltic Sea is on the agenda of the Council during the festivities.

Antti Kaikkonen

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Member of the Baltic Sea Parliamentary Conference

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European cooperation crucial as banking sector in the East has to weather global crisis

By Thomas Mirow

The financial crisis that began in the United States in 2007 and then spread to western Europe and beyond is now taking a huge toll on the countries of eastern Europe.

The economies of the former Soviet bloc had finally started to strengthen, the result of two decades of punishing economic reform and sacrifice.

Now the first signs of social unrest are emerging in countries whose people had sought economic, political and social stability. The fruits of those earlier sacrifices are in jeopardy. That earlier growth is quickly grinding to a halt.

The region as a whole could still avoid the substantial contraction that is now inevitable in the more advanced west. But we must seize the opportunities that exist now to ensure that the progress of the past does not become the sustained economic downswing of the future.

The common denominator across the region is that those countries suffering most acutely now are those that have striven hard to open themselves up to the global economy. They are now paying the price.

The region's problems are deeply interwoven with those of the rest of Europe. As demand from the EU dries up, the export-dependent economies of the east and seeing their market place shrink.

It is incumbent upon the economies of western europe to help to address this situation and to seek a solution that lies in a co-ordinated response from both public authorities and international financial institutions.

The banking sector is crucial to the current crisis and to the region's recovery. As a practical step, there must be close co-operation in addressing both regulatory concerns and providing financial support for parent banks and their subsidiaries in emerging Europe.

For this very reason, the west must embrace an initiative by European banks calling for fast, joint action to support eastrern subsidiaries. A worsening crisis in emerging Europe will threaten Europe as a whole.

The vast majority of the central and eastern European banking sector is owned by a small group of European Union-based banks. For years, this has been a source of stable capital flows and proven critical to the success of these economies. Now that parent banks are confronted with the global financial crisis it is crucial that they uphold their commitments to emerging Europe.

The governments in eastern Europe lack the means to finance national rescue packages and at the same time there is a genuine danger that measures introduced in the west will ignore the plight of their once profitable eastern subsidiaries.

The international financial institutions have embarked on joint approaches to tackle the crisis in the most affected countries. The swiftness of the reply so far has been encouraging.

Within this group, the European Bank for Reconstruction and Development is taking a leading role, especially in providing support for the financial sector in order to maintain a crucial flow of credit to small and medium sized enterprises.

We have decided to expand our business this year by 20 per cent to €7bn and in recent weeks additional funds have already started flowing to systemically important banks Georgia, Romania, Ukraine and Russia. We are also planning a sharp increase in our trade financing to maintain regional commercial links.

Similar initiatives are being taken by the European Investment Bank and the World Bank Group. But much more must be done and a regional approach is needed. Given the enormity of the crisis, it is clear today that every isolated intervention can easily be seen as just a drop in the ocean.

The engagement of the EU and its governments is crucial. We can address the problems properly if the EU, the European Central Bank and the international financial institutions apply their resources in a structured and co-ordinated manner

By agreeing to an increase in investments this year, the shareholders of the EBRD have recognized that this is the time to engage in Eastern Europe – not to retrench.

What is true for the EBRD is true for other investors. The potential in Eastern Europe remains enormous and those investors who stay the course now will reap the benefits of those investments when this current crisis abates – as it inevitably will.

An economically and politically stable Eastern Europe is in the interests of the whole world.

More importantly, the people of Eastern Europe have made immense sacrifices over the last 20 years to prepare a better future for their children and future generations. They deserve this more prosperous future and we need to make sure they are not disappointed.

Communism failed them once. The west must not fail them a second time around.

Thomas Mirow

President

The European Bank for Reconstruction and Development

Regional cooperation that works – the EU's Northern Dimension Policy

By Paul Vandoren

The European Union with its population of 495 Mio people is a global economic power and the world's biggest trader. It is also the world's biggest donor. The EU however also takes on responsibilities to define relationships with the rest of the world in terms of removing trade barriers, develop poorer regions and promote peace and prosperity.

The EU takes a keen interest in cross-border cooperation along its external borders in order to let neighbouring countries benefit from its internal market and to foster stability and growth, which in return also contributes to the EU's security and prosperity. The EU has a wide range of policies and financial instruments available for the conduct of its external relations and in line with the geographic focus of the "*Baltic Rim Economies Review*", I would like to elaborate on the Northern Dimension (ND) Policy, its importance for the Baltic Sea region and EU Russia relations.

Let me start with the importance of the Baltic Sea region, which is of great relevance for Europe's economy and environment. Its nominal GDP in 2005 amounted to 71% of Germany's. It accounts for a little less than half the EU's land area, around a fifth of its population and a sixth of its GDP. It has tremendous potential and is home to an important part of Europe's environmental capital.

As far as Russia is concerned, the EU and Russia are interdependent in many ways. Russia is the EU's third biggest trade partner while Russian energy supplies make up a significant percentage of Russia's exports to Europe and thus a crucial source of income for Russia. Furthermore, the EU and Russia share many contemporary threats to which common answers are needed, such as in the field of security, migration, human trafficking and many more.

On 24 November 2006 in Helsinki, the Russian President, the EU Presidents of the Council and the Commission, as well as the Prime Ministers of Norway and Iceland adopted the Northern Dimension Political Declaration and Policy Framework Document.

The ND not only provides an important platform for discussions with non-member states (Russia, Norway, and Iceland) but also includes concrete mechanisms for practical cross-border cooperation. For example, there are currently two existing partnerships, on environment and on public health, which both function well and bring concrete benefits to the people in the ND region. The European Commission financially contributed to both partnerships together with all countries that are part of the ND policy.

Under the Environmental partnership, which has a fund of grants administered by the European Bank for Reconstruction and Development (EBRD), almost 3 billion Euros in grants and loans have been mobilized for the benefit of a cleaner environment, i.e. to help cleaning up nuclear storages and other dangerous sites in North West Russia as well as infrastructure projects concerning waste and water treatment.

The ND Partnership for Public Health and Social Well-Being is a mechanism for promoting public health strategies in the region by bringing together experts (for example from the Baltic Sea Network on Occupational Safety and Health) on HIV/AIDS, Primary Health Care, Prison Health, Social Inclusion and other thematic areas.

The ND Ministerial meeting in St.Petersburg in October 2008 decided to establish a Partnership on Transport and Logistics. This is of particular relevance given the ever increasing volume of EU-Russia trade. Furthermore, it was decided to launch preparatory work to assess the feasibility of a Partnership on Culture.

What is the added value of the ND policy and its relevance for EU-Russia relations when compared to the general framework for EU-Russia relations as expressed in the 2005 agreement on the four Common Spaces?

The ND policy is a regional reflection of the Four Common Spaces and addresses issues of cross-border cooperation in economically and environmentally important regions such the Baltic and Barents Sea, the Russian Oblast of Kaliningrad and the Arctic and Sub-Arctic areas.

While the priority sectors of cooperation of the ND policy coincide largely with the Common Spaces, the ND policy puts greater emphasis on the environment. In addition, it includes two specific areas that are not mentioned in the Common Spaces, i.e. the protection of indigenous people and public health and social well-being.

Despite some well publicised difficulties in EU-Russia relations, the ND policy has shown that fruitful and concrete cooperation with Russia is possible. It has provided a way to keep Russia positively engaged at a regional level and Russia not only shows keen interest in actively participating in the policy but also demonstrated co-ownership by means of its financial contributions.

From the EU side, ND projects and initiatives are financed primarily by the European Neighbourhood and Partnership instrument (ENPI) from the cross-border financial envelope, and to a lesser extent from the ENPI allocations for Russia.

The implementation of the ENPI cross-border cooperation programmes is due to start in the first quarter of 2009. Almost all of the programmes with Russia are in the Northern Dimension region. EU funding amounts to almost 290 million Euros and Russia committed to contribute with 122 million Euros.

From the experience with the ND policy, we can say that project based regional cooperation has an important role to play in addressing regional challenges and building bridges between people. Projects under the ND policy typically involve a wide range of actors such as regional and local authorities as well as civil society organisations, thereby creating important links and platforms for discussions on issues of common concern.

Finally, let me mention at this point that the European Commission is currently preparing an EU Strategy for the Baltic Sea Region as requested by the European Council conclusions from December 2007. The aim of this strategy is neither to create new structures nor to replace the well functioning cooperation under the ND policy but to focus on coordinating and strengthening the use of existing instruments and policies. This strategy is foreseen to be presented in June 2009 and is mainly targeted at the EU member states around the Baltic Sea, however it will also contain issues that will call for cooperation with third countries in the region, i.e. with Russia. Therefore, we can say that the ND policy will form the basis for the external aspects of the new Baltic Sea region strategy and thus also lay the ground for continued and re-enforced successful cooperation in the region.

The experience with the ND policy shows that this is an area where the interests of the EU and Russia clearly coincide, which inspires confidence for the future in new potential fields of cooperation.

Paul Vandoren

Deputy Head

Delegation of the European Commission to Russia

Against the financial recession with Baltic cooperation

By Ari Korhonen

An economic downward spiral is shaking up the world. The ultimate depth of the recession is yet difficult to predict. It is clear, however, that the effects are massive and far-reaching. The S&P 500 index of the United States' stock market perhaps indicates the historical severity of the economic situation. Measured with this index, the year 2008 was as bad as 1937. So far, there has been only one year in the financial history that has been worse, the year 1931.

The critical financial situation will also have a great impact around the Baltic Sea. We need to discuss and estimate various prospects for the future to foresee and prevent the negative effects. The countries whose economical situation is in some way dependant on the conditions of traffic on the Baltic Sea have an especially important role in the prevention of the negative effects. Also the role of the European Union is very important.

Decrease in transportation and tourism

As the consumer buying power weakens, goods traffic decreases. No investments will be made in new ports or roads during the recession. The development of the capacity of new routes, such as Russian ports, is postponed. As a consequence, much of the traffic to Russia from the west will continue to run through Finland. It is important to take this into account when the Finnish government ponders the traffic investments to revive the economy. It would be sensible to direct the investments at enhancing the conditions of transport and logistics or make them with the environment in mind. The operational conditions of transportation to and from Russia play a key role in coming back from the recession.

Another key factor in the transportation to and from Russia are the formalities at the border. Finland must be active toward Russia as well as inside the EU in promoting the transportation and tourism across the border. It is a question of will and negotiation skills, not of money.

The weak economic situation reduces tourism that has been a growing source of livelihood in the Baltic Sea region. The level of prices in, for example, the Baltic states and Poland has risen rapidly in the last decade as a result of tourism, among other reasons. When the prices go down enough, tourism will begin to recover and speed up the recovering from the recession as well. When the difficult times are behind us, it is important that the tourist destinations, hotels, properties and infrastructure are in good condition and available for tourism.

Is there enough money for a clean and safe environment?

The weak economic situation also affects the environment, both negatively and positively.

The decrease in traffic naturally reduces pollution and the risk of oil spills in the Baltic Sea. Also, the traffic will not necessarily increase very fast as the domestic market and production are the first to recover. As a result of this, transportation of goods from far away is limited especially in the beginning of the new economic growth.

On the other hand, the probability of serious environmental hazards in the Baltic region will grow as a result of the recession. In a poor economic situation there is not as much money for the prevention of the risks as during economic growth. Cutbacks will be made in investments in equipment and the development of systems designed to reduce the load on the environment will cease in agriculture, industry, water purification and transportation. Reductions will be made in development and research.

The right kind of policy in the Baltic region right now is to enhance the working and recovering conditions of the economy and to take care of preventing the environmental hazards. The European Union has risen to the challenge by drawing up the European Union Strategy for the Baltic Sea Region. Implementing the EU strategy and the Baltic Sea Action Plan, financing mechanisms, safety in sea traffic, implementing the EU legislation in new member states and the continuation of the Northern Dimension are the key issues. In addition to the strategy, we need joint measures and funding from the EU to save the Baltic Sea.

We need political decisions and common effort

The citizens of each member state have a chance to influence the policies in the European Union parliamentary elections in June 2009. The substantial policy issues in the European politics are practically resolved between a conservative and a social democratic Europe. Regionally, however, it is in our best interest that all the politicians from the member states surrounding the Baltic Sea push for the common agenda.

In addition to the European Union dimension we also need national decisions that support the realisation of the common policies in a larger extent and at the same time contribute to the recovery of the Baltic Sea region and a cleaner Baltic Sea. This calls for common policies and common effort in the member states even in the harder times.

Ari Korhonen

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The impact of the international financial crisis on the stability of banking systems in Central and Eastern European countries

By Wojciech Kwaśniak

The ongoing crisis of confidence in financial institutions observed in international financial markets, and in particular, the crisis of confidence in banks, has had a negative impact on the stability of financial markets both in global and regional terms.

Such a situation not only leads to the need of non-standard intervention of central banks in providing liquidity to the financial markets but also requires governments of individual countries to take large-scale measures to provide financial support to financial market participants.

The measures aimed at maintaining the liquidity of the financial market and solvency of certain institutions do not, however, eliminate the major risk to economies of individual countries, i.e. the systemic risk aversion of banks. This risk aversion takes the form of limiting the scale of bank cooperation in the interbank market and a radical tightening of lending policy towards enterprises and households.

Such a situation shows that there is a need for a new critical look at the standards and practices existing in the financial markets and the ways of auditing and supervising financial institutions. It also requires a verification of relations within international financial groups between the controlling entities and their subsidiaries.

The present financial crisis has once again demonstrated banks' particular vulnerability to crisis situations and a fast cross-border crisis transmission. This leads to a further deepening of the crisis and considerably raises the cost of overcoming it.

In addition, the financial crisis has confirmed central banks' special role in quickly identifying risks to the stability of the financial system and their leading role in providing banking systems effectively with liquidity necessary for their further functioning.

The transfer of risks through international financial groups is particularly well visible in Central and Eastern European countries. In the last 15 years, a large expansion of international banks through acquisitions of locally operating banks has taken place in these countries. A large group of these banks is systemically important for the stability of the local financial markets and important from the point of view of providing bank loans to national economies. At the same time, these banks represent only a small portion of international financial groups and the banking market of Central and Eastern European countries represents but a marginal part of the whole EU financial market.

The situation where the market was booming and the banking services market was far less developed compared to the developed countries led to a large increase in the lending rate. This was, in particular, the case of the poorly developed market for real estate funding. International banking groups, in their efforts to maximize their short-term financial results, were willing to grant foreign currency loans on a large scale and loans based on funds obtained in the international financial market.

The above bank strategy provided households and enterprises with easy and cheap access to bank loans. However, in view of serious financial market turmoil, this strategy has become, owing to the transfer of risk from controlling entities to their subsidiaries, an additional element increasing financial market instability in the host countries.

There was an abrupt increase in risk aversion in subsidiary banks, notwithstanding their good financial results and the absence of assets whose valuation is difficult. This was followed by banks' demands for public institutions to take over the whole or some of the risk. It seems that due to a concentrated shareholding structure of these banks the demands can, in fact, be attributed to international financial groups who addressed them to central banks and governments in the countries of their operations. Such demands have probably been triggered by banks' expectations of a support similar to what they have received from public institutions in their home countries, despite the fact that their subsidiary banks do not, in their majority, actually need such a support.

Unlike global institutions, the majority of which had or still have dispersed shareholding, banking systems in Central and Eastern European countries have banks controlled by specific owners, i.e. owners of significant stake of shares. It is them first of all who should be expected to have a positive influence on the prudential and stable management of the bank, and who should provide support if needed. Only when such activities prove ineffective or insufficient should public aid be considered. Therefore, a lot depends on the efficiency of measures taken by governments and bank supervisors that support central banks in the dialogue with the banking system on instruments aimed to provide actual aid to banks, encouraging them to continue the lending support for the economy.

The present international experience shows that an accurate financial market diagnosis, the quality of market supervision and cooperation between central banks, financial market supervisors and governments are of particular importance. These elements may ensure an adequately quick response and lead to identifying risks and restoring the stability of and confidence in the banking system.

Owing to the fact that responsibility for the stability and safety of the financial markets lies within the competence of each country the influence of central banks on banking system supervision should be strengthened under the European System of Central Banks. This applies in particular to banking groups operating systemically and on a cross-border scale that are important for individual national financial markets and the single European market. International cooperation and European solidarity in overcoming the present crisis and maintaining economic growth should be strengthened at the level of governments. The scope of partnership cooperation should also be expanded to control risks in a better way, which will be conducive to a quick evaluation of emerging new threats.

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St. Petersburg's commercial real estate market – some recent trends

By Oleg N. Misko and Sergei F. Sutyrin

At least during last five years St.Petersburg real estate market has been due to several economic and geopolitical reasons one of the most appealing targets for both domestic and foreign investors. Logically enough it has experienced impressive growth. Traditionally market under review is structuralized into three major sub-markets. Namely they are: office premises, retail/wholesale premises, and finally warehouses/logistical centers. These sectors, on the one hand, have their own peculiarities regarding location priorities, level of prices, transportation requirements, etc. This is twice as significant due to a mere size of the city – the largest metropolitan area in Baltic region. On the other hand, all abovementioned sub-markets share some common features in their development. In particular they result from the pattern of regulatory framework – provision of specific land plots, city government approvals with respect to procedures of projecting and construction, etc. Meanwhile the most important common feature is gradually growing deficit of territories suitable according to their natural and legal statuses for respective activities.

In case of office premises aforementioned deficit generated as late as the end of 2007 a new approach in city government policy – relocation of plants and factories from old industrial zones either to outskirts of St.Petersburg or towards Leningrad province. In contrast to first wave of relocation initiatives in 1990s largely initiated by ecological considerations without any serious specific plans regarding disengaged territories, current focus is on construction there new business areas. The latter might be created either via renovation of already existing premises or as totally brand new buildings. It goes without saying that relocation is a relatively lengthy process taking several years. Under the circumstances its impact on respective prices so far is minimal, if any. It is not by chance that just during first 8 months of 2008 monthly rent for square meter of office premises increased about 20% and reached 35 euro.

In case of retail/wholesale premises the need to adjust the policy to the lack of territories ultimately forced city authorities to reject substantial number of small- and medium-scale projects and focus on large multistore so called "multifunctional trade complexes" (MFCs). Being initially introduced into St.Petersburg landscape about decade ago they gradually expanded and by September 2008 account for 3 600 000 sq.m. with about 95% of this total under permanent use. Two large groups of actors operate the market: representatives of large chains (METRO, O'KEY, LENTA, IKEA, etc.) and individual entities (Grand Canyon, Gulliver, etc.) The former is clearly dominated by Moscow and foreign owners, while the latter is shared by locals as well as outsiders. Expansion of MFCs resulted in crowding out of small retail stores. Certain amount of those first and foremost selling basic food mainly to inhabitants of nearby houses is financially protected within the framework of city SMEs support programme.

Finally, in case of warehouses/logistical centers abovementioned deficit reveals itself in a most dramatic way. The total supply equals to as little as 1 429 339 sq.m. including those put into operation in the 3d quarter of 2008. More than that, these are mainly low quality premises with Class C and Class D warehouses accounting for 81% of the overall. Since largely due to transportation constrains no new construction is possible in the downtown and old industrial areas of the city the only promising projects are located in the outskirts close to main motorways and railroads. It is worth mentioning that many well-known foreign companies are very active here. Another interesting feature of the sub-market under review relates to the fact that respective contracts between the owners of warehouses/logistical real estate under construction and their potential clients tend to be signed at the very early stage, often after construction *per se* is just started.

All discussed above deals with relatively long-term trends. In contrast to that, some new changes resulted from current financial and economic crisis. First of all, it brought contraction of investments into the sector and hence decline in total volume of construction. In particular, only in sub-market of warehouses/logistical centers about 1 000 000 sq.m. of incomplete construction were frozen during last several months. Secondly, there is an evident trend towards increase in length of construction with completion of many projects being postponed in average for 1.5 years against initial schedule. Thirdly, in case of warehouses/logistical real estate and office premises the gap between supply and demand tended to widen. This largely resulted from the fact that the crisis hit construction earlier than other industries. And finally fourthly, due to deterioration of living standards MFCs experienced disengagement of their premises, in particular as long as substantial number of retailers was forced either to quit totally or to diminish the scale of operations.

In general one might argue that St.Petersburg commercial real estate market will suffer from the crisis to the less extent than respective national one. There are two main reasons for this optimism. On the one hand, abovementioned deficit of city premises will by no means disappear. On the other hand, due to the overall high investment potential of St.Petersburg commercial real estate will most probably continue to attract both domestic and foreign investors.

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University of Joensuu as an active partner in cross-border cooperation in Northwest Russia

By Perttu Vartiainen

The University of Joensuu (UoJ) is a multidisciplinary university with over 8 000 undergraduate and graduate students. The UoJ is the easternmost university of the continental European Union, located only 70 kilometres from the border of Russia. Consequently, cooperation with academic institutions in the Soviet Union and Russia has been a natural choice for the UoJ ever since its foundation in 1969. In the Soviet time, the cooperation focused on humanistic studies addressing the common cultural heritage of the Karelian region, which connects eastern Finland and the Karelian republic in Russia. In 1978, the UoJ and Petrozavodsk State University signed a memorandum of understanding on cooperation between the universities – the first one of its kind for both of them.

Following the collapse of the Soviet Union, interaction between the UoJ and its Russian partner institutions has increased in many ways. First of all, the lively exchange of students and academic staff has created a framework for forming sustainable partnerships both at the institutional and the personal level. At the same time, the topics of mutual interest have expanded to cover also the current social, economic and environmental issues characteristic to the border region between Finland and Russia. Secondly, the UoJ has been an active player in implementing the cross-border and neighbouring policies of Finland and the EU. Furthermore, in continuing education and entrepreneurial activities, the university has carried out projects that are of interest to various public and private organizations on both sides of the border. The range of these projects reaches from forestry to legal institutions and customs. Thirdly, the geographical core of these activities now covers the whole of Northwest Russia with St. Petersburg as the main economic and academic hub of the area. This has given impetus to widen these activities to new fields of science and technology in order to reach new synergies between Russian high-level basic science education and Finnish technology-driven research and business expertise.

In its current strategy, the UoJ defines “border studies and Russia” as one of its four strengths and areas of expertise. This expertise rests both on research and teaching relating to state borders and cultural boundaries as well as on applied knowledge in subjects like forestry, business and law. These subjects lie in the core of the current cross-border activities in the border region between the EU and Northwest Russia. In the humanities and social sciences, this border region is also of interest to a wider community of scholars wishing to conduct multidisciplinary, comparative border studies. The leading research institution addressing borders and Russia at the UoJ is the Karelian Institute, which has also gained recognition as the coordinator of several national and European research projects.

Questions pertaining to borders and their formation have shaped the Russian studies conducted at the UoJ. Thus, Russia and Russianness from the perspective of borders and cross-border interaction form a key element in research activities in social, cultural and theological studies at the university. This allows our researchers to assume a special profile both in the national and the wider European context. The university’s expertise on borders and Russia also serves as the foundation for the multidisciplinary competence centre “Europe beyond East-West Division” at the UoJ as well as for the nationally recognized Ph.D. programme “Russia in Europe” coordinated by the UoJ. The three main fields of research of the competence centre currently include “External borders of the EU: Regional Dimensions of the New Neighbourhood”,” Post-Soviet Change, Globalisation and Governance” and “Border, Ethnicity and Identities”.

The UoJ offers several study programmes, study modules and courses whose thematic core is built around borders and Russia. This concerns not only studies in Russian language and culture, but also subjects like history, human geography and forest sciences. In most of these programmes, the language of instruction is English and they also attract international students. The UoJ hosts a growing number of Russian students, most of whom now study in international programmes. One of the most attractive programmes among Russian students has been the International Master’s Degree Programme in Information Technology, IMPIT.

A new major programme for cross-border cooperation in academic studies between Finland and Russia is the Finnish-Russian Cross-Border University (CBU) coordinated by the UoJ. The CBU is a partnership between five Finnish and four Russian universities. In the pilot phase, these universities have offered Master’s degree programmes in six fields of study ranging from business to public health.

In 2010, the UoJ will merge with the University of Kuopio to form a new multi-campus University of Eastern Finland (UEF). This opens up new opportunities to widen our expertise to health sciences, medicine and social work; which all seem to be critical for solving the current social problems in Russian society and border areas in particular.

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The January 2009 Russia-Ukraine crisis and the imperative of bypass pipelines

By Jonathan Stern

January 2009 Russia-Ukraine gas crisis was a seminal event in European gas and energy security history. It marked the end of 40 years of reliable supply of Russian gas to Europe. For a number of reasons – commercial, political and technical - it called into question whether the Russia-Ukraine gas corridor can henceforth be regarded as reliable. Finger-pointing and accusations of blame for this event should not be allowed to obscure the inescapable fact that, for the first three weeks of January 2009, Russian-Ukrainian bilateral relations suffered a catastrophic breakdown, and for two of those weeks Europe failed to receive around 20% of its gas supplies. There is no guarantee that these events will not be repeated.

Those who hold Russia principally responsible for this event will see no remedy other than phasing out European dependence on that country's gas supplies. But given long term contracts with European utility companies stretching out as long as 25 years in the future, and the lack of any immediate (gas or other energy) supplies to replace, even a fraction of those currently supplied by Russia, this is an impractical proposition in anything other than the very long term. Those who believe that the principal problem lay – and continues to lie – in Ukraine and in the Russian-Ukrainian bilateral relationship, may conclude that there are only two options:

- The creation of a consortium of European, Russian and Ukrainian companies which would own and operate the Ukrainian transit network;
- new pipelines from Russia to Europe bypassing Ukraine.

Time for discussion has largely run out. January 2009 abundantly demonstrated was that European institutions – whether the European Commission and its presidency, the Energy Charter Treaty or European gas companies - have no significant leverage over either Russia and Ukraine to resolve a bilateral energy dispute and this is not their responsibility; the same cannot be said of EU energy security crises. For as long as Ukraine refuses to implement a transit consortium, bypass pipelines remain as the only medium term solution.

The Nord Stream and South Stream pipelines have been discussed for some years with both projects having encountered opposition. Opposition to Nord Stream among Baltic countries is well known and has succeeded in delaying the progress of that pipeline. Conspiracy theorists have even suggested that the January 2009 crisis was staged by Russia to rally European Union support for Nord Stream. Without entering into such speculation, it is important to observe that had two Nord Stream and a South Stream pipeline been in operation on January 1, the impact of the dispute would have been reduced to minor inconvenience for the vast majority of European consumers. It is European – and particularly south east European - consumers who suffered severe humanitarian consequences from lack of gas supplies, to whom concern should be directed.

Economic objections to Nord Stream and South Stream can be quickly dispensed with. These projects will of course be much more expensive than new pipelines carrying similar volumes of gas via existing or new land-based routes, but this is largely irrelevant as long as finance can be raised by the commercial partners in these projects. Those who continue to insist that new pipelines should be land-based are unconsciously or wilfully missing the point: the problem as seen from Moscow is the unreliability of transit countries; Russian export strategy is aimed at eliminating transit countries to the maximum possible extent. While Moscow's position may be considered mistaken, or its own fault, it is a policy which can only have been reinforced by the January 2009 events. Those who further assert that this is "Russia's problem" to solve are also missing a key point: Gazprom is prepared to provide highly expensive alternative pipelines to guarantee European gas security at its own (and its partners) expense. If European Union countries wilfully delay or prevent such pipelines from being built, then the consequences could be seen to be Europe's – just as much as Russia's – responsibility.

Other objections to Nord Stream and South Stream pipelines range from environmental opposition, to accusations that the pipelines will allow Russia to conduct espionage operations against the littoral states, or to isolate individual European countries to make the latter more amenable to political pressure. The resistance of (particularly) Baltic countries, and the political nervousness of all former Soviet states and Warsaw Pact/Comecon member-countries, to any Russian initiative which might seem to place them at an economic and political disadvantage to Russia, is completely understandable. With the Soviet and Cold War eras still fresh in many minds, these countries have no reason to do Russia any favours, and much reason to be suspicious of its motives. However, the world has changed. While nobody is expected to forget history, all of us need to move on. NATO and EU membership have – or certainly should have - provided protection from fears of military and/or economic hostilities.

Governments which retain suspicions about adverse consequences of dependence on Russian gas supplies should extricate their companies from long term contracts with Gazprom, and arrange for alternative gas or energy supplies. Despite continual discussion of these options in a range of European countries, actual results have been extremely modest. This is not a criticism, but an observation that, for the majority of these countries, to replace even a part of Russian gas supplies – either with alternative gas (and LNG) supplies or with nuclear or coal-fired power stations - will be both extremely costly and require at least 5-10 years to achieve. Decisions now need to be taken, but should be taken by national governments about the energy future of *their own countries*, not by governments on behalf of others.

The January 2009 events mean that Nord Stream has ceased to be a "Baltic issue" allowing regional countries a license to delay the pipeline, just as South Stream is not a "Black Sea" issue giving countries such as Ukraine a similar license. These pipelines have become pan-European gas security issues. Individual European governments have the right to refuse to take gas from these pipelines; but they should not prevent others from doing so.

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Forum of gas exporters – design

By Leonid Grigoriev

Gas Exporting Countries Forum (GECF) has been finalized legally by ministerial meeting in Moscow on December 23, 2008. CECF includes main (not all) gas exporters: Algeria, Bolivia, Venezuela, Egypt, Iran, Qatar, Libya, Nigeria, Trinidad and Tobago, Equatorial Guinea, Russia, with Norway (observer) and Kazakhstan (guest). The very idea of creating the special non-governmental organization for natural gar producers is going back to 2001 when it was announced. Producers of natural gas obviously are interested in the exchange and sharing of information about market trends and principles of international pricing rules. Some of these issues were discussed at the meeting of High level in Caracas (Venezuela) on 8-9 of October, 2008.

Extensive media coverage was focused on some statements of some Iranian officials, Russian non-officials, and American and European commentators: is it “Gas OPEC” or not. We argue that GECF has designed as “IEA of exporters – not OPEC”. We would suggest distinguishing between the realty of gas industry world and media reaction, sometimes going a too long way to “cartel paranoia”.

First limitation on gas cartel is the fact, that it is still not a single global gas market – North America, Pacific and Europe have different system (pipes and LNG mix) and geographical sources of supplies. Supplies are mostly based long term contracts, LNG or pipes regardless. That is a major difference to the oil market. As people in the gas industries say: “nobody produces unsold gas”. That reflects the size of the projects – biggest projects in oil are small projects by the gas industry scales. Financial risks are too high and cost recovery periods are too long to gamble on spot prices at the start of the investment cycle. LNG share is growing (10-15% by now), what may create more footing for the output manipulation – “Oil Style”.

As soon as the gas infrastructure has been built, the spot pricing is coming into picture. Graph 1 reflects the similar fluctuations in the market with the expected steep decline in 2009. Long-term European contracts were invented in Europe with price formula, based on oil spot prices. This is the major safeguard against the gas cartel in the EU markets since all physical volumes and prices are essentially predetermined for the next 30 years. This feature should be taken into account while discussing the future of gas pricing system. Long-term contracts on net-back formula look rather a fashion of the day. Oil spot pricing gave us for sure the long swings in prices ($8 - $145 -$35 in one decade) and investments, but had not prevented forming the oil cartel.

For mentioned above reasons CECF cannot become the “gas OPEC”, regardless what proponents or opponents may say at the outset. In the long run the abolishing the long-term contracts and the domination of LNG on the global market might create the ground for gas cartel. From our prospective some stability of prices may be helpful for the long-term investments in the global oil&gas industry, especially considering the Energy Saving and Climate Change prevention objectives. IEA was designed for OECD (consumers) countries to understand the global energy markets and to adjust its policies accordingly.

Design of the Gas Forum more resembles the International Energy Agency with the focus on the market analysis and forecasting. There are no quotas or voting procedures for setting output level or price targeting. Critiques of GECF were mentioning investment decisions, but it does not take any organizations for companies to understand the future risks. It is more symbolic than practical issue – gas exporters probably would never be pitched against each other in the blind competition for the sake of creating “consumers’ market”. Long term investment decisions are determined by price expectations and costs (currently at $60 minimum for “new oil”) and national decisions. For example, Qatar’s Government had long ago decided to limit its investment program in LNG by 2010.

By statements of participants at the meeting Moscow in December countries decided on the setting the Head-quarters in Doha (Qatar) – Saint-Petersburg lost the voting - and on the coordination in four areas:

- Relations with countries - gas consumers;
- Exchange of information on forecasts and investments;
- New technologies;
- Cooperation in LNG production.

Gas Forum may give to gas producing countries better understanding of the future gas demand, technologies, legal regimes etc. It may become a partner to the IEA and other agencies in the developing global energy vision for the 21 century.

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President

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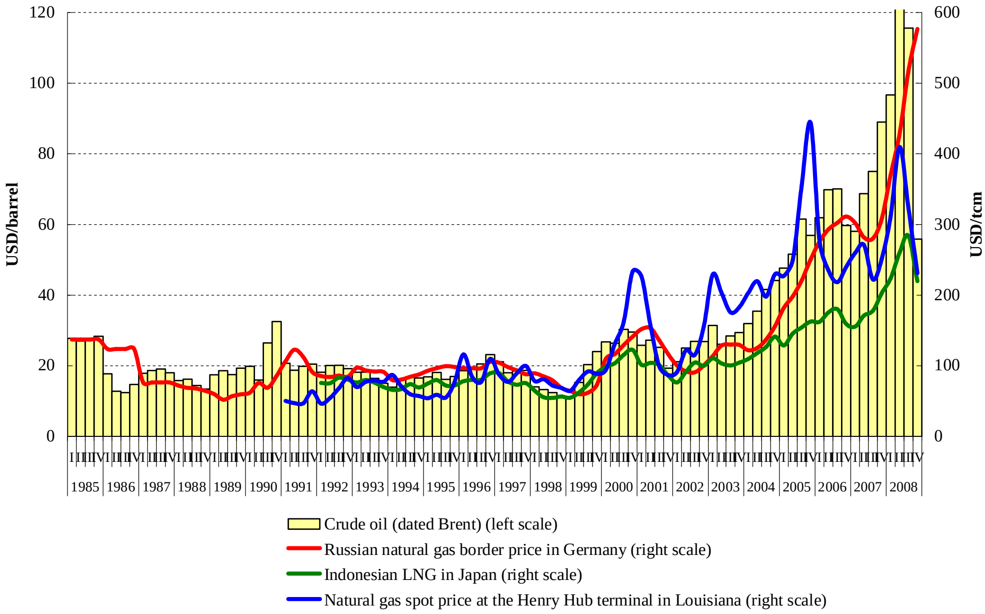
Russia

Graph 1. Oil and natural gas prices on main markets, USD/tcm, 1984-2008, annual averages.



Source: IMF

Ukraine's energy lesson to the EU

By Kari Liuhto

The EU's gas reserves are non-existent; around 2% of the global reserves. Despite such a tiny reserve base, gas is a strategic commodity for the EU. Approximately 20-25% of the primary energy consumption of the European Union is covered using natural gas.

The Union's own production takes care of 43% of its natural gas consumption, but the share of the Union's own production is to dive sharply. In two decades from now, the EU will be able to meet only 15% of its natural gas needs, meaning that 85% of the Union's natural gas consumption is soon to be imported.

Russia is by far the EU's main external supplier of natural gas. It accounts for 24% of the gas consumption of the EU27. Norway comes second with 13% and Algeria with 11%. The remaining nine per cent of the EU's current gas consumption is supplied by several countries, mainly by Nigeria, Libya, and Qatar. The natural gas reserves of Norway and Algeria are modest compared to those of Russia. Norway and Algeria together hold less than 5% of the world's natural gas, whereas Russia's stake is 25%, and therefore, Russia has the potential to increase its stake in the EU's gas consumption in the future.

The recent gas dispute between Russia and Ukraine has brought the issue of the reliability of an external gas supply back to the European headlines again. Norway, due to its European values and strong democratic traditions can be considered to be a reliable natural gas provider to the EU, but Algeria's political situation already raises certain doubts. When one evaluates Russia's capability to increase its gas exports, one should not forget that Russia's own gas production declines because the colossal West Siberian fields are depleting and Russia's own gas appetite will begin to grow when its economy has recovered from the current crisis.

One should not forget that Russia is an extremely gas thirsty economy. Close to 60% of the country's primary energy consumption is catered for by gas. Russia should carry out a major energy reform before it can reliably meet the needs of both Russian industries and households and their European counterparts in the future.

When we estimate Russia's capability to deliver gas to the EU, we should remember that the new giant gas fields are far-away and are located in a harsh arctic environment, and therefore, investments climb exceptionally high. For instance, the opening of the Stokhman gas field in the Barents Sea is unfeasible, until oil prices go above $50-60 per barrel. Presently, the barrel price stands at around $40 and energy companies are reluctant to invest mammoth amounts of capital in very risky projects. The EU should acknowledge that the opening of the new giant gas fields in Russia will be delayed by several years, even if the global recession will be shorter than is generally expected.

Russia's leadership has stressed that the era of cheap gas prices has come to an end due to major investments required by the new arctic fields. This has been one of the reasons, why the Russian leaders have underlined the importance of freeing the natural gas price from the oil price, which has lately developed very unfavourably for producers. The attempt to strengthen the Gas Exporting Countries Forum, founded in 2001, can be considered as an attempt to destroy the correlation between oil and gas pricing, and hence, an attempt to increase natural gas prices. Even if it is not easy to create a functioning market for natural gas, since gas is mainly transported via pipelines and the gas agreements are usually long-term, the plan to formalise the Forum should finally open the eyes of the decision-makers in the EU member states. The Russian leaders would not spend a considerable amount of time in strengthening the Forum, unless they consider that it could become a practical tool in increasing natural gas prices.

The current gas dispute between Russia and Ukraine could have been predicted long before the issue jumped into the news headlines, since Russia has to justify the need for new gas pipelines, namely Nord Stream and South Stream, bypassing Ukraine. The justification of the new pipelines is achieved by destroying Ukraine's reputation as a credible gas transit country. If Gazprom would truly have been interested in securing the supply for its EU consumers, it would have started negotiations much earlier. Russia's Blue Gold has become the EU's Blue Cold.

The lesson to be learned! Russia's short term goal is to get rid of the transit countries and by reducing the importance of the transit, to force the transit countries into its sphere of interest. This time the operation is not executed with soldiers and tanks, but now the conquest is accomplished by using pipelines and banks, which finance the acquisition of major energy assets in the transit countries. With pipes bypassing Ukraine, Russia wants to close Ukraine's path towards the EU and NATO in particular, and ultimately strengthen its own negotiating power over the Sevastopol military base. The Russian Black Sea Fleet is to leave the base in 2017, if the agreement is not renewed. Moreover, Russia's long term goal is to increase its political leverage towards the EU, particularly towards its biggest members. In order to increase the energy dependence of big member states further, Russia offers those states attractive stakes in major hydrocarbon fields.

The interdependence between the EU and Russia is not sustainable, since the Union becomes more dependent on Russia's energy deliveries than Russia on the European energy market. If the EU follows its current path, the Union becomes, day by day, more addicted to Russian gas. The energy interdependency between the EU and Russia is comparable to a relationship between a heroin dealer and a heroin user. Both of them need each other but at the end of the day the heroin addict becomes more dependent, as long as no alternative is available for the user. In order to create an alternative, the EU should invest in energy savings programs, introduce energy solidarity between the member states and invest more in its own energy production, particularly in nuclear production, i.e. the EU should create an energy policy for itself.

Russia can survive several months without the financial inflows generated by gas exports to the EU, but can European households and industries survive a gas blockade, especially if it happens in the wintertime? This fresh dispute indicates that some countries cannot even survive days, not to mention months of non-supply. The EU countries' energy emergency storages are inadequate to balance their overdependence on increasing energy imports. The Union's overdependence on Russia may turn Nord Stream and South Stream, originally intended to strengthen stability and peace between the EU and Russia, into a political crisis and major conflict. Daydreams might become a nightmare for both the EU citizens and the Russians.

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Living up to our promises – fostering a sustainable Baltic Sea Region

By Mia Crawford and Risto Veivo

For more than 10 years our neighbourhood of the world, the Baltic Sea Region, has had a clear vision of turning the principles of sustainable development into practice. For a decade we have had the strongest commitment by the Heads of Government in all the countries around the Baltic Sea to tackle environmental degradation and socio-economic inequalities and foster sustainable solutions and best practices. For 10 years, Baltic 21 has contributed to advancing sustainable development in the region by coordinating goals and activities, and by servicing as a forum for cooperation across borders and between stakeholders.

However, despite this commitment the overall development of the region is still far from sustainable and many alarming trends point to the opposite direction. The consumption and production patterns of the region are highly unsustainable. The state of the environment of the Baltic Sea is getting worse due partly to eutrophication, overfishing and extensive marine transport. The bio-diversity is decreasing both on land and at sea, and socio-economic inequality is a daily reality for far too many. Energy use is at peak levels, while regional car density is increasing. Currently, transport is the most dominant sector in terms of both energy demand and CO_2 emissions in Europe. The key challenge for the success of Baltic Sea regional co-operation and for the development of the whole region is how to turn these negative trends – how to move from declarations to real practise.

Moving from words to actions requires a solid (political) commitment and allocation of necessary resources. On the technical level, the solution lies in the implementation of concerted actions involving different levels of governance and civil society, as well as co-operation across administrative and economic sectors and borders. In order to contribute to the solution, Baltic 21 has promoted Baltic Sea regional Lighthouse projects to demonstrate sustainable development in practice. During the last two years, Baltic 21 has facilitated the development of strategic projects under specific themes. These projects show-case how sustainability can be advanced effectively and concrete results achieved.

In the beginning of 2009, Baltic 21 launched four new projects, addressing topics such as mobilising the bio-energy potential of the region, promoting innovations for sustainable production, balancing urban and rural development, speeding up local and sub-regional sustainability processes. Co-funded mainly by the EU Baltic Sea Region Programme 2007-2013, these new projects have mobilised 80 partners in the region, including ministries, other national authorities and agencies, funding institutions, NGOs, regions and cities, expert organizations, universities and public companies. The project funding of 15 Million Euros is still very modest considering the challenges and potential resources of the region. However, these projects will play a role as catalysts, leading to new solutions, practices and policies, and thereby potentially mobilizing much larger resources and action for change. Project implementation will continue until 2011/2012, and is lead by different Baltic 21 members, representing the multi-stakeholder approach of Baltic 21.

In addition, The HELCOM Baltic Sea Action Plan, adopted in 2007, is soon to be accompanied by national implementation plans. This Plan is the cornerstone and roadmap for the efforts of the region to improve the environment of its most important shared resource, namely the Sea. Moreover, the Council of Baltic Sea States has identified sustainability as one of its long-term objectives. The European Commission is currently developing the EU Strategy for the Baltic Sea Region, and environment and sustainable development have from the onset been identified as one of its main objectives. The envisaged Strategy will be accompanied with an indicative action plan of some key actions that will, if implemented, contribute to steering the region in a direction towards an environmentally friendly, prosperous, accessible and attractive, as well as safer and more secure place.

Catalysts like the projects of Baltic 21 and others are certainly helpful in showing the ways forward. Solutions on the technical/methodological level need to be developed and demonstrated, and this is best done in multi-stakeholder co-operation such as in the case of Baltic 21. Still, such actions alone do not constitute a sufficient Baltic Sea regional response to the challenges faced. The existing political commitment needs to be strengthened and accompanied by allocation of stronger resources for implementation. In parallel with great economic challenges, the global community is facing an ever-growing challenge of sustaining the livelihood of our planet.

Across the lands and oceans, far and near, people of the world are demanding change. Real change in terms of ensuring prosperous economies, healthy societies and dynamic ecosystems. Baltic Sea Region has repeatedly declared its commitment to sustainability and global responsibility. Indeed, sustainable development needs to be further strengthened as a priority focus for the full range of our collaboration initiatives. Words on papers must be accompanied by real action – action that brings concrete results and initiates change. We must face the odds and turn the trends. Baltic 21's multi-stakeholder network is well-positioned, prepared and willing to contribute to solving the challenges on our path to realizing the shared goal of sustainability.

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Finland

GAS-OPEC – cooperation or confrontation?

By Chris Weafer

Russia, Qatar and Iran formally inaugurated a new gas exporters forum in Moscow last December. The intention is to expand its membership to include all of the world's major gas export countries and to establish a permanent secretariat with a fulltime Secretary General. If this fledgling structure does succeed in bringing together the world's major gas producers, and in establishing some common goals, then it may become a catalyst for a substantial increase in upstream gas production, in transport infrastructure and, in particular, the development of LNG to be a more important global energy source. Not only is that environmentally preferable to other energy alternatives, there is also sufficient available supply to achieve the critical mass required. An increased supply of gas globally, especially in the form of portable LNG, would improve energy security rather than place it at risk.

Moscow views this forum as a mechanism to help it advance its goals of attracting more investment funds into its gas industry to substantially increase production volumes over the next two decades and also establishing Gazprom as a major global force in the LNG business. Yes, it would also increase Russia's importance as an energy partner to both western and eastern consumers, but counter balancing this is the fact that, if LNG was more widely available and used in Europe this past January, then the fears over the disruption of the gas flows via Ukraine would have been substantially lessened.

It is also important to focus on why the Kremlin wants to promote gas as a more important factor in global energy, with Gazprom having a central role. It is not the Kremlin's objective to have greater control over energy supplies so as to leverage for political gains or to hold consumer economies hostage. That has never been the case since gas first started flowing from the former Soviet Union and it is not now. Energy, especially gas, is Russia's competitive advantage. It has a lot of it and is well placed between east and west to efficiently export it. The current government has made very clear its long-term ambition to create a more diversified economy in Russia with a higher level of global integration. Bartering energy for increased trade and to increase investment access to the rest of the world is a key part of that strategy.

The mistake that consumer countries made with OPEC was that they viewed it initially as irrelevant, and later as a threat, rather than as a partner. The legacy of that today is that there is relatively little coordination between OPEC and the I.E.A. and that is a big part of the reason for price volatility and supply uncertainties. Consumer countries should not make that mistake with this gas exporters group. By engaging with Russia and its partners in the new gas forum from the outset, including sharing costs and being involved in planning, then a higher level of energy security can be better assured.

If Russia is able to start realizing its long term economic goals, greater global integration would allow the country develop a more stable economic model faster and that would also help the country's social structure develop. The middle class segment today represents only about one-fifth of the population rather than the 60% level typical in developed economies. Greater economic integration would also make the country much more dependent on the countries to which it exports energy. In the recent dispute with Ukraine, Europe had arguably more at stake than Russia. That is because the EU depends on energy imports from Russia to a much greater extent than Russia depends on non-energy trade the other way. There would have been a much different dynamic in that dispute had Moscow more at stake over the short-term.

When Russia first put forward the idea of a more formal gas exporters forum to that set up by Qatar in 2001, western politicians immediately either dismissed it as impractical or viewed it as a threat. Russia's role was particularly viewed with suspicion and has become a focal point of the criticism. That is partly because of the 2006 and 2009 disputes with Ukraine but also because of the history of, e.g. YUKOS and Sakhalin-2. No doubt, the Kremlin has not done itself any favours with the way that it has gone about restructuring the ownership of assets in the industries it deems strategic. It viewed structures, such as Sakhlin-2, as having been concluded during a period when the country's government was weak and the deal unfairly biased against the state's interest. The legislation governing the future involvement of foreign investors in the country's most important industries, including gas, was put in place in May of last year. The new "rules of the game" are now a lot clearer. International energy companies understand that – Total, StatoilHydro, ENI, BASF and E.ON have been amongst those making deals since – but politicians in many western consumer countries still do not, or choose not to.

To develop the countries considerable gas resources and especially to establish LNG as a bigger portion of the global energy pool will require hundreds of billions of dollars in investment. Russia cannot afford to fund that own its own and nor does it want to. The gas exporters forum will provide a mechanism for creating joint development projects and for greater coordination to ensure that projects are commercial and relevant. Including both gas forum partners alongside industry investors in production projects located in Sakhalin, the Arctic and Yamal Peninsula, plus proposed new LNG plants on the Baltic Coast and Murmansk, will ensure that these can proceed at a faster pace than if Russia was left alone to develop them. That makes a lot of sense not only to the Kremlin but for consumer countries also. That's why the EU, in particular, and other energy importers needs to have a close involvement with the new structure.

Europe currently imports approximately 400 billion cu meters (bcm) annually and 40% of that comes from Russia. 80% of Russia's gas flow to Europe passes through the Ukraine pipeline. By 2020 it is estimated that Europe will need to import approximately 600 bcm of gas because of the growth in demand plus the forecast decline in the region's own production. At least half of that incremental demand will have to be sourced from Russia. The two phases of the planned Nord Stream pipeline are forecast to have a total capacity of 55 bcm while the South Stream pipeline is planned with a capacity of 30 bcm. To fill these pipes, to provide gas to the planned LNG plants and to replace the expected decline in production from Gazprom's existing, aging fields, Russia will need to spend at least $500 bln to develop new gas fields. Many of these deposits are located in deep water Arctic of off the Pacific Coast and will also require both new technologies and techniques. Russia cannot make this work on its own. It needs the involvement of international energy companies and partnership with other gas producer countries. In exchange Russia will increase investment in production, and help develop export routes, with other gas producing countries. But, with such a huge investment required, Russia and its partners in the new gas forum will also require more assurance on demand. Otherwise we will likely see delays, poor coordination and, ultimately, more supply fears. In a world where energy demand in rising and energy security is the new mantra, it makes a lot of sense for that greater coordination between the consumer nations and those with gas resources.

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Russia

Russia and the European Union – partners in energy cooperation or rivals in "Great Game" confrontation?

By Hanna Smith

The relationship between Russia and the European Union has never been an easy one to analyse. It seems that it is a topic which can never be sufficiently researched. It is an oversimplification to describe the relationship as a good one or a bad one. Perhaps a more appropriate way of describing it would be to compare it to a rollercoaster ride, with some frightening descents, difficult uphill climbs, thrilling loops and steady bends where it is possible to take a breath and enjoy a feeling of relief after surviving a shaky ride. At present Russia-EU relations are yet again resembling a section where there is a scary fall. There are many factors behind this downhill ride, but one factor that plays a serious part in the present increasingly tense situation, possibly in an altogether new way, is the complex issues and competing views over questions related to energy. Headlines like "When Russia turned off the gas to Ukraine, it sent shivers across Europe where customers are increasingly dependent on Russia to keep warm", are well known to most EU citizens. This report from the BBC in fact relates to the 2006 gas crisis but could just as easily have come from this year's dispute.

Energy resources bring significant benefits to the Russian state budget. Russia needs to export energy but it also benefits from being able to use its own energy resources for domestic consumption. Russia is an energy resource-consuming country. The EU is an energy importer and many EU member countries are very dependent on Russian gas. The statistics are well known but do very little to help us understand why Russia-EU relations are so fraught in relation to the energy question. Statistics in fact tell us that both Russia and the EU need each other, and that there should be a clear picture of interdependence. Interdependence in international relations encourages cooperation and win-win thinking, but so far there is little evidence that this principle is working in EU-Russia energy relations.

Russian energy policy reached a clear watershed in 2003 with the YUKOS case. Energy became a strategic asset for Russia and therefore state involvement grew and took over the way business regarding energy was dealt with in Russia. This approach was tightly linked with Russia's determination to achieve Great Power status, the guiding ideological principle of Russian foreign policy. The state's goal was to help Russian companies attain prominent positions in the world's top league, while preventing foreign takeovers of Russian energy companies, resources and transport routes. Russia's role as an energy power started to emerge strongly in 2005. The first incident to cast doubt over Russian motives and intentions in Russia's energy policy towards the EU was the deal concluded between Russia and Germany on the Northern European gas pipeline in autumn 2005. In the Baltic states and Poland the deal was condemned as a "new Molotov-Rippentrop pact". On the Russian side, however, the energy minister Viktor Khristenko saw the deal as representing a real option for diversifying supplies of Russian gas. "We need to examine these kinds of schemes for transport across reliable transit territories or through extra-territorial zones for the future" he said in a February 2006 interview with Russia Profile. Russian energy policy did not only include plans for the diversification of supply routes but also sought to abolish energy subsidies to the former Soviet states, at least from those that were openly proclaiming pro-Western policies and criticizing Russia or otherwise being uncooperative towards Moscow. These countries were Ukraine, Georgia and Belarus. All of them went through disputes in the energy sector with Russia between 2005-2009. Ukraine and Belarus twice experienced disruptions either in gas or oil supplies and Georgia has had problems with both electricity and gas. Some problems have also been experienced in the Baltic states and Poland after they took up membership of the EU.

From the EU side all this represents a very worrying trend. If Russia is capable of using energy shutdowns as a form of negotiating tactic with former Soviet states and in some cases further afield, why should it not hit the EU directly in the end? On the one hand the EU has so far only been affected indirectly since, for example, the gas dispute between Russia and Ukraine in early 2009 was mainly just that - a dispute between Russia and Ukraine. On the other hand the EU is directly involved since it is the biggest market for Russian gas and without the EU's involvement Ukraine would not hold a strong hand in negotiations with Russia once the gas is turned off. The only way for Ukraine to achieve a stronger position is to make sure no Russian gas reaches the EU countries as long as Russia is not supplying gas to Ukraine. Although Ukraine herself lost a certain amount of credibility through this episode, cutting off the transit of gas to the EU was the only effective way of mobilizing the EU to intervene in finding a solution to the crisis.

Since Russia declared an energy policy safeguarding its national resources from foreign ownership as well as making clear its desire to control all the transit routes and buy into downstream operations itself, the EU has been looking for diversification of energy supplies, has been trying to unite its energy policy and has planned different transit routes bypassing Russia and/or Ukraine. This has created a situation where two parties who naturally depend on each other with good perspectives for cooperation have turned into competing entities with increased suspicion on both sides.

The situation where there are competing projects - Russia has the South Stream (crossing the Black Sea to Bulgaria) and Nord Stream (going under the Baltic Sea to Germany) plans and the EU has its eyes on the Transcaspian (between Turkmenistan and Azerbaijan) and Nabucco (linking existing pipelines in Turkey through to Austria) pipelines - resembles the Great Game between Russia and Britain in the 19th century: instead of being over who controls which territories, it is about who controls which pipelines. All the planned projects still face significant challenges. The only thing that would make real sense is for Russia, Ukraine and the EU to cooperate on different pipelines. Exploring alternative routes so that the EU is not entirely dependant on gas passing through Ukraine makes some sense, but doing so in a climate of recrimination and great power competition which threatens to cut Ukraine out altogether may prove costly. 80% of Russian gas used in the EU comes through Ukraine, which provides the most direct route. Devoting diplomatic energies and financial resources towards Ukraine would be more effective than constructing expensive and complicated new pipelines. With proper investments into the existing pipeline systems and different monitoring systems as well as greater EU-Russia cooperation over Ukraine, the question of EU energy security would be solved much faster than competing with Russia over different pipeline routes. Constructive dialogue and imaginative thinking over ownership, monitoring, and the source of transit fees, would mean preserving existing supply routes at the same time as exploring others. As Andrew Monaghan from the NATO Defense College in Rome put it "We shouldn't just move away from Russia without knowing where we are going. If we just exchange Ukraine for Turkey, we will still have all our eggs in one basket." Proceeding by strengthening the existing pipelines might leave money over for research on alternative energy sources. The fact remains that Russia is highly dependent on the EU market (note that all Russian plans end up leading to the EU) and Russia does for some years to come at least have what the EU wants and needs. The 19th century Great Game did cause unnecessary wars and suffering and in the end both empires vanished. History should not repeat itself but teach us a lesson. Russia is less of a threat over the negotiating table than in open confrontation.

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South Stream planning started in June 2007: the 900 kilometre (560 mile) long offshore section of South Stream would start from the Beregovaya compressor station at Russia's Black Sea, and would run to Bulgaria's Varna. From Varna, the south-western route would continue through Greece and the Ionian Sea to southern Italy. The north-western pipeline will run through Serbia and Hungary to Austria ending at the Baumgarten gas storage. Russia has signed agreements with Italy, Greece, Serbia, Bulgaria and Hungary. There are however many questions still open. Nord Stream: The deal between Russia and Germany was signed in September 2005. The route is from Vyborg, Russia to Greifswald, Germany. Nabucco: The pipeline will run from Erzurum in Turkey to Baumgarten an der March in Austria . It will be connected near Erzurum with the Tabriz-Erzurum pipeline, and with the South Caucasus Pipeline connecting the Nabucco Pipeline with the planned Trans-Caspian Gas Pipeline. The project is included in the EU Trans-European energy network programme. Trans-Caspian Gas pipeline : The Trans-Caspian Gas Pipeline is a proposed sub-marine pipeline between Türkmenbasy in Turkmenistan, and Baku in Azerbaijan. According to some proposals it will also include a connection between the Tengiz Field in Kazakhstan and Türkmenbaşy. In this project Iran is in a key position. Before the project can go forward the status of the Caspian Sea needs to be agreed upon.

EU – Russia – the Baltic angle

by Raivo Vare

There are several reasons for the relationship between the European Union and Russia to stay at the top of the agenda. Most importantly, the Russian Federation remains the biggest trading partner and the key energy supplier for the EU, as the considerable Russian economy is a natural target market for European businesses and at the same time the EU is becoming more and more addicted to Russian energy supplies. This codependent relationship is further stressed through the geopolitical situation where Russia is the EU's largest neighbour and the only considerably influential non-EU power in Europe. This leaves no other option than for the two leading players to manage their overlapping spheres of interest – where the Baltic States are faced with being caught in the middle of these two powerhouses.

The bilateral relations between the EU and Russia were supposedly based on a „strategic partnership", as stressed by both parties during their disputes over common interests and the existence of „shared values". It has become more obvious in the light of recent events that the balance has shifted from values to just interests, as there aren't, in fact, many values to be shared between a western democracy and a home-made Russian „sovereign democracy". Therefore the relationship between Moscow and Brussels has hardly ever been the kind one would find between real friends or partners. Instead there have been several examples of constant mutual distrust and frustration both between the EU and Russia and, even more intensively, between the Baltic countries and Russia. Most recently this was evident, for example, in the different positions towards the war in Georgia and its outcome, the Ukrainian situation and the „Bronze Soldier" crisis in Estonia. While many leading continental countries have rather relaxed and flexible attitudes prevailing in their Eastern politics, constant irritations still remain a key element in Baltic-Russian relations.

The European Union is a soft power, while Russia prefers the no-gloves hard-tackle policy, preferring to focus on geo-strategic issues rather than economics, because it holds the second largest stockpile of nuclear weapons in the world, but not sufficient worldwide economic influence as the 8th largest economy in the world (predictably dropping to 13th or 14th position after the 2009 crisis). Russian policy-making style is leadership-driven, interest-based and hard-nosed – a stark contrast to the EU's policy-making through compromises and committees, which the Russians see as evidence of inefficiency. On the other hand, the Russians have mastered the use of this inefficiency and consensus-building practice dominant in European foreign policy and economical cooperation to push through their own interests through bilateral special agreements and well-stimulated personal engagements.

It may be difficult for „Old Europeans" to fathom Russia's true needs and the real drivers behind its interests. But Baltic nations do understand from their own first-hand experiences that it is not always business that comes first in the East. Therefore they are trying to balance the European pragmatic business-driven approach towards Russia. However their historical background makes them highly cautious of the real motivation of their powerful neighbour and its ability to trade off both political and economical interests with other key players. This results in the Baltic countries suspecting an intrigue behind all sizeable bilateral projects with Russia and thus bringing some emotionally justified skepticism into traditionally pragmatic European approaches, which is certainly disturbing the accord in the Eastern policies of the EU.

Undoubtedly it is in the European Union's security interests to have stable, prosperous and democratic neighbours. The „Old Europe" is relying primarily on the soft power of economics to produce security, while countries of the „New Europe", especially the Baltic States, with their historical experience and respective complexes and reflexes tend to rely more on NATO.

Although it is obvious that autocratic „sovereign democracy" has finally prevailed in Moscow, the European Union is still continuously attempting to positively engage Russia. This time not through common values, but increasingly through mutual interests as they are understood in the capital cities and corporate headquarters of the „Old Europe", based on hope that security is best protected by economical codependency, of which the European Union itself is the living proof. Russia has now turned to voicing its support for these arguments, even though based on its different perception of the term „economic security".

The Russian government has not requested any policy advice or financial assistance from the EU or any other country or organization, at least not until the recent crisis. Russia sees its relationship with the EU just as a tool to strengthen its domestic economy through trade and technology and, to some extent, through investments. The West and the EU in particular have been considered by Russia merely as a "modernisation resource" and an object of its different interests. This is quite bluntly the essence of the present Russian supportive agenda of economical and energy-related interdependency between Russia and the West.

A significant breakthrough in full spectrum of aspects, not merely economical, of the relations between the EU and Russia, including Russian-Baltic relations, should not be expected as long as Russian politics continue to dominate its economics. The current state of Russian-Baltic relations can be described as relative progress, which could develop further due to the impact of the current global economic crisis and current political agenda, but this development wouldn't be too obvious. Russia hopes to impose the sphere of influence in the former Soviet courtyard, using often economic instruments as political tools, for example by turning energy supplies into political instruments, instead of nuclear policy, to pursue its political goals.

The relationship between Russia and the EU and particularly the Baltic countries will remain strained in the future as well, as Russia is not perceived in Europe as Russia identifies itself. Due to its increasing desire for greatness and might, Russia continuously positions itself as a great power-centre and not as a society, leading Russia to pursue rather hegemonic "realpolitik".

The Baltic angle towards EU-Russian policies is driven by answers to following questions. Whether to put everything in perspective through a security prism or not? Do the Baltic specifics form a part of an united EU approach or are simply overlooked? Would it be reasonable to expect a „win-win" situation in dealings with Russia, as only coordinated approach will stand a chance of success, whereas separate policies will not? The challenge will be to deal with eastern neighbour jointly, requiring in-depth knowledge and understanding of the partner and a lot of wisdom.

Raivo Vare

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Former Minister of State and Minister of Transport and Communications

Estonia

Plus ça Change – infrastructure & energy transit to Europe

By David Dusseault

Delivering the post-mortem

Following the latest manifestation of the gas transit row between Russian and Ukraine last month, many observers and analysts alike have predicted a boom in the business of constructing alternative pipelines as a direct result of both the EU's and Russia's knotty relations with the transit states. Despite the presence of immense common economic and political interests on all sides, a "go-it-alone" strategy is developing among consumer, transit and producing states, which would serve only to enhance the growing cacophony that is today's European energy sector.

Hubris, great intentions, and the road to energy insecurity

It has been reported with surety that Russia vs. Ukraine Part II was precipitated by steep declines in world hydrocarbon prices brought on by Wall Street's financial meltdown. However, besides the usual suspects of global economic malaise, the political and economic dimensions of the resource curse, and the Putin bogyman, substantial structural shifts that occurred back in the early 1990s are the predominant precursors to contemporary policy dissonance.

Europe's initial wake-up call to these structural changes came in early 2006. The first major gas row between Russia and Ukraine was not solely profit-driven. With control over the remnants of the defunct Soviet energy system in flux, a struggle ensued over who pays and who profits from Russian / Turkmen gas flowing through Ukrainian pipelines to European consumers. It is evident that the institutional collapse of the USSR not only created new states, but fractured a unified system of interests based on and infrastructure for the exploration, extraction, processing, transit and distribution of hydrocarbons upon which Europe's consumers were tacitly reliant.

Apart from the institutional adaptations that took place upstream, the EU had its own understanding of the transforming policy environment downstream. Decoupling various components of the distribution and retail sector was seen as politically and economically sound, in that competitive markets made happy European consumers. As long as world prices for oil, natural gas and electricity remained low, the ability to set the energy agenda rested with European consumer states. Consequentially the EU could afford to rely on the market to regulate the energy trade.

However, Europe's liberalisation of its internal energy markets continued under conditions of increasing commodity prices worldwide. Unwittingly the EU liberalisation policy ceded more financial and agenda-setting control upstream to producers such as Russia and Turkmenistan. Simultaneously, the transit states Ukraine, and to a lesser extent Belarus, Georgia and Moldova became wildcards.

For Ukraine, its bickering political elite cannot achieve institutional consensus in order to deal with policy priorities such as energy market deregulation, its flagging economy, the high rate of domestic energy intensity, or its obligations as a trade link between Russia and the EU. In sum, during last month's gas pricing row with Russia, unintended consequences and structural incentives have contributed to Ukraine's proclivity to pressure both the upstream and downstream actors in the pursuit of the domestic elite's short-term political interests.

Pipedreams: et-tu Nordstream?

For all the preliminary bad press Nord- and Southstream received in the media centering on reliability of supplies, overall profitability, technical viability, and associated environmental risks, the implication of the 2009 gas row for individual states may be to seek out partners for alternative infrastructure to diversify their oil, gas, and electricity supplies away from existing options. This may be excellent news for the industries associated with underwater pipeline, or even nuclear power station or LNG terminal construction.

However, the possibility of a steep escalation in an "energy infrastructure race" presents a would-be nightmare for regulators, politicians and businessmen alike. In the rush to gain short term solutions to access, consumers are tripping over themselves seeking any way to link directly to supplies and disregarding the existing interdependence with other consumer, transit, and producer states.

By pursuing expedient unilateral strategies, fundamental questions such as resource finiteness, geographical proximity, prohibitive sunk costs, sufficient numbers of consumers, profitability, regulation, and environmental impact are increasingly ignored. There is a palpable risk that the disparity among the energy poor and energy rich in Europe will grow without a significant commitment to a longer term vision and concerted approach to the energy issue at hand.

Recommendations: more is not better

Despite the unintended consequences of structural changes in the European energy sector, concrete solutions to contemporary challenges such as the transit issue are within our grasp. For a start, the ability of transit states to defect from their obligations as a crucial link in the energy value chain between consumers in Europe and producers upstream needs to be curtailed.

Among all interested parties, the sharing of the financial and political risks while ensuring the continued flow of energy to consumers along the whole length of the value chain is a major priority. The establishment of a transit corporation to directly regulate all aspects of the energy trade among Russia, Ukraine, and the EU is one option.

Another, more problematic area in which the EU must take more responsibility is the reigning in of the "go-it-alone" strategy. Member states must realise that unrealistic expectations for the cumulative success of individual energy policies through endless diversification of supplies or infrastructure may well serve to undermine energy security for the whole of Europe.

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Finland

Russia is digging its own grave by disturbing gas supplies to Europe

By Laura J. Rantanen

On this New Year's Eve I was sitting with my friends in a cozy kitchen in St. Petersburg. We were having a nice time drinking Sovetskoe shampanskoe and watching television. The evening news were telling us that Gazprom has threatened to cut off gas supplies to Ukraine at midnight, if it does not receive $2 billion in arrears and a new supply deal with higher prices is not concluded.

Gazprom officials said they had received a letter from Ukraine's state energy firm Naftohaz stating that if Russia turns off the gas, Ukraine could confiscate Russian fuel bound for customers in Western Europe.

"Ukraine is blackmailing Gazprom, Russia, and Western Europe," Alexander Medvedev, head of Gazprom's export arm, told a news conference with a stern look in his face.

I thought that I had experienced a New Year's Eve just like this before.

No reason to rely on Russia, crisis showed

Disputes over natural gas payment and pricing have become a recurring New Year's ritual in Russian-Ukrainian energy relations. Russian energy giant Gazprom and Ukraine's Naftohaz quarrel about the money owed from the previous year, the price that Ukraine should pay for Russian gas supplies in the coming year, and the fees Gazprom should pay for transporting gas through Ukraine.

In January 2006, the row ended in a sensational three-day cutoff of Russian gas to Ukraine that affected several European states. Then most governments and analysts saw Russia as the guilty party, bullying the nascent democracy in Ukraine.

This time around, it was hard to pity either side. The crisis lasted almost three weeks, and neither Russia nor Ukraine seemed to be in a hurry to make quick amends, although Southeastern Europe was shivering with cold and Gazprom suffered almost $2 billion losses.

Still, it needs to be asked, why Russia entered yet another dispute that would worsen its relations with the EU?

At the moment, about 60 per cent of Russian government tax revenue comes from energy exports. Russian markets and the stock exchange are founded on the wealth generated by the oil and gas industry. Therefore, disturbances in energy exports, especially to the European Union, the biggest importer of Russian gas, have drastic impacts on Russian economy.

It's clear that ruining its reputation in the eyes of Europe as a reliable gas producer is not in Russia's interest.

Still, it is doing exactly that. Russia is willing to ruin its reputation, as the basis of its decisions regarding energy are political rather than economical. Russia is driven by the need to restore its super-power status and authority in global politics.

This makes Russia unpredictable in commercial issues, and thereby unreliable energy partner for the European Union.

Was Russia's aim a regime change in Ukraine?

Gazprom denies any political motive in the row and says it simply wants Ukraine to pay market prices for gas. However, it was no other than Russian Prime Minister Vladimir Putin who, in a televised meeting on January 5, ordered Gazprom CEO Alexey Miller to cut off gas delivered to Europe via Ukraine.

There are several things that indicate the row was not about gas pricing. Had it been, Moscow could have initiated serious talks about long-term supply contracts, similar to ones it has with its Western European partners, rather than engaging in annual price squabbles. The Kremlin disrupted supplies after the democratic revolutions in Ukraine and Georgia. Russia-friendly states such as Belarus and Armenia can go on paying significantly less than the market price.

The cutoff seems to have had multiple goals.

Ukraine irritates Russia by seeking membership in the NATO, as does Georgia, against which Russia fought a war last summer. Kremlin tries to shake the Ukrainian government, as it wants it to be replaced with a more Russia-friendly regime. At a press conference in January Putin appeared to question the very legitimacy of the leadership in Kyiv. He said that Ukraine's leadership is unable to organize normal economy based on market principals and that there is a political collapse underway in Ukraine. If this was a call for regime change, it follows a similar pattern to Russia's conflict with Georgia, after which Moscow argued that President Mikheil Saakashvili had lost his legitimacy and called for him to be replaced.

Russia wants to discredit Ukraine and Georgia and expose them as unreliable European allies.

Gazprom is in trouble

For Russia, the gas dispute came at the worst time. The effects of the global financial crisis are rippling through the Russian economy. The ruble is being devalued, Russian companies are facing bankruptcy and, according to analysts, the government's huge budget surplus will turn into a deficit next year, if prices do not rebound.

Slumping energy prices have turned Russia and it's political weapon Gazprom into a giant with feet of clay. A year ago Gazprom was the third biggest company in the world measured by market value. Now it's ranked 35th. Gazprom has taken big foreign currency loans. In case energy prices don't go up sharply, the company will get out of the red only with governments help.

Gazprom desperately needs the stable income it recieves from Europe in order to get on with necessary investments. By now indeed the company hasn't had will to invest in new gas fields and energy infrastructure, and with falling energy prices it doesn't have sufficient funds.gas it ships to Europe is now mostly produced in the Central Asian state of Turkmenistan. In order to secure long-term rights to that gas, Gazprom has agreed to pay the Turkmen prices that lead to losses in European markets. If Gazprom loses these supplies, it is going to have trouble meeting its commitments to Europe.

It seems that Russia is once again digging its own grave by disturbing energy supplies to Europe. Some analysts say this year's crisis could become a watershed that causes Europe to turn around its energy policy. The EU has grown deeply tired of what has become an annual farce at Europe's expense.

It's about time. Years of talk about energy security have by far generated nothing but hot air. If the EU is serious about energy security, it has to diversify away from Russian supplies as quickly as it can.

As a consequence of the severe damage the latest gas dispute caused in Europe, the EU is now closer to understanding that it finally has to move from words to deeds. Finding new gas suppliers and transit routes won't be enough. It has to introduce an alternative for gas altogether.

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The economic crisis and regime stability in Russia

By Richard Sakwa

By mid-2008 the economic good fortune that had accompanied Putin's presidency gave way to what would clearly be a prolonged crisis, threatening the stability that had been trumpeted for so long as the main achievement of the 2000s. The financial crisis mercilessly revealed not only global inadequacies but also Russia's. While declining economic performance tests any political system, in an unconsolidated democracy performance legitimacy is particularly important.

The price of oil decreased from its peak of $147.27 a barrel on 11 July to under $40 in December 2008. With oil and gas revenues comprising one-fifth of Russia's GDP and 50 per cent of federal budget revenues, budget projections were in disarray and the government faces a $150 billion shortfall in its spending plans for 2009, accompanied by a projected 3-4 per cent budget deficit. The response in Russia, as elsewhere, was more government intervention, including the partial nationalisation of the banking sector and growing protectionism. However, with some $50 billion committed to help refinance corporate foreign debt through Vneshekonbank by November 2008, the perception developed that the Russian authorities were hurrying to redeploy official reserves to assist the oligarchs and their corporations while neglecting the domestic rouble market. With inflation reaching 13.3 per cent in 2008, instead of the anticipated 8.5 per cent, people's savings were at risk while the cost of living, especially foodstuffs, continued to rise. An open letter signed by Mikhail Gorbachev, Alexander Lebedev and others warned in an open letter on 16 January 2009 that the government's tight control of politics and the economy was only making the crisis worse, and declared that resources were being directed not so much at protecting the interests of a majority of citizens as at saving the assets and property of a narrow circle of influential businessmen.

The financial crisis from mid-2008 had deepening effects on the 'real economy', with cuts in wages, stagnant real gains in living standards and rising unemployment, raising the prospect of a growth in industrial militancy. Unemployment in 2009 was anticipated to rise to over two million, seven per cent of the workforce. In response, on 25 December 2008 the government approved a list of 295 companies of strategic importance that could apply for financial assistance from a specially designated fund of some $200 billion, designed to reduce the social and economic consequences of the crisis. At the same time, planned cuts to MVD internal troops were abruptly halted on 16 December, although cuts in the regular army continued.

A possible beneficiary of the crisis would be the Communist Party of the Russian Federation, the least co-opted party in Russia. Just Russia was created to tap into neo-socialist sentiments, but not clear whether it will soak up the protest vote and manage protest actions. The CPRF for the first time in many years in January 2009 called for the Putin government's resignation.

The middle class had acquiesced in the government's heavy-handed paternalism when the times were good, but they could now turn against the regime. The possibility of increased labour activism prompted references to the events in Novocherkassk on 1-2 June 1962, when workers' protests were crushed by the army with the loss of 23 lives and dozens imprisoned. The administration's response to protests, including the brutal suppression of protest actions (against a rise in imported vehicle tariffs) in Vladivostok on 21 December 2008, revealed its fears that the economic crisis could be exploited by an outsider group to mobilise public discontent to launch an orange-style assault on the system.

Already there had been clear signs that official structures and conformist NGOs were being bypassed by the rise of a form of spontaneous protest movements, reflecting in particular the concerns of the aspiring middle class. A new generation emerged of what the economist Yevgenii Gontmakher dubbed 'new informals' (referring to the original wave of *neformaly* in the early perestroika years), characterised by their genuinely self-organised and non-political nature. The new organisations addressed ecological and housing problems, administrative pressure on small businesses, abuses in the educational sphere, and infringements of the perceived rights of drivers. Most of the new activists were defending property or political gains, and thus reflected the beginning of the political self-organisation of the middle class.

There was a clear threat to the stability of the tandem, and while president Dmitry Medvedev and prime minister Vladimir Putin stressed their unity, Medvedev in early January 2009 voiced discontent with the government's slow response to the crisis. Threats to the system, however, should not be exaggerated, with polls at that time indicating that over three-quarters of respondents approved of the president's performance, while approval for Putin's work as prime minister remained astronomic. In these circumstances, there was not much scope for a colour revolution.

The regime was also cushioned by its gold and hard currency reserves. In ideological terms, however, there was a problem, since the Russian government (like those elsewhere) had taken all the credit when times were good, and it would not be so easy to place all the blame for the crisis on external factors. The longer the crisis lasted, the greater the threat to the regime. The Putin system had been built on a new version of the 'neo-Stalinist compromise', the tacit pact whereby the government promised ever increasing standards of living, pensions, incomes and the like, in exchange for political passivity in the face of state encroachments on political rights and freedoms. In the late Brezhnev years the original version of the compromise broke down when the government could no longer deliver, and this opened the way for Gorbachev's reforms and the breakdown of the system in its entirety. The 1998 crisis had not been so system threatening since it came against the background of an almost permanent crisis since the establishment of an independent Russian state in 1991, whereas the crisis from 2008 revealed the inadequacies of a system that had precisely claimed to have overcome the crisis of the 1990s.

The crisis now meant that Russia's ambitious economic modernisation plans accompanied by assertive foreign policy rhetoric would have to be scaled back. Exaggerated ambitions and expectations were the first casualties of the global financial crisis, and in that sense proved salutary for Russia. In domestic politics the balance between liberal-technocrats and the *siloviki* was threatened, with the latter encouraged to enhance the role of state corporations by consolidating the energy sector in government hands while strengthening the barriers to foreign competition. The crisis, however, offered an opportunity for Medvedev to open up the economic and political system, and to force through long-delayed reforms.

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High-tech response to modern challenges and new opportunities

By Peter Coachman

Despite very challenging business environment and economical conditions of 2008 Technopolis continued its vigorous expansion both in Finland and in Russia and it proves the fact that tough times is the right moment to turn to innovative way of thinking and different business models based on cutting-edge technologies and ideas.

The Russian innovation system has not obviously been formed yet or at least it can't be claimed a working and effective system. Due to a continuous underfunding and general country crisis nothing substantial has been done for years to recreate the innovation infrastructure or mechanisms.

Nevertheless St.Petersburg has huge potential as a science and educational centre. It is one of Europe's leading R&D hot spots and an attraction point for the whole-world R&D community. It's common knowledge that unique research work and cutting-edge technologies in various fields of basic and applied science are developed here.

However high technologies require above-average management. Technopolis sees its role in creating such a favourable and efficient innovation ecosystem which will make the innovative product go successfully through all stages of development from the idea to commercialization and entering international market – that is the key question for Russia and St.Petersburg in particular.

What is done in practise to make this wheel turn? There are three major components of effective innovation system:

1. Ideas
2. Funding
3. Clients.

Technopolis uses its best practises accumulated during more than 25 years of business development activities to connect these three crucial elements and create favourable conditions for their cooperation. Carefully screened and selected innovative ideas grow in our start-up centres, through Technopolis tools they get access to affordable sources of venture capital while wide client network provides an opportunity to promote and sell packaged products in the market.

Serious steps have been taken in 2008 towards creating St.Petersburg innovation ecosystem. In cooperation with St.Petersburg Technopark OJSC, Technopolis launched Technopolis-Ingria incubator which will provide business development services to knowledge-based start-ups, internationalization and growth services to promising young entrepreneurs in St.Petersburg. Simultaneously we launched regular networking events for IT and high-tech companies which bring together the interests of companies, investors and end-users in order to organize mutually advantageous cooperation in this sensitive and highly-specialized environment.

Technopolis is creating a first-class operating environment for high-tech and knowledge-based business which will serve as a platform for their development and internationalization.

In 2008 Technopolis started construction of Pulkovo technopark and already made impressive progress in construction works. Pulkovo technopark is constructed in the immediate vicinity of the International airport creating unique concentration of high-tech business at the crossroads of numerous transport routes. The first stage of technology park totaling over 80 000 m2 is scheduled for completion at the end of April 2010. It will offer 23 000 m2 of ultra-modern flexible premises tailored to the needs of high-tech companies in design, lay-outs, communication data systems and infrastructure which ensure that no valuable development will be lost of the sight.

Creation of the first Technopolis technology park in St.Petersburg is intended to boost the community's business and innovation dynamics, provide a foothold for new knowledge-based companies to grow and help to transform St. Petersburg into a world class business and innovation hub.

Peter Coachman

Director of Russian Operations

Technopolis

Russia

The economy crisis is the moment of truth for Russia

By Jukka Mallinen

The share of Russia in the world GDP is about 2,5 per cent and it is rather decreasing. The big incomes from raw material export are just a temporary advantage. If Russia is not able to create an innovative economical and social progress, it can fall to the margin.

Economist Jakov Pappe has said, that if now, when world moves over to period of low raw material prices, Russia is not able to increase production, it goes to the road of Indonesia and Nigeria.

Anyway, the Kremlin has in practice admitted, that Russia will not get out of the economic independently. It will wait the rise of the world economy, which then will lift Russia up.

Within the crisis Russia turns out to be more a producer of raw materials. Only the production of oil and gas has grown. All the other branches, investment as well as consumption, have dived.

The share of ”the new economics” in Russia is about 3 - 7 per cent, when in the developed countries it is about 50. The Russian economy is still based on Soviet time factories and technologies. It manufactures mostly consumption goods with simple forein technology.

The new car composition factories etc are even more low degree of production than the export of raw materials. Components, composition lines and technologies, owned and runned by foreigners are just moved inside the custom walls. This does not mean manufacturing progress.

In the current atmosphere of remilitarization and cold war Russia plans to arm itself again to the death. But if raw material recources are an objective factor, deciding for an armament race is not. Particularly the nuclear weapons take a fatal share of Russia's national income.

The Russian economics carries the ”gens” of the socialistic command economy. The real competition branches in Russia are just some 5 – 10 per cent. The rest is more or less monopolistic ”enterprising”, that rather resists development, competition and innovations.

In principal crisis will heal by eating the ineffecient and the over-aged. When weak enterprises die, the effeciency and competition ability grows. But in Russia the state financing crisis is directed for political reasons to the monopolistic enterprises - the inefficiency is supported. Market enterprises don't get state support unlike the companies, controlled by the power elite, that swallow the private owners in trouble.

So the process at the moment is interesting and even fatal. Finance minister Aleksei Kudrin, who defends market mechanism, has been able to keep his mind. The oligarchs have got their loans thus avoiding bankruptcy, but now they are in the pocket of the creditor – the state. The ”silovicks” (army and intelligence) couldn't yet turn the economical politics to complete state ownership.

Anyway, ”the velvet renationalisation” weakens efficiency and competition capacity. It is possible, that in crisis Russia looses the best companies, not the worst. Parallel, the political orders, type of the command economy, ban the cutbacks in enterprises to increase efficiency in the name of employment and social stability.

So strengthens the Bysantic apparatchik economy, where state money runs. Innovation economy and market mechanism looses. The weathering of efficiency of ”Gazprom” is a good example of this.

The Kremlin declares it's direction to the diversification of economy and to innovations. It promises investments to help structural diversification, high tech economy and contemporary service sector.

But the Decree of President on creation of the national innovation system from year 2002 impends to stay a formality. Decisions on monopolist high tech state enteprises in aviation, shipbuilding, nuclear industry and nanotechnology don't seem to create innovative production.

Now new national investment decisions are cureent in Russia. But they will take at least a year as a minimum. Only after that the entrepreneurs can plan their future.

So will the state or the private business be the locomotive for rising from the crisis? Now the state projects and companies have the priority. Money flows to them, although state has never been able to raise the economy to a quantitatively higher level and growth.

Only the private initiation can save the country from crisis - it increases the efficiency and competition capacity.

Now the harmony between state and entrepreneurs is lost. The state don't trust to the entrepreneurs: it considers capital escape from country, caused by economy crisis, as an embezzlement of national economy. Entepreneurs, in contrary, don't trust the economical policy and legality: they feel, that they are forced to save their capital abroad.

The development visions of Russia suppose the rise of the middle class from the current 20 per cent to 60 per cent of the population. Middle class would be the carrier of the new life: civil society, enterprising, dynamic. It's will, energy, self discipline would reform the country, that today is still characterized by Soviet time paternalism and passivism. Middle class would activate itself for reaching the western quality of life: democracy, legality, security.

But paradoxally the 1990´s turned to the most vulgar materialism. Middle class took for it's ideal the consumption, meaning senseless waste and luxury. The trend was not economy, but hysterical consumption and involvement in debts.

The state was fomenting this, too. It's goal was to raise the consumption level, not to build the basics for a welfare state. Corruption and luxurious life of the elite and officials gave the example for the people. Consumption hysteria indivialised and atomised more and more the society, that has not ever been . The constructing political potential for creation of welfare state weakened and consumption superseded it values.

Today Russia needs the ethics of work, meaning the classical spirit of Protestantism by Max Weber. Yet, in Bysantian ortodox feodal East the private entrepreneur has always been hard to outline. Independent ownership has no tradition, property has been political, dependent of the will of the autocrat.

Diversification of economy and the rise of the innovation technology depends on the development of the democratic system and civil society. The state should guarantee and activate the freedoms and legacy.

Last year Russia published a draft for the strategic plan until the year 2025. It seems to based on state centralization, on full control of the Kremlin. But at least it takes the responsibility for the common development of the country. Now it seems to be forgotten.

A ”New Deal” for Russia could rise the country from crisis and modernize it. The companies would orientate themselves to the future, innovations, competition capacity.

But this would take power from securocracy, because it would lean on the activity of the population And ”the hereditary of the power” has been the most important value also in new Russia.

Jukka Mallinen

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Sustainable innovation – what is it?

By Vesa Harmaakorpi

Sustainable development has been one of the hot topics in recent years, maybe the hot topic in the Baltic Sea Area. Sustainability often refers to ecological aspects of sustainability in practical discussion. It is to prevent further pollution of the Earth and save the scarce natural resources for future generations. However, sustainable development has other aspects, including social and economic sustainability. It means that to make sustained progress the development has to be sustainable from ecological, economic and social perspectives.

Innovation is another current hot topic. The innovation paradigm is said to be radically changing. Mainstream innovation was earlier said to originate in science and technology; and especially in science-based technology. However, recent studies in Europe have demonstrated that only a minor part of innovations stems from science and the vast majority have a very practical origin. Besides scientists and technology experts, customers and employees acquire new roles in the future innovation practices.

When the two hot topics are joined together we get a concept "sustainable innovation". What is this? Hautamäki in his book published by Sitra (Finland) defines the principles of sustainable innovation as

- ecologically sustainable development, that is, innovation towards sustainable development
- participatory innovation, that is, innovation with customers, employees, users and the general public; including development of and respect for partners' knowledge
- continuous innovation, that is, the ability to continuously regenerate and break boundaries
- global innovation, that is, innovation in global co-operation using knowledge distributed everywhere
- innovative management, that is, management facilitating and encouraging innovation in organisations and society; leading to new management and leadership practices.

Every time we innovate the ecologically sustainable aspect ought to be considered. We already use about 30 % more natural resources than the earth can sustain. Global warming is a real threat. It seems that the old innovation logic: innovation – productivity – growth can no longer be the only logic to follow. According to Hautamäki, the old logic should be replaced by a new formula: innovation – renewal – wellbeing.

Participatory innovation means that customers and employees must be given radically new roles as partners in innovation. The customers must be considered subjects of innovation instead of objects. That does not sound very radical, but it is; at best with the old methods we have only been able to guess the needs of customers. Customers in user-driven "Living Labs" can create completely new perspectives on innovation. Employees outside the actual R&D departments are a vastly unused resource for innovation. Often employees only do what they have been told to do leaving their creativity outside the company when they come to work. However, everyone should have two tasks in a company: produce goods and services, and think how the goods and services can be improved. Everyone is capable of contributing to the second task if the work culture encourages it.

Continuous innovation means that we must continually create novel ideas. A natural scientist once said "very good scientists get two good ideas in their lifetimes, good scientists get one and average ones none". Maybe it is due to the differences in definitions, but I strongly disagree. Everybody should generate ideas monthly in order to keep his or her company competitive. However, ideas may be hard to find without new input from different fields of knowledge. There is certainly a need to break boundaries and achieve intellectual cross-fertilisation between innovative partners so as to keep innovation continuous and sustainable.

Global innovation also means open innovation. The leaders of many big companies argue that open innovation no longer gives any special competitive advantage, it is a must. I strongly agree with them; the Schumpeterian creative destruction of today can be outlined by closed and open innovation: companies and industries relying on closed innovation models come under destruction and those relying on open innovation models are creative and thus successful in the future. In spite of this, surprisingly many companies practice quite closed innovation models, perhaps because of the lack of social capital surrounding them. However, sustainable innovation is about open innovation in the future!

The managerial impacts of sustainable innovation are remarkable. Borders/Boundaries in organisations and networks can be crossed/broken by means of creative management. The key notions in this management process are tolerance, uncertainty, interrogation and interpretation. It is more a question of leading interpretative innovation processes than just of problem-solving innovation processes. Managing sustainable innovation can be divided into three components: expertise, creative thinking skills and motivation. Promoting expertise refers to managerial abilities to make possible worlds visible for the innovating partners; promoting creative-thinking skills refers to managerial abilities to break boundaries; and promoting motivation refers to managerial abilities to motivate people with very different backgrounds to focus on the same innovation process.

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Is Russian sports economy performing well?

By Wladimir Andreff

The Russian Olympic squad was expected to win 96 medals in Beijing last summer according to our econometric forecast published in the French journal *Revue d'Economie Politique* (n°2, 2008). The prediction was based on two major variables, for all participating countries, that is GDP per capita and population, and some additional dummy variables. The underlying idea was that Russia, despite a stagnating or slightly decreasing population had nearly recovered from its transformational recession of the 1990s in terms of GDP per capita due to seven years of strong economic growth in a raw. This must have translated into good Olympic performances. A study by Wolgang Maennig (University of Hamburg), leaving more room to non economic variables, reached a less optimistic number of 78 medals while Pricewaterhouse, in a report sponsored by the Beijing Olympic Committee, anticipated 79 medals for Russia.

What happened? The Russian Olympic squad left Beijing with 72 medals, of which only 23 gold and Prime Minister Putin officially and loudly made his dissatisfaction explicit. Measures should be taken to improve Russian performance at next summer Games. It is a poor outcome compared to 92 medals in Athens 2004 and 88 in Sydney 2000. It is only during the worst of the transition meltdown that the Russian squad was less performing with 63 medals.

Contrasting with this, Russia increased its sporting efficiency in winter Olympics (16 medals in 2002 and 22 in 2006) and obtained good performances in some professional sports: 19 wins at the World athletics championship, 21 wins at the tennis ATP tour. Even more impressive is the raising status of Russian football clubs in European competitions, in particular Zenith St-Petersburg winning the UEFA Cup 2008.

For economists, sporting performances of a country are to some extent linked to, if not determined by the current state and evolution of the sports sector in the economy. Explaining both professional sports successes and mitigated Olympic results trace us back to the transformation of the sports economy in Russia starting from the former centralized Soviet state-run sport system.

As the whole planned economy, sport fell into a deep crisis in the USSR during the 1980s. Under *perestroika*, reforms aimed at building up new sport facilities and promoting sports goods production, namely in hosting foreign manufacturers (Adidas, Fischer skis and Donnay rackets). Since the state budget for sports was cut, sport federations became more autonomous and constrained to self finance. Sport commercialization and a market sports economy started to emerge in 1988 when professional sport was legalized. In order to match their hard currency needs, Russian clubs and federations opened the door to foreign sponsors and started hosting international sport events. Athletics federation signed a sponsorship contract with Reebok and Mobil, tennis federation with Proserv and Nike, and ice hockey federation with Reebok. New sources of funds sprang up from lotteries, betting and gambling on sporting outcomes (Sportlotto and Lotto-million). "Corporatization" of professional clubs was allowed in 1992. Eventually, *Goskomsport* was dismantled in 1991, putting an end to the most crucial formal institution of Soviet sport.

In the 1990s, state investment in new sport facilities nearly vanished overnight. Many state-owned enterprises, in the red, were hit by restructuring and were no longer in a position to finance sport. Sport broadcasting was not yet up-to-date: an absent source of finance compared to Western sport. With rising poverty and increased income inequalities, sport participation and expenditures declined. The market for sports goods shrunk. Increasing prices for sport shows and events triggered a fall in stadium attendances. A number of high level sportsmen and women migrated toward Western professional sport markets, which impacted on national sport performance, for instance the Russian football squad never recovered its 1988 Soviet level (Euro finalist).

In institutional vacuum due to weak law enforcement, Russian professional sport was extensively criminalized in the 1990s. Corrupting referees was a common way to fix a match in Russian football championship: most penalties were whistled in favor of a same team. Football attracted investment from oligarchs and even mafia interests. One of the clean football managers, N. Tolstykh (Dynamo Moscow) was offered bribes and threatened to death. In 1997, the commercial manager of Spartak Moscow was murdered soon after the murder of the Russian head of ice hockey federation. Many sport managers were corrupted or murdered. New informal rules were supplanting unenforced formal institutions. President Yeltsin exempted the National Fund for Sports (NFS) from taxation and customs duties on tobacco and alcohol foreign trade. This had transformed high level sport into smuggling and trafficking system; 80% of funds circulating throughout the national football league were dirty money. Mafia was organizing an underground market for doping products as well as illicit networks of sport betting and gambling. New rich people, oligarchs and Mafiosi utilized sport as a room for laundering their newly, often dubiously, acquired wealth.

Eventually, in the 2000s, new trends emerged. Most professional sport clubs were taken over or sponsored by Russian big companies that were flourishing with economic recovery after 1998. Gazprom is involved in seven football clubs including Spartak Moscow and Zenith St-Petersburg, Norilsk Nickel in CSKA Moscow, Lukoil and Aeroflot in Spartak Moscow, Luzhnicki and Norilsk Nickel in Torpedo Moscow, Oleg Deripaska in Samara football club, Vladimir Radionov in Dynamo St-Petersburg, FSB's interests and Fedcom Invest in Dynamo Moscow and so on. Foreign investors are increasingly attracted to sponsor Russian sport federations and clubs in a stabilizing professional sports economy. The best Russian football clubs have now an annual budget over €50 million and start hiring foreign players and coaches. All this means a tighter alignment of Russian professional sports on the Western market model.

The problem remains that a number of Olympic and amateur sports are not yet really aligned to a market sports economy because they do not drag as much money as professional sports. Using indexes similar to the ones of the EBRD and World Bank we have exhibited that sports institutions were not yet aligned on economic institutions in 2004 in Russia (in "The Institutional Dimension of the Sport Economy in Transition Countries" [1]). Overall, Russia's sports economy is not in tune with its renewed political and economic might today. It will suffer a lot in muddling through financial crisis which knocks down the previous economic recovery since fall 2008.

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[1] Co-authored with Sandrine Poupaux and published in M. Parent & T. Slack, eds., *International Perspectives on the Management of Sport*, Elsevier 2007.

Baltic States competitive position in the New Century

By Viktor Trasberg

One of the targets of the EU Strategy for the Baltic Sea Region is to make the area more prosperous and the countries development level more equal. The countries in the region should explore in a full scale advantages of deeper regional integration and synergies to increase their wealth and quality of life.

By The World Economic Forum definition, countries ability to provide prosperity to its citizen's depends on their global competitiveness. The key indicator measuring prosperity is GDP *per capita* adjusted on the basis purchasing power. The Forum has developed a Global Competitiveness Index (GCI) and ranks more than 130 countries on the basis of that indicator.

Baltic Development Forum, in turn, brings in its Report out Baltic Sea Region countries competitiveness position as a whole entity and compares it with other global areas. The analyses result is favorable – still our region is one of the most competitive and innovative areas in the world. However, there are still significant disparities in a competitive advantage in different parts of the region.

During the last 5 years, the BSR countries are located rather different positions and demonstrated diverse dynamics in the global ranking. In 2008 majority of the Nordic countries and Germany belong to the top ten of the most completive countries in the world. The Baltic States and Poland are placing positions from 32 up to 54.

As a group, both the Baltic and Nordic countries have lost their positions during the period but the Baltic States are loosing their competitive positions rather speedy way.

Competitiveness is assessed as a mix of various factors. Generally, those factors are grouped different factors (pillars) and divided into 3 groups. Namely those groups are as basic requirements for economic activities (like education and infrastructure development), economy efficiency enhancers (like various markets efficiency and their size) and companies' innovativeness.

Estonia is the best in the rank among the Baltic countries (32). The country's advantages are good macroeconomic policies, technological readiness and higher education. The weaknesses are considered as business sophistication and inflexible labor markets.

Latvia as a weakest in the ranking among Baltic countries and ranks on 54 position. The most problematic areas are weak macroeconomic policies, companies sophistication and innovation activities. Latvian strong points are advanced education system, labor markets flexibility and technological improvements.

Lithuania ranks between Estonia and Latvia and its particular weaknesses and strengths are rather similar to other Baltic neighbors.

During the last decade the Baltic countries have increased their prosperity very significantly, even having enjoyed record high growth rates in EU. However, 2008 fast growth turns to a sharp decline. What went wrong and why the Baltic countries have not sustained their growth?

The countries have to realize that latest growth was a result of coincidence unique and favorable factors.

First, the positive outcome of successful market reforms implemented during previous decades. Hard efforts of Baltic nations bring them outstanding prize as increase of the wealth and living standards.

Second, the EU enlargement effect, which opened Baltic countries access to "big markets"; made them attractive to new businesses and investments. Fast integration with EU structures and nearby rich neighborhood definitely supported fast increase of economic growth.

Third, growing incomes and purchasing power in combination with easy access to credits heated up domestic consumption and real estate boom.

However, in the conditions of global turmoil and uncertainty, earlier growth pattern in the Baltic countries is not valid any more. Growth, based on cheap borrowing and domestic consumption, should be replaced by the different growth factors.

To reach a new competitive edge, the countries should "revolutionize" two principal elements of their economic policies. First, to develop new sound macroeconomic regulations, which allow manage the economic cycle in a more sustainable way. That includes efficient fiscal and tax policies in combination with measures to cope with inflation and unemployment.

Second, economic structure should be focused towards more sophisticated and export capable production. Put in simple - economies should move from cheap labor and factor based economies to more innovation and high-added value industries. More than ever before is valid former Estonian president Lennart Meri's well-known phrase - "we should find our Nokia"! Considering that, our Nordic neighbors have demonstrated how to reach highest competitiveness and wealthiest societies in the global world.

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Can we revive a 'Baltic Tiger'?

By Vyacheslav Dombrovsky

Following its accession to the European Union, Latvia enjoyed three years of neck-breaking double digit growth, invoking flattering comparisons with the 'Asian tigers'. Unfortunately, much of the 'tiger' turned out to be a bubble, inflated by the credit orgy of recent years. According to the latest forecasts, Latvia's real GDP is expected to fall by 2.3% in 2008, and by 6.9% in 2009. The authorities adopted an ambitious rescue plan, backed by a 7.5 billion euros loan from the international community, nearly a third of Latvia's GDP. Understandably, managing the crisis will be an important priority for the policy-makers in the medium-term. And yet, the whole debacle also raises some serious questions about Latvia's long-term growth strategy. Clearly, many of the old assumptions are no longer tenable. An advantage of this crisis is that it provides an opportunity to introduce some badly needed new ideas. This is precisely the ambition of this article.

At the risk of oversimplification, I would summarize Latvia's traditional development policy as largely geared towards improvement in the business environment, fostering entrepreneurship and SMEs. In my opinion, which is based on virtually every major survey, this policy has been very successful. According to the World Bank's "Doing Business" 2009 report, Latvia's business environment is ranked 29th among 181 economies. The Global Entrepreneurship Monitor (GEM) also ranks Latvia as a fairly entrepreneurial country. According to the GEM surveys, 6.6%, 6.6% and 4.5% of Latvian adults were involved in early-stage entrepreneurship in 2005, 2006 and 2007, respectively, as compared with the EU-15 average of about 5.5%. Regardless of what the conventional wisdom might be, the evidence says that starting a new venture in Latvia is not such a big problem. However, in spite of its attractive business environment, vibrant entrepreneurial sector, and well-educated work-force, Latvia is doing very poorly by virtually every measure of the modern "knowledge-based" economy. According to the European Innovation Scoreboard 2008, Latvia was the second least innovative country in the EU (after Bulgaria), measured by the summary innovation index. The percentage of Latvian SMEs that introduced product or process innovations was a mere 14.4%, less than half of EU-27 average, and much less than Estonia's 45.8%. Business R&D expenditure was 0.21% of GDP, as compared with 0.54% of GDP in Estonia. Clearly, achieving a measure of success with entrepreneurship is not the end of the story. Something is amiss.

What might be the missing piece of the puzzle? I would like to point to a recent paper by Thomas Hellmann (University of British Columbia) and Enrico Perotti (University of Amsterdam), "The Circulation of Ideas in Firms and Markets" (RICAFE2 Working Paper 30). This paper stresses that production of new ideas entails an important trade-off. On the one hand, elaborating an idea requires sharing it with various persons. A broad circulation of ideas is thus critical for the process of innovation. On the other hand, there is a fundamental problem with the open circulation of ideas, namely that information can be stolen. Often, originators of new ideas have very limited legal means to protect their intellectual property against expropriation by third parties. In this context, firms emerge as a solution to market failure. Established firms provide a safe idea exchange, serving as incubators for innovation. It is well known, for instance, that most R&D is performed in large established firms. In turn, markets complement firms by completing ideas that could not be elaborated inside firms. Firms incubate ideas, while markets increase their chances of elaboration. This complementarity suggests a natural *symbiosis* of open firms and markets.

Thus, the analysis by Hellmann and Perotti suggests that, as incubators of novel ideas, established firms should be a crucial feature of any highly innovative environment. Could there be a problem with such firms in Latvia? For better or for worse, most Soviet-era giants are long gone and new firms are likely to take time to become large and established. As a rough proxy, I use Business Registry data (provided by Lursoft) on top hundred Latvian firms (by revenues) in 1997 and 2007. Only 25 firms were in both 1997 and 2007 lists. Moreover, some 69% of the new entrants were in wholesale, retail, or construction industries, which are related to the recent bubble and, usually, have little R&D activity. In contrast, the data for U.S. show much lesser volatility. Some 49 firms were in the top hundred lists in both 1997 and 2007. In the absence of more convincing empirical evidence, this may suggest a shortage of established firms in Latvia.

Although explaining the shortage of large innovative firms is beyond the scope of this article, I will attempt to point to a possible suspect. In Latvian context, one obstacle to the growth of established firms might be distortions introduced by wages paid in envelopes, i.e. evading taxes. It is widely known that envelope wages are a widespread phenomenon in Latvia. Employees get higher net incomes and employers enjoy smaller labor costs. Such savings might be substantial as the tax wedge (social security contributions and income taxes as percent of labor costs) in Latvia for a single earner with average income is about 40%. For comparison, according to OECD, tax wedges in U.S. and Ireland in 2006 were 28.9% and 23.1%, respectively.

Envelope wages create a distortion because the technology of tax evasion is not uniform across firms of different sizes. Small firms find it much easier to pay envelope wages because they are many and hard to monitor by the tax authorities. This is not the case for large firms. Thus, small growing firms might face a substantial 'speed bump' as going beyond a certain threshold will strip them of competitive advantage from tax evasion. This might discourage growth and result in a shortage of large established firms. Given that many European countries have comparable (or even higher) tax wedges, but do not suffer from widespread 'envelope wages', there should be much room for improvement.

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Business life in a perfect Storm – the first results of a monthly monitoring of the effect produced by the economic crisis on small and medium size enterprises (SMEs) in Russia

By Alexey Prazdnichnykh

The aim of the monitoring project "SMEs Within the Crisis" is to keep a close watch on the changes that occur in the external environment of the SME companies because of the crisis and on the companies' reaction to these changes. During a year the directors of 300 SMEs from various industry sectors in 30 Russian regions will answer every month some questions concerning different aspects of their activity. It'll give us the opportunity to see the dynamics and make certain conclusions about the way and intensity of the crisis's influence on the SMEs. Moreover, through the polling the companies will be able to pronounce their point of view regarding the anti-crisis measures that can support the SMEs successfully. The project is driven by "OPORA" (the non-commercial organization for Russian small and medium business) together with the consulting company "Bauman Innovation".

Nowadays the number of the companies that characterize their state as "good" is almost equal with the number of the ones that find it "bad" – 28% both. The other companies preferred to define it "neither good nor bad". The situation with the businessmen's expectations is worse: 48% of companies are preparing for decline, 25% believe that the crisis isn't going to affect them during the next month, 27% expect growth. The financial crisis provokes changes in the companies' external environment regarding the access to financing facilities, human resources and real estate; the behaviour of the purchasers and suppliers; administrative and criminal pressure. The changes in external environment lead to alterations in some aspects of the companies' activities as well – the volumes of sales and profitability; the number of employees and their salary level; transfer prices and total debt.

Looking at the January monitoring results we can make the conclusion that by now the effect produced by the crisis on the companies' external environment has been ambiguous: the easy access to workforce and real estate can be regarded as a positive trend while the situation with financing facilities, demand, purchasers' debts, suppliers' prices and administrative regulation is becoming worse.

For instance, a most important problem of human resources is becoming less acute: 45% of the companies mention that it's becoming easier to recruit personnel, and only 12% say that it's become harder. Real estate is more accessible now: it's become simpler for 40% of the respondents to find premises for business activities since the beginning of the crisis, and only 17% find it more difficult now. However, the problems of human resources and real estate are still far from being solved: almost half of the SMEs have difficulties with recruiting personnel, and around one third of them – with finding premises. The most serious problem is bad access to debt financing. The situation that had been unfavourable before the crisis has become even worse. It has become more difficult to attract borrowed funds for 76% of the companies; most of them put it as "much more difficult". 87% of the respondents mention growth of loan interest rates for their branches of business. All in all nowadays about 30% of the companies don't have access to debt financing, for other 44% getting it is a big problem.

The deflationary effect of the crisis that can be observed in many countries almost doesn't work in Russia. On the one hand, more than half of the enterprises (65%) mention noticeable growth of prices for goods and suppliers' services. At present the suppliers' prices have been called "rather high" or "very high" by 39% of the respondents; 54% of the companies find them quite moderate. As for the respondent companies themselves, they aren't eager to lower the prices: only 12% of them declared they would do so.

The situation with demand looks doubtful: though it seems to decline (63% of companies say so), more than half of the companies (69%) estimate the present level of demand as moderate or high. However, 43% of the respondents claim that it's accompanied by the growth of the goods and services' purchasers' debts, which, anyways, hasn't become a serious problem for most companies yet.

Companies react at the alterations in their external environment with changing various performance indicators. Most of them mention the downfall of sales volumes and efficiency (59% and 60% respectively). However, less than one third of them venture upon cutting salaries and reduction of staff (24% and 30% respectively). One third of the companies (32%) are raising the prices.

A little less than a third part of the companies (29%) have debts, most often these are the debts to suppliers (21% out of all or 72% out of the companies in debt). 10% of all the companies admit having wage arrears (that's 33% of the companies in debt). The total size of indebtedness is growing.

At present more than half of the respondents (52%[1]) regard cutting their expenses (not connected with employees' salaries) as top anti-crisis measure. Part of the companies is planning to exercise flexibility: change their product proposal or reorient their business (23% and 17% respectively). Such unpopular measures as salary cutting, reduction of staff or production ramp-down are planned by 13%, 12% and 8% of the companies respectively. Only 12% are ready to lower their prices, and only 4% of businessmen prefer to sell their business.

Small and medium business is expecting targeted anti-crisis measures from the government. The companies regard crediting SMEs (43%), tax holidays (42%) and tariff freeze (37%) as most effective ways.

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[1] The respondents were offered to choose three most preferable measures from the list of the possible ones

Russia's energy supplies and the Baltic Sea Region

By Peeter Vahtra and Stefan Ehrstedt

Russia has significant investments in the Baltic Sea Region (BSR) energy sector. The investments are for the most part made by the state-owned natural gas and oil company Gazprom and by the privately held oil company Lukoil. Gazprom has investments particularly in the natural gas sector of the Baltic countries, Poland and Germany. Lukoil on the other hand owns fuel retail companies in the Baltic countries, Finland and Poland.

Geographically speaking Russian energy investments are concentrated particularly in the Eastern part of the Baltic Sea i.e. in Finland, the Baltic countries and Poland. A smaller yet significant share of investments have been made in the large countries of the Southern shore i.e. in Germany and Poland. However, Russian energy investments are not significant in the Western parts of the BSR in Sweden, Denmark and Norway.

Russia is an important supplier of energy in the BSR. In 2007 Russia delivered nearly half of all natural gas consumed in the region. For instance Finland and the Baltic countries are in practice totally dependent on Russian gas. Even the regions overwhelmingly largest energy consumer Germany imported over 40% of its natural gas from Russia. Russia is also a noteworthy oil supplier for the BSR.

The most important energy infrastructure in the BSR is mostly related to Russia. Gazprom is preparing the Nord Stream –gas pipeline from Russia to Germany through the Baltic Sea. The Northern branch of the oil pipeline Druzhba delivers crude oil to Poland and Germany through Belarus but the pipeline branches leading to the Latvian Ventspils and the Lithuanian Butinge have dried out during recent years. Oil has been rerouted through a new pipeline system (BPS) built in the 21st century to the Russian oil harbour of Primorsk in the Gulf of Finland. Another large oil harbour might be also constructed in Ust-Luga in the same Gulf.

The Baltic Sea Region is important also to Russia

The Baltic Sea Region has become one focal point for the Russian energy strategy. Over half of Russian crude oil is transported to the countries of the region or through the region. The planned gas pipeline Nord Stream would shift the focus of gas exports to the region should it be built.

The strategic goal of Russian energy policy is direct export routes to large energy markets such as Germany and Western Europe. Another goal is to reduce the economical and political influence of the current transit countries used in energy exports.

From the point of view of the Russian energy strategy, Germany is the most important country in the BSR. Germany consumes Russian natural gas more than twice as much as all the other countries of the region put together and is a gateway to the large gas market of Western Europe. Thus the Russian energy strategy in the region is certainly focused in the relationship with Germany which leaves the Russian energy strategy in the other Baltic Sea Region, particularly in the Baltic countries, subordinate to this. The planned Nord Stream –pipeline is a concrete example of this.

Russia's aspirations to transfer the focus of its energy transports to the Northern and Southern parts of the continent are quite obvious. With the development of new infrastructure Russian oil exports has gradually shifted to the Russian ports of the Baltic Sea and the Black Sea instead of former soviet republics.

Western media has shed most light on the transit fee disputes between Russia and the transit countries Ukraine and Belarus. Lately Ukraine in particular has been in the lime light due to the recent halt in gas deliveries which left some European countries in a difficult situation. The reduction of political and economical power of transit countries has also been evident also in the BSR. The oil pipeline system BPS has reduced Russia's dependency on the Baltic Sea Region.

The Baltic Sea region and Russia's global energy strategy

The Nord Stream project should be seen as a part of the country's global energy strategy, which aims at increasing export capacity and, subsequently, strategic options regarding the energy exports in the natural gas sector in particular. Similar to Nord Stream, the planned South Stream gas pipeline in the Black Sea region would sidestep the conflict-prone nations in the Caucasus and guarantee a direct supply route of natural gas from Russia to Europe. Both projects would serve Russia's energy strategy by increasing the country's supply capacity much faster than its production capacity.

Apart from the gas pipeline projects Russia has additional plans for setting up the liquefied natural gas (LNG) production plants on the Barents Sea and purchasing several LNG carriers from South Korea and Japan. When realised, the LNG production and transportation plans would provide Russia with a new major energy distribution channel and would add considerably to its energy transportation capacity both to Europe and the USA.

From the viewpoint of European energy economy, the development of Russia's energy infrastructure and direct energy supply routes in particular is largely desirable. From the energy security viewpoint the situation is, however, more complicated, since the emergence of new supply routes inevitably leads to more room for strategic maneuvers for the energy supplier and, consequently, weakened negotiation power of European nations. In addition, when we add to the picture the planned infrastructure projects towards China and Far East, the improvement of European energy security appears even more dubious.

Developing the energy supply routes at the cost of production

The gigantic exploration projects aimed at increasing Russia's natural gas production are lagging well behind the planned infrastructure projects. Russia is already faced by the need to import increasing quantities of natural gas from the neighbouring producing countries in order to fulfill its domestic and international supply obligations. Exploration of the giant Shtokman gas field on the Barents Sea has been postponed for the time being; the Shtokman field was initially expected to provide most of the natural gas pumped through the Nord Stream pipeline. According to recent information, Russia's national gas company, Gazprom, is to prefer the development of vast natural gas deposits at the Yamal Peninsula instead. Although the estimated costs of developing Yamal by far exceed those of developing Shtokman, Gazprom will be able to develop the Yamal fields mostly by its own resources and technical know-how. In contrast, the development of the technologically more challenging Shtokman field would require the company to engage foreign partners in the project. However, even according to the most optimistic estimations, first output from the Yamal fields may be expected around 2015, at the earliest.

The increasing domestic demand for natural gas together with the fact that in the light of current estimations, Russia's gas production growth will be significantly slower than the growth of the country's export capacity leads to the situation where the importers of the Russian energy will compete for ever smaller energy supplies. Coupled with favourable development of energy infrastructure, this in turn leads to growing energy policy leverage of Russia. Highlighting this development, the investments of Russian state-owned energy companies over the past years have been directed to foreign energy infrastructure projects and the European downstream sector instead of domestic production.

Russia's current international energy strategy follows the divide and rule –principle. By simultaneous development of its export infrastructure in both Northern and Southern Europe and diminishing the role of energy transit nations, Russia is likely to be ever more successful in entering into bilateral energy supply contracts with the large EU countries. For smaller Baltic Sea region countries this means further erosion of their negotiation powers, which in turn brings the EU further apart from the common energy policy it tends to claim.

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