Baltic Rim Economies

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

ISSUE NO. 2, 29 APRIL 2009

ECONOMIC REVIEWS:

EXPERT ARTICLES:

EXPERT ARTICLES CONTINUED ON NEXT PAGE

To receive a free copy, print or register at www.tse.fi/pei

pan-european institute

Baltic Rim Economies

bre
Baltic Rim Economies

ISSUE NO. 2, 29 APRIL 2009

EXPERT ARTICLES CONTINUED:

Estonia

Economy stagnates

According to the preliminary calculations by Statistics Estonia, the total GDP decrease for 2008 was 3.6%. The GDP in current prices was almost EUR 16 billion. There was a gradual acceleration in the decrease of the GDP during the course of the year. Major factors contributing to the decrease in demand were a sharp decrease in domestic demand and the decrease in exports due to the decline of external demand. The GDP decreased by 9.7% during the fourth quarter of 2008 y-o-y. This is roughly in line with the 9.7% flash estimate of Statistics Estonia published in the previous issue of Baltic Rim Economies.

The Bank of Estonia sees some positive indicators on the economy despite gloomy forecasts projecting the possibility of a double-digit fall in GDP in the first half of the year. First of all, the Estonian current account deficit has decreased sharply and it expected to regain its balance for the first time in fifteen years. The growth of Estonian wages has practically stopped and the wage level remains at a competitive level when compared to the older member countries of the EU. In addition, the banking sector, which has an important role in future economic growth, is well capitalized due to high profits in 2008 and rather strict banking standards.

The economic downturn has had reflections in the general government debt. The Estonian general government sector deficit was 3% of GDP in 2008 according to the preliminary figures by Statistics Estonia. The general government gross debt level thus underwent a steep increase in 2008 compared to the continuously declining trend which had started in 2002. The positive news is, however, that the deficit still remained within the limits set out by the Maastricht Treaty.

The data of Statistics Estonia on industrial production gives additional information on the downward trend evident in the GDP figures. Industrial production decreased by 33% in February y-o-y. The rapid decline of industrial production which started during the latter part of 2008 has steepened for months. Industrial production fell, for instance, by 22% in December and by 27% in January. The production of building materials fell by 64% and production of wood products by 40%.

Retail trade plummets

The economic crisis has also been reflected in the retail trade figures which have decreased significantly. In February 2009 y-o-y the retail sales of goods of retail trade enterprises decreased 18% at constant prices according to the data of Statistics Estonia. The decreasing trend, which had started roughly a year ago, had remained in the decreasing frame of 1-10% before the February figures which represent a new low. The decreasing sales figures are well in line with the results of the gloomy consumer sentiment indicated by the confidence surveys in Estonia.

Lowest inflation in five years

According to Statistics Estonia the increase in the consumer price index was 2.0% in March y-o-y. The last time that the consumer price index, compared to the same month of the previous year, was below 2% was almost exactly five years ago. As previously, the annual index was mostly influenced by the price increases of housing (+7.2%). However, the price of transport has decreased significantly since March 2008 (-10.2%).

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

Commodity group	*y-o-y*	*Previous month*
Food and non-alcoholic beverages	0.1	-0.5
Clothing and footwear	0.4	1.1
Housing	7.2	-2.9
Transport	-10.2	-0.3
Hotels, cafés and restaurants	3.6	-0.2
TOTAL	2.0	-0.5

Source: Statistics Estonia

The index decreased -0.5% in March compared to the previous month. One major contributing factor to the decrease was the price decrease of housing (-2.9%) which has decreased steadily for some while now. One main reason for the decrease in the price of housing is due to the continuous decrease in the price of thermal energy. Also the long risen food prices have started to decrease slightly (-0.5%).

Some business highlights

- Playtech Estonia, the Tartu based online game manufacturer, is planning to hire 35-40 new employees during the year 2009. The company has also opened a branch office in Tallinn.
- Some large companies in the County of Ida-Virumaa have continued to renew their production. For instance, Viru Keemia Grupp (VKG) has halted its investments in to a cement plant but is preparing to launch a new oil factory. Hiab Balti in turn is going to open a new production building in June.
- A wind park planned to be built on the Island of Hiiumaa has been put on hold for the time being. The developing company, AS Raunisaare, has announced that due to the local residents opposition to the project it will wait at least for a while before starting with the economic calculations regarding the project.

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	-9.7	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	-33.0	2/2008
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	2.0	3/2009
General government budget balance (% of GDP)	0.3	1.5	2.0	2.3	2.3	3.8	2.8	-3.0	n/a	1-12/2008
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	965	1-2/2009
Imports (EUR million, current prices)	4798	5079	5715	6704	8213	10576	11278	10872	1135	1-2/2009
FDI inflow (EUR million, current prices)	603	307	822	775	2255	1341	1817	1366	n/a	1-12/2008
Current account (% of GDP)	-5.6	-10.6	-11.6	-12.5	-10.5	-14.8	-17.4	-9.2	n/a	1-12/2008

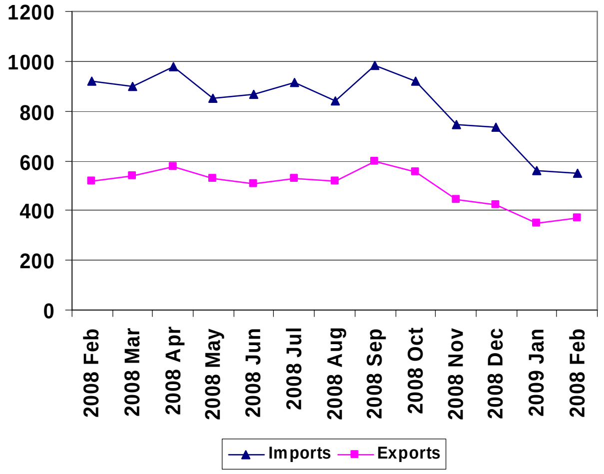
Sources: Statistics Estonia, Bank of Estonia, Eurostat, author's calculations

Latvia

Foreign trade plummeted in February

The value of exports decreased by 29.3% and the value of imports by 39.6% in February 2009 compared to February 2008 according to the Central Statistical Bureau of Latvia. Thus the Latvian foreign trade deficit has continued to shrink and was approximately two times smaller than in the autumn of 2008.

Latvian foreign trade from February 2008 to February 2009 (EUR million)



Source: Central Statistical Bureau of Latvia

Exports decreased in almost all of the main commodity groups. For instance, exports in agriculture decreased by 11.5%, exports in products of chemical and allied industries by 9.0%. Likewise, exports in wood and wood products still decreased, now by 27.7% and exports in base metals and articles of base metals fell by 27.7%. In imports, the trend in almost all of the main commodity groups was even more negative than in exports. For instance, imports in agriculture decreased by 19.9%, imports in products of chemical and allied industries by 15.2%. Likewise, imports in wood and wood products decreased by 41.9% and imports in base metals and articles of base metals fell by as much as 50.9%.

The foreign trade partners of Latvia in February were roughly the same countries as previously. The European Union dominated, both in exports and in imports, having approximately a 70% share of both. Regarding individual countries, the three most important export countries were Latvia's close neighbors: Lithuania (16.4% of total exports), Estonia (13.1%) and Russia (8.2%). In imports, Russia was the biggest (16.8%), Lithuania second (14.0%) and Germany third (11.3%).

High inflation decreases gradually

The consumer price level in March 2009 increased by 8.2% compared to March of the previous year according to the Central Statistical Bureau of Latvia. Inflation has continued its gradual decrease for several months now but has still remained at a high level. The price increase of housing, water, electricity, gas (25.0%) was, as previously, the biggest, but the price trend has been downwards. The price level of food has increased by 6.2%. However, the price level of transport has continued to decrease, now by 2.9%. However, the price level in March compared to the previous month decreased by -1.3%. The price increase of clothing and footwear (3.5%) was the biggest. Several prices have fallen, such as the price level of housing, water, electricity, gas (-0.6%) and hotels and public catering (-0.7%).

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

Commodity group	*y-o-y*	*Previous month*
Food	6.2	-1.3
Clothing and footwear	-3.4	3.5
Housing, water, electricity, gas and fuels	25.0	-0.6
Transport	-2.9	0.2
Hotels and public catering	9.4	-0.7
TOTAL	8.2	0.2

Source: Central Statistical Bureau of Latvia

Industrial output decreased by a quarter y-o-y

Industrial production decreased by 24.2% in February 2009 compared to February 2008 according to the data of the Central Statistical Bureau of Latvia. The last time that the volume index of manufacturing was on the same level as now was seven years ago. The most significant decreases were found in the manufacturing of textiles (-61.1%), the manufacture of motor vehicles, trailers and semi-trailers (-59.2%) and thirdly, the manufacture of non-metallic mineral products (-48.0%).

Some business highlights

- The European Bank for Reconstruction and Development (EBRD) has announced that it is ready to support Latvian business with approximately EUR 200 million. A part of this sum was used in an investment in Parex Banka by the EBRD in which the EBRD acquired a share in the Bank. Otherwise the money is intended for industrial companies, producers, agricultural and energy companies as well as textile manufacturers, according to the EBRD Vice-President.
- Prime Minister Valdis Dombrovskis has stated that the coal and biomass project in Liepaja is considered as the most realistic alternative in helping to solve the country's energy issue. Dombrovskis also added that the project would be conducted by Latvia's power company, Latvenergo, which would take care of the project on a commercial basis.

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	-10.3	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	-24.2	2/2008
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	8.2	3/2009
General government budget balance (% of GDP)	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	-4.0	n/a	1-12/2008
Gross wage (period average, EUR)	282	297	298	314	350	430	683	678	n/a	1-12/2008
Unemployment (% end of period)	12.9	11.6	10.3	10.3	8.7	6.8	5.4	9.9	n/a	Q4/2008
Exports (EUR million, current prices)	2232	2416	2559	3204	4085	4594	5727	6202	722	1-2/2009
Imports (EUR million, current prices)	3910	4284	4634	5671	6879	8828	10986	10534	1109	1-2/2009
FDI inflow (EUR million, current prices)	n/a	223	248	489	568	1324	1797	909	105	1-2/2009
Current account (% of GDP)	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-22.8	-12.6	n/a	1-12/2008

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

Lithuania

Foreign trade decreases significantly in early 2009

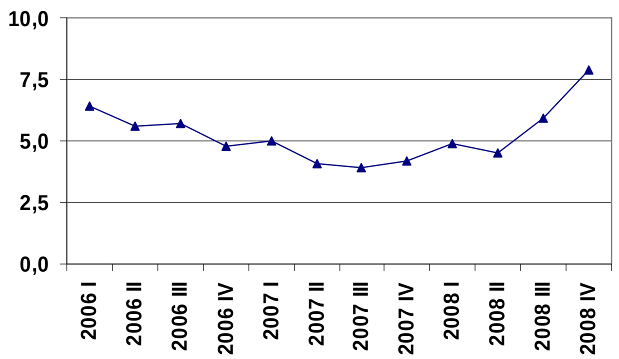
The value of Lithuanian exports decreased in January-February 2009 by 21.8% compared to the corresponding period in 2008, according to the data of Statistics Lithuania. The total value of exports during that time period was over EUR 1.8 billion. Respectively, the value of imports decreased by 41.0% to EUR 1.9 billion. Thus the foreign trade deficit was almost 90% smaller than during the same period in 2008. Mineral products are very important for Lithuanian foreign trade and they have a major impact on the official foreign trade figures. However, if mineral products are excluded, the foreign trade figures stay roughly at the same level. The decrease in exports is 22.9% and the decrease in imports 45.1%.

The decrease in exports in January-February 2009 y-o-y was mostly influenced by the decrease in petroleum oils and oils obtained from bituminous minerals which decreased by 16.4% and by vehicles other than railway or tramway rolling stock which decreased by almost 50%. In line with the export figures, the decrease in imports was mostly influenced by vehicles other than railway or tramway rolling stock which decreased by over 75% and by a decrease of over 25% in the imports of crude petroleum.

Unemployment rises

According to Statistics Lithuania the unemployment rate has been on an upward trend during the latter half of 2008. During the fourth quarter the unemployment rate made up 7.9% which is 2 percentage points more than during the third quarter and almost twice as high as during the corresponding period in 2008.

Unemployment rate by quarters from 2006 to 2008 (%)



Source: Statistics Lithuania

The unemployment rate for the whole year of 2008 was 5.8. Male unemployment was slightly higher than female and as in 2007, youth unemployment was twice as high as the total unemployment rate. The unemployment rate also differs by county. The lowest unemployment rates were found in the counties of Marijampolė (2.8%) and Alytus (4.1%). The highest unemployment rates were found in the counties of Klaipėda (7.2%) and Telšiai (6.6%).

High inflation decreases gradually

The consumer price level in March 2009 increased by 7.2% compared to the January of the previous year according to Statistics Lithuania. Compared to the other Baltic countries, Lithuanian inflation is still approximately on the same level as the Latvian inflation (8.2%) but significantly higher than the Estonian (2.0%). The price increase of housing, water, electricity, gas etc. (21.0%) as well as hotels, cafés and restaurants (11.6%) were still the biggest. However, the price levels of both clothing and footwear (-6.0%) and transport (-0.8%) decreased.

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

Commodity group	*y-o-y*	*Previous month*
Food and non-alcoholic beverages	7.2	-0.2
Clothing and footwear	-6.2	0.6
Housing, water, electricity, gas etc.	21.0	-0.4
Transport	-0.8	-0.3
Hotels, cafés and restaurants	11.6	0.1
TOTAL	7.7	0.0

Source: Statistics Lithuania

However, the price level in March compared to the previous month did not rise at all, being 0.0%. Monthly rises in the consumer price index have been very small for several months. Some of the main commodity groups in which prices rose modestly were clothing and footwear (0.6%) and hotels, cafés and restaurants which rose barely (0.1%). In line with the global trend, the price level of several commodity groups decreased. Some major commodity groups were housing, water, electricity, gas etc (-04%), transport (-03%) and in food and non-alcoholic beverages (-0.2%).

Some business highlights

- The Lithuanian government has received EUR 43 million from Polish PKN Orlen for its 10% share in the Mazeikiu Nafta refinery. The sum represents 20% of the total value of the deal and the remaining EUR 172 million is due on the 30th of April at the latest. PKN Orlen is already the majority owner of Mazeikiu Nafta.
- The Vilnius Airport has changed its pricing strategy due to the diminishing number of flights to the Lithuanian capital. The airport will start offering new half price services which is hoped will attract new flights to the airport.

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	Q1/2008
Industrial production (y-o-y %-growth)	16.0	3.1	16.1	10.8	7.3	8.9	7.2	2.7	-17.9	3/2009
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	7.7	3/2009
General government budget balance (% of GDP)	-2.0	-1.4	-1.3	-1.5	-0.5	-0.3	-1.2	-3.2	n/a	1-12/2008
Gross wage (period average, EUR)	274	293	311	335	421	459	594	672	n/a	Q4/2008
Unemployment (% end of period)	17.4	13.8	12.4	11.4	8.3	5.6	4.3	5.8	n/a	1-12/2008
Exports (EUR million, current prices)	4778	5526	6158	7478	9502	11250	12522	16074	1814	1-2/2009
Imports (EUR million, current prices)	6767	7943	8526	9959	12446	15384	14341	21026	1937	1-2/2009
FDI inflow (EUR million, current prices)	516	772	160	623	826	1448	1645	1223	n/a	1-12/2008
Current account (% of GDP)	-4.7	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7	-11.6	n/a	1-12/2008

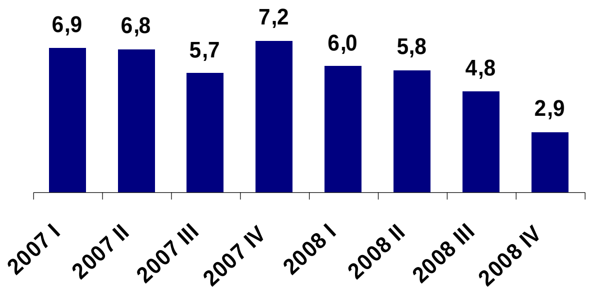
Sources: Statistics Lithuania, Bank of Lithuania, Eurostat, author's calculations

Poland

Economy on a downward trend

The Polish GDP growth has declined considerably to 2.9% during the last quarter of 2008 according to the Central Statistical Office. According to the view of the National Bank of Poland, the major factors contributing to the slowdown in GDP growth are as follows. First, weakening external demand on major Polish export markets such as the Euro area. Second, similarly to other countries, the availability of credit has become more limited and finally, the deteriorating sentiment of economic agents is contributing to the slowing of economic growth. The Polish Government has reacted to the economic crisis by applying, in mid-April, for an over EUR 15 billion loan from the IMF. The funds will be used for increasing the exchange reserves of the National Bank of Poland which is expected to boost confidence in the Polish economy among investors.

Real growth rate of GDP by quarters in 2007–2008 (y-o-y, %)



Source: Central Statistical Office

The decline in industrial output is in line with the decelerating GDP growth. As orders to companies are diminishing, the companies respond by cutting output. According to the data of the Central Statistical Office, industrial production decreased by 14.3% in February 2009 y-o-y. This was the fifth month in a row when industrial production decreased. Output was down in 25 out of 34 industrial sectors. The steepest decline in the main sectors was in mining and quarrying which was down by 19%. Manufacturing decreased by 14%. Particularly bad figures found in manufacturing sub-sectors were noted, as earlier, in basic metals (down by 36%) and in motor vehicles, trailers and semitrailers (down by 33%). On the other hand, some good performers were to be found as well, such as tobacco products which were up by over 21% and beverages, up by 14%.

Inflation increases slightly to 3.6%

According to the Central Statistical Office, the Consumer Price Index increased by 3.6% in March 2009 y-o-y and respectively, by 3.3% in February. Hence consumer prices have grown in early 2009. The Monetary Policy Council of the National Bank of Poland stated in late March that the rise in inflation was mainly driven by rising fuel prices due to previously observed fall in the zloty exchange rate. In addition, all the core inflation indices increased at the same time.

The highest price increase y-o-y was recorded, as in earlier months, in dwelling (up by 8.7%). Food, all beverages and tobacco products were up by 5.6%. The most notable decrease in prices was still in clothing and footwear which were down by 7.9%. The price level in March compared to the previous month increased by 0.7%. The highest price increase was recorded in food, all beverages and tobacco products (up by 1.7%). The price level in communication remained unchanged (0.0%).

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

Commodity group	*y-o-y*	*Previous month*
Food, all beverages and tobacco	5.6	1.7
Clothing and footwear	-7.9	0.3
Dwelling	8.7	0.1
Transport	-5.9	0.6
TOTAL	3.6	0.7

Source: Central Statistical Office

According to the National Bank of Poland, the consumer price index will in the coming months temporarily stay at an elevated level. This is mainly due to the rise in administered prices, primarily energy. However, in the medium term, the global recession and its negative influence on the Polish economic growth is expected to lower inflationary pressure in Poland.

Some business highlights

- Polish natural gas transporter Gaz-System is planning to invest approximately EUR 1.1 billion in constructing almost 1,000 km of gas pipelines in Poland. The first pipelines will be completed in 2011 and all the new pipelines should be finished by the year 2014. The company's own resources as well as EU funds and loans are planned for the funding of the project.
- The Port of Gdańsk made a profit of approximately EUR 1.1 million in 2008 despite the reduced cargo handling in the Port. The total cargo handled decreased by some 10% to 17.8 million metric tons mainly due to reduced handling of coal and liquid fuels.

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	6.2	6.7	4.8	n/a	1-12/2008
Industrial production (y-o-y %-growth)	0.6	1.1	8.3	12.6	4.1	5.7	9.7	3.5	-14.3	2/2009
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	3.6	/2009
General government budget balance (% of GDP)	-3.7	-3.3	-2.9	-3.3	-6.1	-3.9	-2.0	n/a	n/a	1-12/2007
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	10.9	2/2009
Exports (EUR billion, current prices)	40.4	43.4	47.5	59.7	71.4	87.5	101.1	114.6	14.3	1-2/2009
Imports (EUR billion, current prices)	56.2	58.3	60.4	71.4	80.6	100.0	118.8	139.3	15.9	1-2/2009
FDI inflow (EUR billion, current prices)	6.4	4.4	3.7	10.0	8.3	15.1	12.8	11.1	1.5	1/2009
Current account (% of GDP)	-2.9	-2.6	-2.1	-3.5	-1.7	-2.3	-3.7	-5.4	n/a	1-12/2008

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

St. Petersburg

Economy: the fall

In February 2009 St. Petersburg's Government announced general results for year 2008. The region's GRP grew 8.7% in 2008, y-o-y. The GRP totalled EUR 39.1 billion in 2008, while in 2007 the corresponding figure was EUR 31.7 billion. The increase of GRP in St. Petersburg appeared to be significantly higher than in Russia as a whole, where GDP rose by 5.6% y-o-y in 2008. Even the depressive performance of the last two months of 2008, namely November and December, did not spoil the positive results of 2008. Nevertheless, 2009 brought a sharp decline in the basic sectors of regional economy. In January-February 2009 industrial production dropped by 19.4%, y-o-y, which was the biggest decline since the middle of the 1990-ies. Almost all industries experienced a substantial decrease in the first two months of 2009. The only exceptions were export-driven electronic and optical production, and the textile industry: they grew 5.7% and 1.6% y-o-y, respectively. Retail trade, one of the fast-growing sectors during pre-crisis period, fell by 5.9% y-o-y in January-February 2009. Other exceptions were transport and communication. Their monetary output in the first two months of 2009 grew 14.8% and 11.2% y-o-y correspondingly. This growth, however, could be explained by solely raising the tariffs of state monopolies. For example, regional cargo turnover in January-February 2009 fell by 25.8%, y-o-y. But this decline in volumes was counterbalanced by an even higher increase of transport tariffs. Despite the crisis, federal authorities decided to raise the state-regulated tariffs of natural monopolies from transport, communication and communal services in the beginning of year 2009. This led to an unprecedented 32.0% y-o-y fall in real disposable incomes of St. Petersburg's residents in January 2009. The experts forecast a certain improvement of the situation in the mid-term.

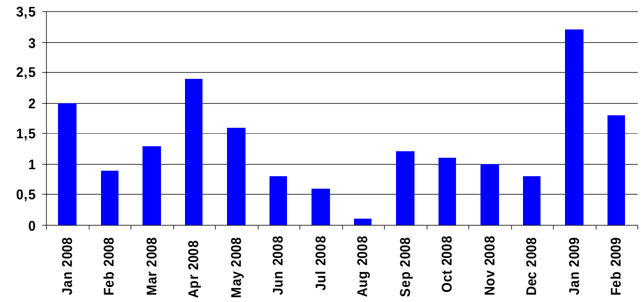
Construction: recession persists

The construction sector of St. Petersburg's economy entered the recession phase earlier than any other sectors and industries in the region. The first threatening symptoms like the deterioration of demand and overheating of the real estate market were already observed in the first half of 2008. In the last quarter of 2008 construction and real estate markets moved into deep recession. And the first two months of 2009 did not show the bottom of this downtrend. In January 2009 the region's construction sector decreased by 18.8% y-o-y, and in February 2009 the y-o-y decline in the sector was 44.9%. Thus, by March 2009 construction lost almost a half of its pre-crisis monthly output. In January-February 2009 the recession, for the first time since summer 2008, started to affect the volumes of dwelling space finalised. Due to the long production cycle in construction, the last quarter of 2008 appeared to be quite successful in finalising some construction projects that were started years ago. And launching of the new (the fifth) metro line in St. Petersburg in the end of December 2008 was a bright example of this kind of project. But since the beginning of 2009 even some almost-finalised projects were frozen, as the cash-flow at the market had stopped. The reason might be the price level. The regional real estate market turned to be less sensitive to crisis trends than, for instance, the stock market. The housing market falls slowly and is still far from the bottom. The rouble-nominated price of one square metre of residential space in St. Petersburg since August 1, 2008, until April 5, 2009, went down by 8.7% on the primary market and by 11.2% on the secondary market. The respective reduction of euro-nominated prices was 26.5% on the primary market and 28.5% on the secondary market. Consequently, the real estate price change in the region could be linked mostly with the devaluation of rouble, while rouble-nominated prices remain high. Incomes of the residents are diminishing quickly, and solvent demand still stays at a low level.

Prices: stagflation?

Despite the fall of consumer incomes, prices in St. Petersburg continued to grow. Moreover, in the first two months of 2009 regional inflation accelerated.

CPI in St. Petersburg, month-on-month % change



Source: Petrostat, 2008, 2009

In January 2009 alone the CPI increased by 3.2% compared to December 2008. In January-February 2009 consumer prices went up by 5.0%, which meant 16.3% y-o-y. This record high inflation emerged due to two factors. One of those was the quick devaluation of rouble in January and the corresponding jump of import prices. Another factor was raising tariffs by state-owned monopolies: this action was needed to sustain some key investment programmes of the monopolies.

Some business highlights

- Russian holding Bazel, owned by aluminium magnate Oleg Deripaska decided to sell its St. Petersburg developer, namely Glavstroy-SPb, to Russian company Nafta-Moskva. Heavily indebted Bazel (with a debt burden of approximately EUR 20 billion) proved to be unable to invest another EUR 5 billion in its construction projects in the region. The price of the deal remained confidential.
- St. Petersburg-based North-western subsidiary of Russia's railway monopoly RZD, namely OZD, cut its investment budget for 2009 by 57%. Nevertheless, OZD still plans to spend EUR 800 million on two "image" projects: creation of high-speed railway lines St. Petersburg-Moscow and St. Petersburg-Helsinki.
- Bank of Russia has withdrawn a licence from Inkasbank, one of the largest St. Petersburg banks, which was a member of VEFK holding. Later, in the end of March 2009 Alexander Gitelson, the main owner of VEFK, was arrested and accused of misappropriating a sum of EUR 20 million.

St. Petersburg - main economic indicators	2001	2002	2003	2004	2005	2006	2007	2008	2009	as of
Regional GDP (y-o-y %-growth, constant prices)	4.5	17.7	8.4	7.2	8.4	8.4	9.1	8.7	n/a	1-12/2008
Industrial production (y-o-y %-growth)	0.2	31.4	5.8	14.1	4.2	-7.0	10.0	4.1	-19.4	1-2/2009
Regional inflation (CPI, y-o-y %-change)	16.3	16.6	13.0	12.7	12.0	10.0	10.9	14.9	16.3	1-2/2009
Gross average wage (monthly, EUR)	n/a	217	209	285	345	407	510	667	528	1/2009
Unemployment (% average annual)	4.4	3.5	4.3	2.8	2.4	2.4	2.0	2.0	2.1	1-2/2009
Exports (EUR million, current prices)	2134	1839	2429	3210	3954	5499	12978	16055	n/a	1-12/2008
Imports (EUR million, current prices)	4423	5158	5123	5560	8081	10299	15093	17475	n/a	1-12/2008
FDI inflow (EUR million, current prices)	127	89	62	90	201	512	567	581	n/a	1-9/2008

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: recession with exceptions

The beginning of 2009 marked a certain change in the economic development of Leningrad province. While the general economic performance was more than negative, certain segments appeared to be new sources of growth in the region. Industrial production in January-February 2009 fell by 8.3% y-o-y. Some branches of manufacturing experienced a dramatic collapse: for example, regional production of metals and metallic items fell by 60.5% y-o-y within the first two months of 2009. Nevertheless, the devaluation of Russian rouble and a corresponding rise in import prices led to significant growth of the food sector in the region. The food industry in general grew 12.8% y-o-y in January-February 2009, while meat production went up by 18.4% y-o-y. Production of fish and fish preserves in January 2009 almost tripled, setting a record for this branch of the province's economy. Construction continued to decrease in the first two months of 2009, losing 25.8% of its output compared to January-February 2008. Retail trade turned out to be less affected by the crisis and declined by 1.7% y-o-y. Catering reduced its output by 7.4%, and the transport sector decreased by 14.7% in January-February 2009, y-o-y. Communication raised its monetary output by 11.1% in the reviewed period, mostly due to an increase of tariffs set by telecom monopolies. Inflation in the region remained high: consumer prices rose by 5.2% during January-February 2009, which meant 16.7% rise y-o-y. The gloomiest result of the first two months was displayed by investment statistics. Investment in non-financial assets of the region in January-February 2009 fell by 47.1%, y-o-y. This might presume that from an investor's viewpoint, the broad revival of Leningrad province's economy is not near.

Agriculture: growth continues

Regional agriculture together with the aforementioned food industry remained the islands of growth in a quickly worsening economic environment. Total agricultural production in January-February 2009 grew 3.8%, y-o-y. Moreover, increase was observed in almost all branches of agriculture. Vegetable production went up by 6.0% y-o-y; egg production increased by 6.1%. Responding to a growing demand by the local food industry, farmers and agricultural enterprises raised hog stock by 60.2% and poultry stock by 19.0%, March 2009 compared to March 2008. It is noteworthy that the basis for this growth was created in 2007-2008 in the framework of state-sponsored projects in agriculture.

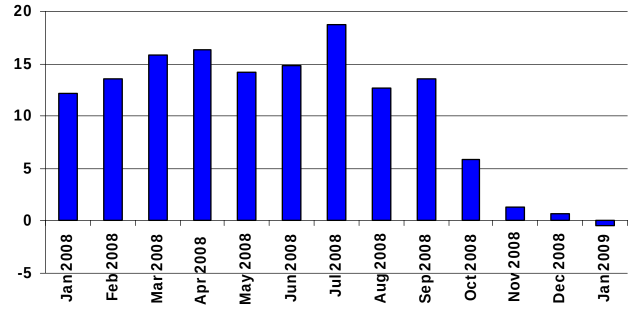
Transport: uneven development

The transport sector of Leningrad province exposed contradictory trends: some branches grew, while some shifted into recession. Automobile transport, one of the most dynamic branches in the region before the crisis, experienced a 42.0% y-o-y fall in the first two months of 2009. Regional automobile carriers suffered from a decrease in construction activity: local and St. Petersburg developers were responsible for a huge part of the demand on transport services. One positive consequence of the contraction in the automobile transport sector was the fall of diesel fuel's price: in February 2009 it became 10.0% lower than in December 2008. Despite this decline in the automobile branch, regional pipeline and marine transporters experienced significant growth: the cargo turnover of these branches increased during January-February 2009 by 4.1% and 10.5% respectively. These two modes of transport are used mostly by exporters: rouble devaluation, making exports more attractive than domestic sales, boosted the volumes of exported cargoes.

Real wages: salary boom ceased

Wages kept on growing in Leningrad province for almost 10 recent years in a row, despite high inflation in the region and in Russia generally.

Monthly real wages, y-o-y % change



Source: Petrostat, 2008, 2009

Nominal salaries increased even faster, compensating for both the price rise and the increase of living standards. For example, in July 2008 the nominal salary in Leningrad province went up by 37.0%, y-o-y. Since October 2008 the growth of real wages started to contract. In January 2009 the deceleration of salary increases turned into a net reduction of real wages. This process was accompanied by a rise in unemployment. Whilst the officially reported share of jobless in the beginning of 2009 increased slightly, the number of people applying for welfare payments almost doubled y-o-y in January-February 2009.

Some business highlights

- RZD, Russian railway monopoly, plans to invest over EUR 300 million in creating new railway infrastructure in Ust-Luga. Vladimir Yakunin, CEO of RZD, named Ust-Luga among "priority projects", which would receive funding despite the crisis.
- Russian developer Olton Plus plans by 2015 to create an industrial park, accommodating window and furniture producers, cottage builders and a wholesale trade complex. The park would be located near Razmetelevo, Leningrad province. Planned investment totals EUR 300 million.
- Russian holding Evrohim re-launched its production facilities in Kingisepp, Leningrad province. The work of the chemical factory in Kingisepp was terminated for three months, from November 2008 till January 2009 due to decreasing demand. Nevertheless, Evrohim signed a contract with Belarus on supplying 150 thousand tonnes of mineral fertilisers to this neighbour country. The contract might help Evrohim's factory to survive in this crisis environment.
- SZNK, a regional producer of construction materials, launched a project of building economy-class townhouses in the Vsevolozhsk district of Leningrad province. SZNK invests EUR 8 million in the project. The townhouses are supposed to attract buyers by a comparatively low price per metre of dwelling space.

Leningrad region - main economic indicators	2001	2002	2003	2004	2005	2006	2007	2008	2009	as of
Regional GDP (y-o-y %-growth, constant prices)	8.5	16.3	14.6	8.8	8.3	8.1	8.5	7.6	n/a	1-12/2008
Industrial production (y-o-y %-growth)	10.7	35.6	20.9	10.3	5.9	26.9	2.6	1.0	-8.3	1-2/2009
Regional inflation (CPI, y-o-y %-change)	19.6	14.8	13.0	14.9	12.0	9.9	9.3	15.5	16.7	1-2/2009
Gross average wage (monthly, EUR)	141	152	173	190	259	324	403	492	407	1/2009
Unemployment (% average annual)	10.8	9.6	9.2	7.5	7.8	6.2	3.3	3.2	3.4	1-2/2009
Exports (EUR million, current prices)	2350	2301	2580	3887	4862	5443	6088	7870	n/a	1-12/2008
Imports (EUR million, current prices)	810	939	1061	1372	2561	2858	4759	5932	n/a	1-12/2008
FDI inflow (EUR million, current prices)	266.0	121.9	104.5	106.6	178.7	288.0	277.0	258	n/a	1-9/2008

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

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

Kaliningrad region

Economic crisis deepens: manufacturing and construction hit hard

The first months of 2009 brought more gloom to the already bleak economic situation in the region. The economic downturn has deepened and its impact has been particularly devastating for import processing manufacturing and the construction sector.

Industrial production fell by 9.7% in the first two months of 2009 y-o-y but this figure combines some growth in oil, electricity and heat production with dismal results in manufacturing where production almost halved. Import-processing assembly plants were hit especially hard. Demand for consumer electronics and cars fell substantially in the recent months and many foreign brand name producers responded by cancelling a large number of orders for contract manufacturing with Kaliningrad's assembly plants. In the first two months of 2009 the production of TVs in Kaliningrad dropped by 63% and the production of cars by 88% (y-o-y). Avtotor, auto producer, and the two largest TV producers in the region, Telebalt and Baltmixt, had to stop their production temporarily in the first months of 2009. Some plants were forced to close down permanently, including a large consumer electronics producer, Radioimport-R, and a refrigerator assembly plant, Tekhprominvest (its parent company Snaige in Lithuania was also on the verge of bankruptcy).

Car Production in Kaliningrad (monthly data)

The Russian government increased tariffs on LCD TVs by 5 percentage points to 15% in January but it is unlikely to provide enough of a breathing space for struggling Kaliningrad's producers.

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

	2009 Jan-Feb	*2008 Year*
Industrial production	-9.7	2.5
Extraction industries	3.7	-0.7
Manufacturing	-48.4	5.5
Electricity, gas and water	6.7	2.9
Construction	-27.8	34.9
Retail trade	3.0	12.1

Source: Kaliningradstat (2008-2009)

After a traditional rush to finish projects by the end of the year, the construction sector almost came to a standstill. Completed housing projects declined by 38.1% in January-February y-o-y in terms of area. However, 78% of all completed housing was done by individuals who built their own houses and their activity actually grew by 22.5% y-o-y. Developers, on the other hand, reduced the area of completed housing projects by 77% in the same period. They were suffering from much more stringent bank lending standards and higher interest rates, even if credit is available.

Retail sales go back to positive territory

After a decline in December, retail sales showed some signs of improvement – they grew by 3% in January-February of 2009 y-o-y. The financial position of the leading regional retailers has also stabilised, at least temporarily, after both Viktoria and Vester, secured large loans from state-owned banks.

However, rising unemployment is likely to have a negative effect on private consumption in the coming months. While data on unemployment rate is not available, anecdotic evidence suggests that it is rising rapidly. The number of people registered with the state employment agency in February rose by 109% over the year before. The number of employees in the consumer electronics sector fell from around 12,000 to 2,500 (*Expert Northwest, #8, 2009*). Manufacturing as a whole had to shed approximately one third of its workers according to the regional government.

Inflation jumps up

Consumer prices grew substantially in the first two months of 2009: by 2.8% in January and 2.2% in February (m-o-m). In January the key inflation factor was traditional increase housing and utility tariffs but in February it was mainly the impact of rouble devaluation that pushed consumer prices up. Kaliningrad has been traditionally more dependent on consumer good imports than most other Russian regions. As a consequence, prices for food and non-food consumer goods are now rising more rapidly in Kaliningrad than in Russia, for example, in the first two months non-food consumer prices increased by 4.4% in Kaliningrad vs. 3.2% in Russia.

Some business highlights

- Another one of Kaliningrad's banks failed: the Central Bank of the Russia recall the banking licence of the Municipal Commercial Bank, which had Kaliningrad City Government as one of its shareholders.
- Kaliningrad's airline, KD-Avia, was saved from ceasing its flights for the second time in the last few months after banks refused to provide loans to the company. Regional government intervened by providing state guarantees for the airline's financing. In exchange, the airline should divest itself of airport Khrabrovo that it owns and operates.
- The economic crisis also brings some odd projects in Kaliningrad. It was announced that Vestles is constructing a plant for manufacturing airships (dirigibles) with a total investment of €1.2 billion. One potential customer emerged – Tuva Republic in the Russian Far East.

Kaliningrad region - main economic indicators	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**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	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	-9,7	1-2/2009
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	17.1	12/2008
Gross wage (period average, EUR)	99	125	137	155	193	285	358	430	351	1/2009
Unemployment (% end of period, LFS data)	10.6	7.2	7.6	6.5	6.6	4.5	3.4	n/a	n/a	Q4/2007
Exports (EUR million, current prices)	508	497	507	876	1470	2025	3666	340	n/a	1-9/2008
Imports (EUR million, current prices)	1169	1701	1894	2419	3283	4275	5714	4770	n/a	1-9/2008
Exports (sales) to Russia (EUR million, current prices)	691	802	989	1449	1901	2471	3901	2240	n/a	H1/2008
FDI inflow (EUR million, current prices)	3.6	6.3	12.4	18.0	15.1	16.9	117.9	89.2	n/a	1-9/2008

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

Lithuania in the Baltic Sea region – a common destiny and shared responsibility

By Andrius Kubilius

The Balts, forefathers of modern Lithuanians, settled by the Baltic Sea more than four thousand years ago. Ever since location by the sea was important to our ancestors from both military and commercial perspectives. Nowadays, membership of eight countries around the Baltic Sea in the European Union provides for a historic opportunity to integrate the region under the banners of peace and prosperity. An opportunity that we must seize and turn into reality.

Lithuania already has strong economic and financial ties with other countries of the region. Over half of imports from and two thirds of exports to the internal market are with the 7 EU member states of the region. Trade within the region constitutes over one third of all Lithuania's international trade. Two thirds of all FDI come to Lithuania from the region. Investment examples include the banking sector, telecommunications, the oil refinery, among many others.

We currently face the important task of overcoming the isolation of Lithuania and other Baltic states from the EU's energy markets. Lithuania, Latvia and Estonia are well linked among themselves and have further energy connections towards Belarus and Russia but there are no inter-connections of the gas and electricity network with the rest of the European market. To this end, we have to build power links with Sweden and Poland, a gas inter-connection with Poland as well as an LNG terminal. The need for these infrastructure links is highlighted by the imminent closure of the Ignalina Nuclear Power Plant at the end of this year. A new NPP in Lithuania is foreseen to be constructed as an unprecedented regional project involving Lithuania, Latvia, Estonia and Poland.

Regional economic integration makes it feasible to undertake coordinated actions to promote economic development. Re-energising the financial sector and removing the remaining hindrances to the well-functioning internal market should be priorities in this respect. It is important to address the „innovation gap" in order to facilitate the inclusion of Lithuania in the innovation networks powered by the North and the West of the Baltic Sea.

Lithuania's geographical location determines the importance of the development of transport infrastructure. The Baltic region should be accessible and well connected to the rest of the EU and to the neighboring countries. Overcoming existing communications bottlenecks is crucial to Lithuania as well as to the whole region. The building of the "Rail Baltica", the development of the "Via Baltica" and the East-West Green transport corridor are the most notable projects in this field.

The Baltic Sea is not just a geographical notion, it is a living organism for which we all are responsible. We should make sure that any large-scale infrastructure planned on the seabed is laid only after careful consideration of its impact on the environment taking into account that the Baltic sea is already ranked among the most poluted seas in the world. HELCOM is an important actor for developing and coordinating the implementation of the measures that could have a positive affect on the state of the Baltic Sea. We should also help the Baltic Sea eco-system through measures with a local dimension, such as improved waste water treatment in neighbouring countries.

The Baltic Sea region is primarily about its people. After long decades of forced isolation, we now discover many opportunities to communicate, share ideas and build a common future. I hope this learning process continues, and we can envisage the emerging and strengthening of a regional identity. We should support this process by promoting extensive contacts between people, in particular but not least the youth.

While strengthening and deepening cooperation of EU member states of the region, we should find ways to engage more closely our neighbours the Russians and the Belarusians to share the dividends of regional peace and prosperity. We believe that existing regional structures, first of all, such as Council of the Baltic Sea States and Northern Dimension could be instrumental in achieving this goal.

In July, Lithuania will take over the responsibility of presiding over the Council of the Baltic Sea States. Innovations, cross-border cooperation and safe and clean region have been identified as main Lithuania's priorities during its one-year presidency. Our objective is to promote the region as a modern and creative space for communication and cross-border cooperation. In June 2010 Lithuania will host a summit of Prime Ministers of the CBSS.

Lithuania fully supports the development of the EU strategy for the Baltic Sea Region and looks forward to its adoption under the Swedish EU Presidency in the second half of this year. I hope the implementation of the Strategy will successfully live up to its considerable potential and the high expectations it already managed to create. I sincerely believe that more coordinated and focused EU cooperation in the Baltic Sea region will contribute to the strengthening of the whole EU.

Lithuania is looking beyond the current economic turmoil, aiming to emerge better equipped to face the challenges of the post-crisis world. More cooperation and coordination in the Baltic Sea region will be essential to this end.

Andrius Kubilius

Prime Minister

Lithuania

Future challenges of transport in the Baltic Sea region

By Antonio Tajani

The successful development of the Baltic Sea Region depends heavily on a well performing transport system. This region, which is located outside the economic centre of Europe, but dynamic and highly dependent on foreign trade in goods, needs transport infrastructure for its economic prosperity.

Focusing on the interconnection of national networks and links between the EU's peripheral and central regions, the trans-European transport networks (TEN-T) have a particular importance for the Baltic region. The TEN-T policy aims at ensuring the functioning of the internal market as well as economic and social cohesion in the EU through realising a number of strategic priority projects. Furthermore, it contributes to sustainable development objectives by minimising negative environmental effects.

The projects of common interest identified in the TEN-T Guidelines with respect to the Baltic Sea region, and in particular the priority projects, respond to these objectives.

The Øresund Fixed Link project, implemented in the framework of a Danish-Swedish public-private partnership scheme with financial support under the TEN-T budget, was already completed in 2001. It has had a positive impact on cross-border regional development and plays an important role for the connection between Scandinavia and, via Germany, other EU Member States.

Other priority projects are partly completed, such as the Nordic Triangle multi-modal corridor, involving rail, road and maritime infrastructure in Sweden and Finland; linking the Nordic countries and their capitals to each other; and improving passenger and freight transport from the region to central Europe, the Baltic countries and Russia. Other projects are under preparation, such as the “Rail Baltica”, which links Estonia, Latvia, Lithuania and Poland and connects with a rail ferry link to Finland; or the Fehmarn Belt Fixed Link between Denmark and Germany, which constitutes an extension of the Øresund crossing and the Nordic triangle road and rail links.

Among the main future challenges with regard to the TEN-T development in the Baltic Sea region are the development of rail interoperability; the removal of bottlenecks, especially to facilitate rail freight transport; the establishment of inter-modal connections, in particular between railways and ports, in order to facilitate freight logistics; and the implementation of traffic management systems to ensure efficient use of infrastructure.

These challenges are addressed in the framework of a broad review of the TEN-T policy, the first milestone of which has been the Commission's Green Paper, adopted in February and followed by a large public consultation. Based on new challenges, in particular the climate change objectives, this review looks into options for further developing the trans-European transport networks.

Well-functioning transport logistics, supported by appropriate logistics infrastructure, are also fundamental to the creation of a sustainable and competitive transport system in the Baltic Region. This also includes innovative systems and cost effective processes contributing to reducing CO2 emissions and at the same time strengthening the global competitiveness of the European transport industries. The EU's Swedish Presidency will take forward the work on freight logistics, rail freight networks, ports policy and maritime freight transports in the second half of 2009.

Naturally, maritime transport plays a key and still increasing role for the region. A strategic vision for this transport mode is reflected in the Commission's recently adopted Communication on a European maritime transport policy up to 2018. Looking at the development of shipping, ports and related sectors over the short, medium and long term is essential, especially at a time when sustainable and competitive alternatives to road transport need to be developed. In parallel, the Commission has developed the concept of a European Maritime Space without Barriers. This aims at effectively implementing the Single Market by simplifying the existing regulatory and administrative framework.

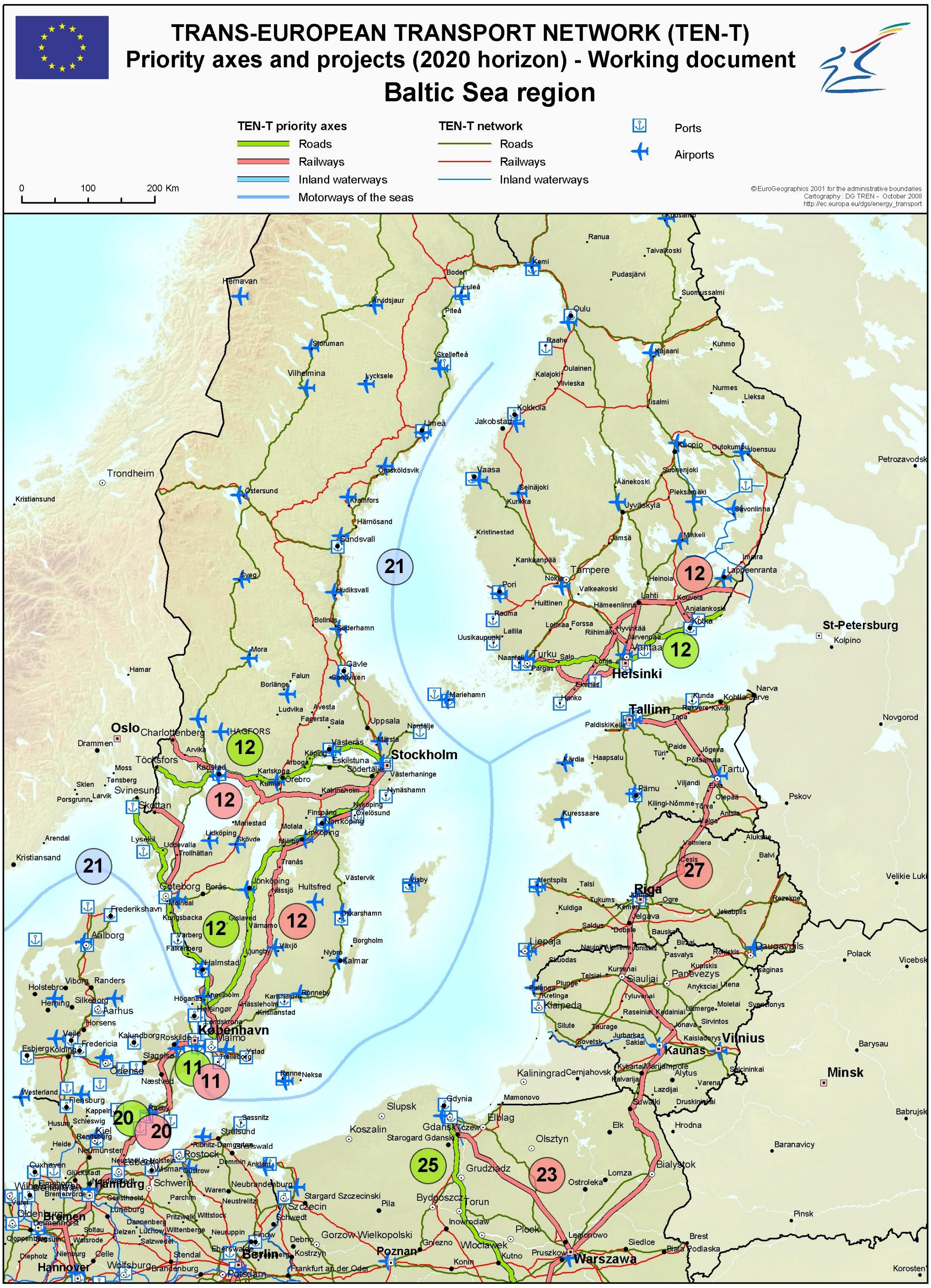
The rail freight market in the Baltic States mainly relies on the trade with Russia given the rail network's characteristic (wide gauge). Its growth, especially over long distances towards the Far East, will depend on the development of efficient rail freight corridors with good intermodal connections. Furthermore, access to the rail market and its safety and interoperability will have to be enhanced in consistency with the Community requirements.

Due to increased globalisation, the very basis for flows of goods, capital, people and ideas has changed. This means that transport needs in the Baltic Region have to be evaluated not only from a national, regional or European perspective, but also from a global perspective. There are increased trade flows from the North (iron ore, wood products) and from the East (new routes to Russia, Central Asia, Far East) which can, if managed well, put the Baltic Sea Region in a strategic position between Europe, North America and Asia.

Antonio Tajani

Vice-President, Commissioner for Transport

European Commission


TRANS-EUROPEAN TRANSPORT NETWORK (TEN-T)
Priority axes and projects (2020 horizon) - Working document
Baltic Sea region
TEN-T priority axes
Roads
Railways
Inland waterways
Motorways of the seas
TEN-T network
Roads
Railways
Inland waterways
Ports
Airports
0 100 200 Km
Stockholm
Helsinki
Tallinn
Riga
Vilnius
Minsk
St-Petersburg
Warszawa
Berlin
København
Oslo

Neighbouring area cooperation and Baltic Sea Strategy of the EU – complementary instruments to support cooperation (and sustainable development) in the Baltic Sea Region

By Paavo Väyrynen

The deepening global economic downturn has already had a strong impact on the Baltic Sea region's economies. The signs of a longer term economic recession can be detected in differing forms. In this situation the task of the governments is to use all available means on both national, regional and other levels to encounter challenges and threats facing them.

We have to ensure that the Baltic Sea region will also during the time of a crisis continue to be a dynamic economic region, building on the EU internal market, focussing i.a on the science and innovation policy and efficient transport and logistics networks as well as on energy and ICT.

The forthcoming Baltic Sea Strategy should help us to identify more clearly the concrete opportunities and challenges of the Region and give us efficient instruments to make the best use of its untapped potential. The Strategy is indeed an evidence of EU's growing interest and engagement to the Baltic Sea Region. EU's both internal and external policies and programmes should be fully taken advantage of in order to create sustainable and environmentally sound economic growth on the regional level.

One of the specific features of the Baltic Sea region is that it forms one part of the external border of the European Union. In this respect it is important to note that the Northern Dimension (ND) framework provides the basis for the external aspects of co-operation in the Baltic Sea Region, as outlined in the European Council's conclusions in December 2007.[1]

As to the financing of the Baltic Sea Strategy, the Cohesion policy and the Northern Dimension partnership model consisting of several financial sources - EU budget, national budgets, private sector, IFIs, such as IBRD, EIB, EBRD, NIB - should serve as a model. Setting out clear priorities for the region as such should contribute to better use of the existing financing opportunities.

Promoting regional co-operation across the borders round the Baltic Sea including the northernmost parts of our region has been one of the key priorities of Finland since the post-war period. Finland has been working actively both on national, regional and more recently on EU-level in order to generate ideas and innovations that should bring closer together the countries, economies and regions. One of these innovations has been the Finnish Neighbouring area co-operation programme, which has also served as a source of inspiration for the new EU approach to the cross-border-programmes currently embodies in the so called ENPI CBC prgorammes.

Finland's neighbouring area cooperation focusses primarily on Northwest Russia, basing on the Agreement between Finland and Russia that I initiated and signed in 1992 as the then Foreign Minister. Since the 1990's 293 million euros has been allocated to Finnish-Russian projects carried out in Russia . The total funding for this year is 19, 5 million Euros. Neighbouring area cooperation is also used to support the EU-Russia strategic partnership, the work in the Northern regional councils (especially CBSS, BEAC and Nordic Council of Ministers) as well as the Northern Dimension policy and its partnerships, including the Partnership on Environment and Partnership of Health and Social Wellbeing and the evolving new partnerships in the fields of transport and logistics as well as the partnership of culture, presently under preparation.

The greatest successes of the Finnish neighbouring area cooperation coincide with the successful flagship projects of the Northern Dimension Environmental Partnership, namely the St Petersburg Southwest Wastewater Treatment Plant, which is of special importance for the protection of the Baltic Sea. (Finland has supported its construction by about 12 million Euros.) Cooperation in the field of forestry promotes sustainable forestry and biological diversity. In the field of radiation safety the promotion of the safety of the Kola and Leningrad nuclear power plants is our priority. Finland has also made a marked input in the prevention of communicable diseases, especially to combat HIV/Aids and tuberculosis, both within the Northern Dimension Partnership and in supporting international cooperation in the Barents region

The Finnish Government has outlined its new priorities of the neighbouring area cooperation taking into account the recent developments in its neighbourhood. The main objective of Finland's cooperation with its neighbouring areas is to support economic and social development in the area and to promote the preconditions for cooperation between the public authorities, business life and citizens. The cooperation fosters administrative and legislative reforms and encourages civil society development. Furthermore, efforts are made to reduce risks related to the environment and nuclear safety and to prevent the spread of drugs and communicable diseases. Finnish neighbouring area cooperation will focus more than before on the promotion of economic cooperation, which is of special importance during these challenging times of economic downturn.

Dr Paavo Väyrynen

Minister for Foreign Trade and Development

Finland

[1] 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 Northern Dimension covers a broad geographic area from the European Arctic and Sub-Arctic areas to the southern shores of the Baltic Sea, including the countries in its vicinity and from north-West Russia in the east to Iceland and Greenland in the west. (Northern Dimension Policy Framework Document, paragraph 2.)

The Arctic region – shift in geopolitics?

By Jānis Sārts

Global warming and climate change have brought new challenges to world politics. The Baltic Sea region is no exception. Harsh weather conditions and high costs for extracting resources have deterred major business activities in the Arctic region and the Baltic Sea region remains the cheapest and most reliable option for transportation of goods in the Northern European region. However, due to the melting of the Arctic ice cap, these conditions may change and increase the economic potential for the High North. Research suggests that in the very near future the melting of ice will open new sea routes and ease access to large fish and hydrocarbon resources. In the next 20 years the Arctic Ocean could be accessible to transportation at for several months out of the year. These are issues that we should take into consideration.

The Arctic region and its challenges should be addressed in the wider context of the Northern Dimension that addresses not only international implications of new challenges, but also increases the importance of regional politics thus having effect on the Baltic Sea region in terms of environment, economy and security.

Three out of six Arctic rim states (Norway, Denmark, Russia) are also part of the Baltic Sea region thus the challenges faced in the Arctic surely will have implications in this area.

The European Union already has developed its Northern Dimension policy which historically was firstly applied to the Baltic Sea region and now is broadened to also include challenges posed by climate change in the Arctic. The EU has demonstrated its clear interests in Arctic problems as this has implications to the growing energy demands of the EU where the Baltic Sea is of strategic importance. One important aspect is that the Nord Stream gas pipeline that will cross the Baltic Sea will most likely carry gas from the Shtokman gas field which lies in Arctic Circle.

Sweden has already indicated that during its EU presidency in the second half of this year the main focus will be devoted to climate changes and challenges. especially devoting Efforts will be particularly devoted to the Arctic and the Baltic region, as well as improving cooperation with Russia thus stressing the importance of synergy of these regions.

Russia is certainly an important actor in this context. It is a country that has already demonstrated its ambitions in the Arctic region by claiming not only the extension of its economical zones, but also by increasing military activities. The key in this process is cooperation based on equal contribution towards common objectives. However, economic interests should not replace security concerns and the interests of all states involved. The geopolitical environment of the Baltic Sea region can be defined as a microcosm of wider Europe and is somehow similar to the High North. It includes members of NATO and EU, Russia and neutral states (Sweden, Finland). Comprehensive involvement of international organizations has ensured security and stability in the Baltic Sea region and some of the lessons learned are worth considering for further High North policy. Therefore I would like to argue that the mechanisms for cooperation in the Baltic Sea region could serve as a basis for further engagement with Russia in the High North.

Development of the High North will also involve security challenges that go beyond the competence of the Arctic rim states and will stress the need for broader cooperation and the possible involvement of NATO. Although only five Arctic rim states are NATO members, consequences of the trends in the High North could have implications for the entire Alliance and it seems appropriate to suggest that NATO may have an increased role to play in the High North. Further development of the High North may considerably increase NATO's possible area of interest. However, NATO's role should not be transform into an arbiter in interpreting international law. The main basis for solving territorial claims between Arctic rim states should remain the Arctic Council. The main challenge for NATO, in an area as large as the High North, would be the provision of maritime security. Advantages of new shipping routes and increased commercial activity in the High North may also be used by organized crime for shipping of weapons, narcotics and human trafficking. The increase in shipping activities will also increase potential for accidents requiring search and rescue support. NATO could provide these necessary capabilities. Moreover, the growing amount of shipped and piped hydrocarbon resources will proportionally increase the risk of ecological disasters and need for relief operations.

From the Latvian perspective, the positive side effect could be the increase of geographical and situational awareness of the challenges in the northern parts of NATO, including the Baltic Sea region. The issue of the High North should not be excluded when Allies will start reviewing NATO's Strategic Concept. NATO must define its role. I believe that the High North issue once again underlines the importance of NATO's role, tasks and responsibility for its territory, taking into account concerns of each ally and the principle of indivisibility of security. Moreover, NATO must to strengthen its capabilities to respond quickly to unforeseen circumstances and meet the challenges of the 21st century, including concerns already raised in this context.

Jānis Sārts

State Secretary of Ministry of Defence

Latvia

A vital alliance turns 60

By Martin Erdmann

NATO (THE NORTH ATLANTIC TREATY ORGANIZATION) approaches its 60th Anniversary. Maintaining an Alliance of Sovereign Nation-States over six decades remains a unique historic achievement. NATO is thus often ascribed being the most successful politico-military Alliance in history. Yet, the anniversary is being celebrated with few signs of euphoria or triumphalism, as the achievements of NATO's past cannot hide the challenges of the present and future.

Talking about NATO: What kind of Alliance do we have in mind? Does the NATO of, for instance, 1985 equal the NATO of 2009? Certainly not! As every other successful institution NATO had to adapt itself over time to the ever changing security environment and will need to continue.

In my view today's NATO is an Alliance in its fourth incarnation.

NATO in its first incarnation is long gone, does not exist anymore, but is preserved until today in the memories of most people. That is the NATO of the Cold War, from 1949 to 1989/90. That NATO is the NATO of the history books.

The second incarnation started in 1990, when the Alliance after the end of the Cold War stretched out its hands to the newly democratic and independent States of Central and Eastern Europe and of the former Soviet Union. Today, ten of these then newly democratic and independent States have become members of this Alliance. In the period between 1990 until 1995 NATO developed its partnership relations in the framework of the Partnership for Peace (PfP) and the Mediterranean Dialogue. Finland since those years has become one of the closest Partners of NATO. Today the Alliance has partnership relations with more than 40 nations, including countries as remote as Australia and Japan.

The third incarnation started with NATO's operational activities in the Balkans after the Dayton Peace Agreements for Bosnia in 1995. The Alliance thus begun operational peacekeeping and peace enforcing activities in Bosnia-Herzegovina, Kosovo, later on in Afghanistan, in the context of the Darfur crisis in Africa and only most recently in the fight against piracy off the cost of Somalia. Until 1995, for more than 45 years of its existence, the Alliance never fired a single shot. That changed in 1995 when NATO and NATO Partner Nations started their operational activities in the Balkans.

The 11th September 2001 was the starting point for NATO's fourth incarnation when all of a sudden the new dimension of asymmetric threats entered the global stage. It turns out this incarnation period to be the most difficult one. Amidst mounting operational difficulties and demands, NATO Allies are grabbling with divergent threat perceptions and increasingly fragmentized security perceptions, domestic constraints on the use of their national armed forces and a more and more impatient public opinion vis-à-vis the felt lack of progress in the reconstruction of Afghanistan.

And there is more. Just as NATO is trying to adapt to the globalization age, an assertive Russia has brought NATO's traditional European mission back into focus. Russia's new found self confidence, bolstered by an economic upswing due to huge oil and gas revenues, has allowed her to go beyond merely articulating its discontent with the observer role granted to her by the West. Russia's aggressive rhetoric against some of its neighbors, its use of energy deliveries as a political tool and most of all its disproportionate use of force in the August 2008 conflict with Georgia indicate that Moscow has decided that it will take action whenever it perceives Russian interests to be at stake.

This new Russian assertiveness has created a challenge for NATO at several levels. First, it has raised new questions about the proper balance between NATO's collective defense at home and expeditionary missions abroad. With several of NATO's easternmost Allies arguing for a review of NATO's defense planning and deployment patterns, and with a palpable desire of some Allies to host additional NATO and/or US installations on their soil, the limits of a mere "virtual" military presence in the new NATO members have become painfully evident. Second, Russia's assertiveness has called into question the future of NATO enlargement as a benign means of consolidating Europe as an undivided and democratic security space. With many pundits now criticizing NATO's enlargement policy as the problem rather than the solution to European security, there is a widespread expectation among the international strategic community that this process may now have come to a halt. Nevertheless, NATO's open door policy remains as valid as ever and unchanged, as laid out in Art. 10 of the Washington Treaty.

Most importantly, however, the Caucasus conflict has exposed divisions among the Allies on how NATO's future relationship with Russia should be structured. While the desire for a trustful and trusting NATO-Russia relationship is shared by all Allies, views continue to differ on whether that relationship should be conditional, i.e. dependent on Russia's behavior, or whether it should be pursued largely independently of Russia's rhetoric and policies vis-à-vis its neighbors. The freeze in NATO-Russia relations immediately after the August 2008 provided both NATO and Russia with some time to reflect on their future relationship. Sooner or later, however, the issue needs to be resolved.

All this adds to why NATO celebrates its 60th Anniversary in a rather contemplative mood, without a self-congratulatory attitude.

On this occasion we may not forget the contribution NATO enlargement followed by the enlargement of the European Union has brought to the stability of the Euro-Atlantic area as a whole and the Baltic Sea Region more specifically. Today six coastal nations of the Baltic Sea including three former Republics of the Soviet Union are members of NATO. Finland and Sweden are working closely together with NATO and have in the past 15 years considerably increased political consultations and military interoperability with NATO. The public debate in Finland about a future possible membership in the Alliance underlines the importance the Finnish public opinion attaches to NATO. And rightly so: The whole Baltic region since the end of the Cold War has become a more secure and stable environment in the north-east of Europe.

We tend to take those developments for granted. But let us not forget: These developments are based on political choices that NATO Nations and Aspirant Nations once had to take about their membership. Today we see that the choices were the right ones.

Martin Erdmann

Ambassador

Assistant Secretary General for
Political Affairs and Security Policy

Mr. Erdmann exclusively expresses his personal opinion.

Baltic Sea gas pipeline in Finland's economic zone – project raises many questions

By Bo Österlund

With present energy solutions, Europe is increasingly dependent on gas coming from Russia. Treaties concluded, a statement issued in 2006 by Vladimir Putin when he was President and the estimates of security arrangements over the pipeline route presented at a public hearing on 11 March 2009 in Turku concerning environmental impact assessment (EIA) of the gas pipeline are, from Finland's point of view, neither commensurate nor in line with policy. In giving its consent to the project that may be carried out in the Exclusive Economic Zone of Finland, the country must agree on questions of supervision and responsibility unambiguously and in advance.

The gas reserves of the European Union represent about 2% of the world's known sources of gas. Natural gas is responsible for 20 - 25% of basic energy consumption in the EU. According to Kari Liuhto, the EU's own production covers less than half of its total gas consumption. Of natural gas consumed in Europe, 43% comes from Russia. In 2005, production stood at 314 billion cubic metres (57% of consumption). It is estimated that imports will increase to 509 billion cubic metres per year (81% of consumption) by 2025. With present energy solutions, Europe is increasingly dependent on gas coming from Russia.

Russia, then again, is just as dependent on gas exports as Europe is on its import. Of Russian gas exports, 75% goes to the 27 countries of the European Union. The oil and gas industries are the basis of the Russian economy, and the export of gas is a significant source of income in the nation's budget. Oil and gas account for 20% of total industrial production and 40% of tax revenues. Gazprom alone brings in 25% of the State budget.

Russia has the world's largest gas reserves, at about 50 trillion cubic metres. The Baltic Sea Gas Pipeline Project in its entirety is part of the gas programme under the Russian state administration. Europe increasingly requires gas for the needs of industry and transport.

The shareholders of gas pipeline company Nord Stream are Gazprom of Russia, BASF and E.ON Ruhrgas of Germany and Nederlandse Gasunie of the Netherlands. By joining Europe's gas pipeline network to Russia's natural gas reserves, it will be possible, through the Nord Stream project, to transfer to Central Europe the quantity of natural gas required for consumption by the EU countries.

The length of the pipeline planned between Vyborg and Greifwalder and consisting of two adjacent pipes will be 1,220 kilometres. The pipeline will pass through the territorial waters of Russia, Germany and Denmark and through the exclusive economic zones of Finland and Sweden. As a result of opposition from Estonia, the pipeline was previously moved away from the territorial waters and exclusive economic zone of Estonia. In the Gulf of Finland, it is planned that 375 km of the gas pipeline will pass through the Exclusive Economic Zone of Finland but **outside its territorial waters**.

It is planned that the first pipeline will be ready in 2011. In the second phase in 2012, an identical adjacent pipe will be added to the route, which will double the annual capacity to about 55 billion cubic metres of natural gas. This quantity corresponds to the loads carried by about 650 LNG tankers, so about 1,300 voyages per year across the Baltic Sea. On a daily basis, this means 3-4 vessels constantly coming or going in the Gulf of Finland.

As far as the Exclusive Economic Zone of Finland is concerned, issues and boundary conditions relating to the laying, supervision, operation and protection of the gas pipeline are dealt with in the United Nations Convention on the Law of the Sea (UNCLOS), the Act on the Exclusive Economic Zone of Finland, the Penal Code, the Water Act, the Act on the Protection of Certain Submarine Cables and Pipelines and the Environmental Impact Assessment (EIA) in the Espoo Convention.

The Exclusive Economic Zone of Finland, established in 2005, constitutes the maritime area in the immediate vicinity of Finland's territorial waters, the outer boundary of which is defined by agreements concluded with Finland's neighbouring countries. The location of the outer boundary is assigned by Government decree. The new Act on the Exclusive Economic Zone of Finland is based on UNCLOS. It is a question of almost the same area, which Finland previously prescribed in the Continental Shelf Act and the Act on the Fishing Zone of Finland. According to UNCLOS, an exclusive economic zone may stretch no more than 200 nautical miles from the base lines of the territorial waters. For geographical reasons, however, nowhere does the Exclusive Economic Zone of Finland extend out to its full proportions. Finland has agreed on the outer boundaries of its territorial waters with Russia, Sweden and Estonia. Other nations bordering the Baltic Sea previously formed their own exclusive economic zones. It has been agreed with Estonia that the exclusive economic zone of neither country will extend over the midline of the Gulf of Finland onto the other side.

The regulations of the previous Continental Shelf Act and Act on the Fishing Zone of Finland are combined in the new Act on the Exclusive Economic Zone of Finland. According to the Continental Shelf Act, Finland has the exclusive right to survey the continental shelf at its coast and its interior, and to exploit certain natural resources in its territory. The Act on the Fishing Zone of Finland, then again, gives Finland the exclusive right to rule on fishing taking place within its fishing zone, and to take steps to conserve and increase its fish stocks, unless otherwise prescribed by EU directives or international agreements.

All countries are free to navigate through or fly over the Exclusive Economic Zone of Finland, free to put down underwater cables and pipes and free to utilise the sea for all other activities approved in international law. This concerns, for example, activities with vessels, aircraft, undersea cables and pipelines, which are in harmony with UNCLOS regulations.

Legislation for the Exclusive Economic Zone

UNCLOS provides extensive rights for the laying of undersea cables and pipelines in an exclusive economic area: 'All countries have the right to lay undersea cables and pipelines on the continental shelf in accordance with the regulations of this article'. On the basis of this, therefore, Finland cannot forbid a pipeline project that is appropriately implemented.

The regulation on jurisdiction is also extensive. According to the agreement 'The regulation in this section in no way affects the right of a Baltic coastal state to set conditions for cables or pipelines running through its territory or territorial waters, nor does it affect the jurisdiction, which a Baltic coastal state has in connection with surveying its continental shelf, exploiting the natural resources on the continental shelf, or with work involving artificial islands, equipment and constructions under State jurisdiction in relation to cables or pipelines to be installed or used'.

Upon receipt of an application, the Government may give consent to the exploitation of natural resources on the seabed and its interior within the Exclusive Economic Zone of Finland, and to exploration aimed at such exploitation or to the performance of other work in the Zone, the purpose of which is the economic exploitation of the Zone. Upon receipt of an application, the Government may also give consent to the building and use of artificial islands and equipment and other constructions used for the above-mentioned activity and other such equipment and constructions that might hamper Finland's use of rights based on international law in the Exclusive Economic Zone. The contents of such an application are dictated by Government decree.

The Government may give consent for a fixed period of time or until further notice. The decision must define the conditions, which are necessary from a point of view of safety and the public good. This puts the Finnish Government in a challenging position. The supervision of jurisdiction comes under the Finnish Border Guard. UNCLOS addresses the issue as follows: 'A coastal state may take the necessary steps to ensure compliance with the acts and regulations approved in accordance with this agreement. In these cases, it may, for example, be a question of boarding a vessel, the carrying out of inspections and arrests and the initiation of legal proceedings'.

An offence committed on or targeted at an artificial island, equipment or other construction referred to in the Act on the Exclusive Economic Zone of Finland and within the Exclusive Economic Zone and attempts to punish such an offence will be deemed to have taken place in Finland in accordance with the Penal Code. An offence committed in another exclusive economic zone: environmental offences in the zone, a violation of Water Act permit in the zone, a fishing offence, the illegal concealment of a catch, a fishing violation and breach of general fishing policy in the zone, a hunting offence, illegal concealment of quarry, a hunting violation and breach of the provisions of the Hunting Act in the zone, a mining violation in the zone or other unlicensed activity in the zone and attempts to punish them will be deemed to have taken place in Finland in accordance with the Penal Code. Through the establishment of the Exclusive Economic Zone, Finland's legitimate jurisdiction, which includes the right to use coercive measures, was endowed with significantly more extensive scope, rights and obligations.

In order to gain Finnish governmental consent for the laying of a pipeline through the Exclusive Economic Zone of Finland, on 9 March 2009 the gas pipeline company, Nord Stream, submitted the application required under section 7 of the Act on the Exclusive Economic Zone of Finland (1058/2004).

The Espoo Convention - the special position of Russia

Environmental impact assessment in a transboundary context has been agreed in the Espoo Convention (Convention on Environmental Impact Assessment in a Transboundary Context). Finland ratified this European Economic Commission convention of the UN in 1995. The agreement entered into force in 1997. The Baltic Sea nations, Russia excepted, are all parties to the Espoo Convention. Russia has signed the agreement, but has not yet ratified it. According to gas company, Nord Stream, 'Russia acts as a party of origin as long as it considers it possible according to its legislation'.

The contractual parties have the right to participate in environmental impact assessment procedures carried out in Finland, if the harmful environmental impact of the project under assessment will probably affect the country in question from the territory of Finland. This means that Finland is a subject of origin. Correspondingly, Finland has the right to participate in the environmental impact assessment procedures for a project located in the territory of another country, if the impact of that project will probably affect Finland, whereby Finland is the object. For the time being, however, Finland is not entitled to participate in impact assessment originating from the Russian part of the Gulf of Finland.

Extensive round of statements

In March 2009, the gas pipeline project moved to a stage, the purpose of which is to offer parties the opportunity to express their opinions and statements on EIA work related to the gas pipeline. The assessment presentation round began on 10 March in Helsinki, from where it continued to Turku on 11 March and on to Hanko on 12 March. The assessment was presented in Maarianhamina on 16 March and finally in Kotka on 19 March.

UNCLOS acknowledges the plans of a foreign country to utilise the exclusive economic zone of a coastal state by laying a gas pipeline through its territorial waters: 'The determination of the route of a pipeline in an exclusive economic zone requires the approval of that coastal state. The coastal state has the right to carry out whatever measures and exploration it deems as reasonable, in order to exploit natural resources and prevent, reduce and monitor damage caused by the pipeline. The supervision of legal administration in the Exclusive Economic Zone rests with the Finnish Border Guard.

When exercising its rights, the organisation laying the pipeline should take into account the rights of the coastal state and comply with the acts and regulations, which the coastal state has approved. According to UNCLOS, 'A coastal state may take the necessary steps to ensure that acts and regulations approved in accordance with this agreement are observed'. In these cases, it may, for example, be a question of boarding a vessel, carrying out inspections and arrests and initiating legal proceedings.

According to UNCLOS, a foreign vessel may be pursued if there is good reason to suspect that the vessel has violated the acts and regulations of the coastal stat within that state's territorial waters or exclusive economic zone. Immediate and direct pursuit may only be initiated by the coastal state's naval vessels or military aircraft or by other vessels or air-craft that are clearly marked as being involved in and bearing the authority to engage in such State reconnaissance tasks. Finland principally used Border Guard vessels for such functions, which have the responsibility of monitoring the Exclusive Economic Zone, and have the authority required for the necessary actions.

As, according to UNCLOS, the Baltic Sea is a semi-landlocked maritime area, the countries that border it are obliged to co-operate and should act collaboratively when using their rights in accordance with UNCLOS.

Since 2005, Russia's Baltic Fleet has been involved in the Nord Stream gas pipeline project. As Russia's President, Vladimir Putin stated in a televised address on 26 October 2006 that the Russian Navy would participate in researching, constructing and monitoring the pipeline. "*This is a major project, very important for the country's economy, and indeed for all Western Europe. And of course we are going to involve and use the opportunities offered by the Navy to resolve environmental, economic and technical problems, because since the Second World War no one knows better than seamen how to operate on the bottom of the Baltic Sea. Nobody has similar means to control and check the bottom, nobody can better accomplish the task of ensuring environmental security*".

By the action of the project management, it has been reported that a 200-metre plated security zone the security of which 'shall be enforced', will be established above the gas pipeline. It has also been reported that, during construction, the security zone would be kept at 2.5 - 3 kilometres. Putins's announcement means that the frequency of sailing of Russian Navy surface vessels and certainly also submarines will increase in the Exclusive Economic Zone of Finland in connection with the protection of the pipeline.

Russian Foreign Minister, Sergei Lavrov, further announced in march during his visit to Poland that Russia, as builder of the pipeline, has the right to decide along what route the pipeline will be laid.

In an article dealing with the pipeline project in the Helsingin Sanomat on 15 March 2009, a representant from the Finnish Ministry of Defence made a statement about the sweeping of mines and underwater explosives beneath the pipeline: 'Our resources for carrying out this job are limited, and the Naval Forces are concentrated on sweeping mines within the territorial waters of Finland. The gas pipeline project is purely a private venture'.

The above-mentioned convention, the statements by Putin when he was President and Foreign Minister Lavrov and the EIA presented at the public hearing in Turku on 12 March concerning the security arrangements for the pipeline, which amount to a separate 'security department', are neither commensurate nor in line with policy.

Within our Exclusive Economic Zone, have we internalised the significance of the responsibility of a coastal state in the above-mentioned operations? Is it possible that the project will give rise to conflict between parties with different interests? Will we be saddled with the overall responsibility for monitoring and guarding the entire 375 kilometres of pipeline that will pass through the Exclusive Economic Zone of Finland and are we also ready to allo-cate the necessary additional resources to it?

If necessary, these matters should be agreed in advance, as investigation taking place after the fact might uncover new problems.

Bo Österlund

Commodore (ret)

Finland

Finland is developing the European Union's border security

By Jaakko Smolander

Europe's border security has again been brought to the fore in recent times. For example, the recent expansion of the free movement area (i.e. Schengen area) to new EU member states and Switzerland has significantly improved the movement of people between countries. To counterbalance the development of the Schengen area, the EU is strengthening its external border control noticeably. EU member states with an external border play a major role in the fight against borderless crime on land and sea and at airports.

Finland and the Finnish Border Guard have played a central role in the development of the EU's border security. Today, external border control on land and sea as well as at airports is managed by specially trained border guard units operating under interior or justice ministries, as agreed in the Tampere Summit.

The core element of border security is a jointly prepared risk analysis that provides an accurate picture of current threats and challenges. This procedure, which was developed by the Finnish Border Guard, has been used by Finnish authorities for decades. Now it is in use throughout the EU. The initial analyses were prepared at the risk analysis centre in Helsinki. The risk analysis is now carried out by the EU border security agency (FRONTEX). Finland played a major role in establishing the agency, which is now led by the Finnish Border Guard General Ilkka Laitinen. Each member state is responsible for its own border security, but FRONTEX can support planning and training by lending additional troops and technical equipment. Every year FRONTEX organises and finances tens of operations in cooperation with member states in target areas indicated by risk analyses.

During the previous Finnish Presidency of the EU, Finland submitted a proposal for the introduction of an integrated border management system along the EU borders. With this model, the authorities can already tackle borderless crime in the country of origin and transit. The model's next level involves cooperation between neighbouring countries and the country's own border control. The final level focuses on seamless cooperation between internal security authorities inside the EU.

Much has been done. But what is the current situation along our borders and what measures should be taken in the future. Finland's border security is under control. Several tens of people cross the European Union's longest external land border illegally, with almost all of them being apprehended. Each year, at border crossing points, the authorities deal with more than a hundred attempts to enter Finland illegally, most of which involve false documents. They also investigate tens of human trafficking cases annually. Most of these cases lead to criminal sentences.

What about elsewhere in Europe: each year the authorities apprehend at borders about 170,000 persons who have been illegally assisted into the EU and about 10,000 organisers of illegal immigration. The real situation is much worse. For example, in 2004 about 700,000 people were deported from the EU and over 200,000 illegal residents left voluntarily. The current estimate is that there are about 8 million illegal persons in the EU. The key routes for illegal immigration are Central Europe, the Balkans the Mediterranean Sea, and the Canary Islands. Other centres of illegal immigration are the biggest airports. In light of these numbers, one can conclude that our joint borders are leaking badly. Today human trafficking is a profitable form of crime, as transporting one person can cost up to 15,000 euros. In fact, human trafficking is currently more profitable than drug smuggling and sentencing is more lenient.

What has led to this situation? The key issue is the need to bring illegal labour into the EU. Of course, this includes more serious forms of human trafficking such as prostitution. Those countries that are the biggest users of illegal labour exhibit the same key trends in human trafficking.

To gain control of the situation, authorities must take measures at all levels of the integrated border security system. The visa application process must be improved to identify fake applications in the country of origin. In the future, common visa policy could logically lead to joint EU consulates that work towards shared targets effectively. The labour requirements of EU member states should be channelled legally through such consulates.

The border surveillance of countries of origin and transit countries must be supported with various training and support projects. Such measures must also apply to refugee and asylum policies. For example, the Finnish Border Guard has assisted Tajikistan, Azerbaijan, Georgia, Ukraine and Belarus. This cooperation helps to proactively prevent pressure build-up at the EU's external border.

There is a need to cooperate closely with the EU's neighbouring countries to ensure border security. For example, return agreements for illegal immigrants need to be implemented along the entire external border.

In order to make the EU's external border surveillance more effective, the member states need to improve their performance in areas indicated by the risk analysis. Member states also need to continue joint audits of border security, which help identify faults in national border security. Lastly, an effective registration system must be developed to keep track of people entering and leaving the EU.

At the same time all key internal security players in the EU must cooperate seamlessly. These parties must also have joint access to information collected by FRONTEX, Europol, national customs agencies, as well as immigration authorities. The use of illegal labour must be made a criminal offence for employers and subcontractors. Europeans must also take a hard look in the mirror. **No one is abused if there are no abusers.**

Once all these measures are implemented, the EU's "leaky" borders can be controlled and the member states can carry out the active immigration policy Europe sorely needs in the future. Such measures also ensure that people who need protection receive it at our borders.

Jaakko Smolander

Vice Admiral (ret)

Finnish Border Guard: Assistant Chief 1998-2004 and Chief 2004-2008

Finland

Do we really need Nord Stream?

By Hanna Foltyn – Kubicka

The Baltic Sea Region (BSR) is gaining more and more importance within the European Union. With the launch of the European Strategy that will be officially implemented by the upcoming Swedish presidency, we shall get new tools to coordinate the cooperation and shape the future of our region. Although it will not be as significant as the Mediterranean (which has its own EU – financed budget line, and despite the fierce efforts of the Baltic Europe intergroup in the European Parliament, this probably will not be the case with the BSR), it marks the beginning of a new era with enhanced possibilities for all the littoral states. One of the landmarks of this plan is to resolve the environmental challenges related to the Baltic Sea. And that means that we will have to tackle one of the most important dangers to the fragile ecosystem of the Baltic, which is the North European Gas Pipeline.

Nord Stream, a project almost purely political in its nature (contrary to what the main shareholders, Germany, Russia and the European Commission constantly repeat), from the very beginning has been contested as – at best – doubtful from the economic point of view. Its estimated costs has dramatically risen (from around 4 billion EUR in 2006 to 12 billion EUR or even more today), while the actual construction process have not yet started. There are numerous voices raising concerns about Russia's ability to provide a sufficient amount of gas to fill the pipeline, and they are coming from even the highest circles of power in Russia itself. Gazprom has been heavily affected by the crisis and instead of pumping money to the budget, it is asking the Kremlin for loans, and therefore will not be able to invest in new gas fields – and that is a *sine qua non* condition of being able to use the pipeline to its full capacity. Moreover, there are gas shortages for the consumers inside Russia and if there is no radical change in Gazprom's strategy, the experts predict a possible break down of the internal gas market by 2011. And even if the gas somehow will finally flow, the question of its price for the consumers in the EU remains open.

Regardless of the market aspect of the whole project, the main opposition is on the grounds of the ecological danger it will pose to the Baltic. The recent information about the plans to detonate an unidentified number of World War II munitions lying on the path of the pipeline (their number may be anywhere between 30 and 900), mainly in the Bay of Finland, caused very serious concerns among the Members of European Parliament, ecologists and the general public. Data provided during the Baltic Europe Intergroup meeting in March by Anders Tarand, MEP from Estonia, is really alarming – according to these facts, 20 cm under the bottom of the Baltic lies a thick layer of mud containing dioxins, one of the byproducts of the paper – producing industry in Finland between 1940 and 1984 that were pumped directly to the sea. It is easy to imagine the impact on the ecosystem if these chemicals begin to mix with the water as a result of no less than 30 explosions. Each of these will heavily contaminate the area in the radius of at least 15 kilometers. According to the scientists even today there are traceable quantities of dioxins that can be found in the Baltic herring, and one can only imagine what will happen, if Nord Stream goes ahead with its plan of underwater detonations. If we add to that the information given to the Baltic Intergroup members by Andreas Calgren, Minister for Environment from Sweden, who said that out of 26 independent ecosystems which exist in our sea only 10 are functioning normally – and that even their number is constantly decreasing – we arrive at a really distressing picture of the situation.

Even before the information mentioned above became public, the European Parliament adopted a highly critical report that strongly condemned the plan to build the North European Gas Pipeline under the bed of the Baltic Sea, pointing out numerous dangers connected with the construction: the hazard of detonating the chemical and biological weapons that still lie under its waters, shipwreck graveyards lying on the path of the pipe, the threat to numerous species living in the Baltic (especially to porpoises), disturbing a total area of 2400 square kilometers of its soil or the plans to clean the pipeline with toxic glutaraldehyde that would be eventually pumped into the sea. The work on the report was marked with heavy Nord Stream lobbying – to the point where whole sets of amendments tabled by some MEPs were actually prepared by the company and aimed at removing large quantities of text (in fact if they all were adopted, the final resolution would be about one page long!). There are two crucial points mentioned in the report: one that voices the opposition of the EP to carry-out the investment on the proposed scale without first having a positive environmental impact assessment, and another one calling for analysis of alternative ways, especially the overland routes.

Such an alternative actually exists – a pipeline that would connect Russia and Germany, going through the Baltic States and Poland, all members of the EU. The Amber Pipeline, as it is called, would be more cost effective (the total expenditure would not exceed 3 billion EUR) and, what is even more important, much more friendly to the environment. However, Russia does not even consider this option – again mainly due to political reasons.

The last thing the Baltic Sea needs today is another danger to its already fragile ecosystem. Let us hope that the Swedish presidency which will take over from the Czechs this summer and which plans to focus on the Baltic will see that and act accordingly.

Hanna Foltyn – Kubicka

Member of the European Parliament

Poland

The EU and Russia

By Reino Paasilinna

Where is Russia heading? There exist many informed opinions about this. Some say that Russia is a prisoner of its own history, its geography and thus can't change. Russia prepares its initiatives and legislation rationally, but executes and interprets them 'creatively'. For example Vladimir Putin's program to stamp out corruption has been a victim of this trend.

During the last decades the Russian economy has expanded dramatically and the internal political situation in the country has calmed down. Russia has found a stable place in the international sphere. Its leaders have made a conscious decision to switch form being exporters of raw materials to being salesmen of knowledge based products and services. President Dimitri Medvedev has distilled these goals into five 'i's: investment, institutions, infrastructure, innovation and intelligence. Russia is a great power and wants this to be recognized internationally. According to this doctrine, we have moved away from a uni-polar world towards one where cooperation between actors is necessary.

Relations between Europe and Russia have suffered individual difficulties for years. Examples are the Polish beef crisis and the Nord-Stream gas pipeline in the Baltic. The EU enlargement to former Warsaw Pact countries put an even greater strain on relations.

Now since the war with Georgia and the latest Ukrainian gas crisis, Russia's relations with Europe are once again going through a rough patch. As the gas crisis has once again underlined, European energy dependency on Russia is the defining element in the relationship, albeit Russia is equally dependent on European payments and investment. The steep drop in world oil prices has had a major impact on the Russian economy. Initiatives of OPEC to slow production to bring the price up again have so far been unsuccessful.

The World Bank has calculated that the Russian economy will contract 4.5 % this year. Russia is of course especially influenced by the world economic downturn because of its dependency on oil and gas exports. Last July oil was being sold at 150 dollars a barrel and now the price is 50 dollars. That is a huge drop.

If the latest gas crisis has made the EU doubt Russia as a reliable supplier, the war between Russia and Georgia in July 2008 damaged its political reputation even more. Russia came in for intense criticism in Europe, although Georgia was the one to start hostilities by heavily bombing Tskinvali, the South-Ossetian capital. Russia did, however, prove its willingness to use force at its troublesome border region.

In a BBC World Service poll, conducted across 21 countries in January 2009, views of Russia have become more negative compared with the year before.[1] In the big EU countries only just over 22% of the public felt positively towards Russia while almost 59% felt negatively about Russian influence. In general, views of Russia around the world had also become more negative with 30% positive against 42% negative. This may be a general reflection of Russia's growing influence.

Even if the public perception of Russia is still rather dark, diplomatic efforts between the EU and Russia can be intense as well. During the gas crisis the Russians as well as the Ukrainians were in intensive contact with the EU and there was a real willingness to solve the problem (at least in the short term) in trilateral talks between Russia, Ukraine and the EU. In a situation where the EU had one simple common interest, i.e. the resumption of gas deliveries to Europe, it was for once able to speak with one voice.

In general, however, Europe's political situation is not favourable for Russia. The EU gained new members a few years back in its Eastern expansion. Some of these countries are keen to seek compensation for the wrongs done to them during the Soviet period.

Apart from the most recent political crisis situations in Georgia and Ukraine, Russia looks forward to enjoying possibly better relations with the US under President Obama than with George W. Bush. Obama has already hinted that the plans for the US military base in Poland will not go ahead. I believe that membership in the EU in the long term of some countries, such as Ukraine, would be less provocative towards Russia than their membership in NATO.

However, the problems we now have with Russia are limited. They don't have an ideological base and both parties want to find solutions to them.

It is important for Russia's image that the Partnership and Cooperation Agreement (PCA) PCA-negotiations advance rapidly. The renewed would create a framework for both sides could develop their cooperation. The EU incorporates at least three approaches to the negotiations. Some want in depth negotiations linked to Russia's membership of the WTO. Others would be content with a short political declaration connected to the sectoral agreements[2]. And of course there are those who would be happier without any agreement.

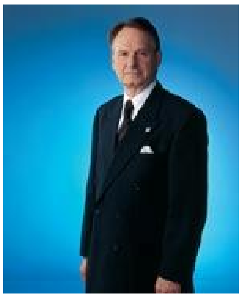
The poor image of Russia in Europe hinders it from achieving its political goals and solving issues. Trade is more difficult and investors are more careful. Many barriers can be lowered by developing Russian legislation and policy public. An important image factor, Russian culture, is fairly unknown in the West. There is a need to get the communication strategies of large companies to the same level as in the West Europe. To copy what the Americans and Japanese have successfully done would be especially important within the European Union.

Dr. Reino Paasilinna

Member of the European Parliament

Vice-Chair of the European Parliament delegation to the EU-Russia Parliamentary Cooperation Committee (PCC)

Finland



[1] Views of China and Russia Decline in Global Poll, 6.2.2009, http://www.worldpublicopinion.org/pipa/pdf/feb09/BBCEvals_Feb09_rpt.pdf

[2] Colmart, Thomas: EU-Russia Relations, CSIS July 2008

The EU's relations with Belarus – how to get things moving?

By Aloyzas Sakalas

Belarus has often been labelled as "Europe's last dictatorship". Although the regime has frequently announced that it would be interested in a better relationship with the EU, these words have rarely been followed by deeds. The EU has designed its European Neighbourhood Policy (ENP) to encompass Belarus, but it found itself caught in a trap insofar as participation in the ENP programmes is conditional on progress on democratisation and human rights. As the Belarusian regime has for many years abstained from substantial progress, Belarus could not be included into the ENP. No policy framework for relations between the EU and Belarus was developed and the EU could not deploy its usual political, financial and other instruments in order to execute political leverage on the Belarusian regime.

In November 2006 the European Commission issued a non-paper which explains what the EU could bring to Belarus' citizens if the regime fulfilled certain conditions as the release of all political prisoners, the abolition of the death penalty, an assurance of a free media and freedom of expression, the independence of the judiciary, respect for democratic values and for the basic rights of the Belarusian people. In order to strengthen Belarusian civil society, the EU has however been supporting the independent media, Belarusian NGOs and students as well as the exiled European Humanities University in Vilnius, Lithuania.

Still, the situation inside the country remains largely unchanged. In 2008 the EU therefore undertook several steps to come out of this deadlock. The Commission opened a Delegation in Minsk in order to enhance dialogue. In October 2008 the Council of Ministers furthermore decided to provisionally suspend a visa ban on certain regime officials. On 16 March 2009 this suspension has been prolonged for a further 9 months. Belarus' Minister for Foreign Affairs was invited to Brussels in the margin of a Council meeting in October 2008 and in January 2009 and the EU's High Representative for Foreign Affairs Javier Solana travelled to Minsk on 19th February. Although the EU has not yet set up regular forums for dialogue, these first meetings clearly blew a breach that enables the EU to better convey its messages towards the Belarusian leaders. The establishment of a human rights dialogue is currently under discussion between the EU and the Belarusian authorities.

As a strong advocate of a policy towards Belarus which offers better opportunities to Belarus' citizens, the European Parliament has adopted many resolutions over the last years. On two occasions it has awarded its annual Sakharov Prize for Freedom of Thought to Belarusian citizens (the Belarusian Association of Journalists in 2004 and the opposition politician Aliaksandr Milinkevich in 2006). The European Parliament is closely monitoring arrests and releases of members of civil society and opposition activists. During election periods it has repeatedly called on opposition leaders to demonstrate unity. It has also actively been lobbying for a reduction in visa fees which, due to the enlargement of the Schengen zone to Belarus' direct neighbours Poland and Lithuania, rose to 60 EUR.

In contrast to the Commission and the Council, the European Parliament is less optimistic about the recent developments in the EU's relations towards Belarus. Due to their regular contacts to Belarusian opposition politicians and representatives from the civil society, Members of the European Parliament are well aware that many of the changes announced by the regime will probably remain cosmetic changes. It is therefore all the more difficult to decide if the moment for a restricted cooperation with the regime has already come. It seems only possible to soften the regime if the latter can see at close range on which advantages it misses out by not cooperating with the EU. In order to let the regime understand this, a minimum of communication and a minimal opening towards Belarus is necessary. The European Parliament though is closely monitoring the latest developments so that this opening does not betray the EU's goal of democratizing Belarus on the long term. By building up relations between the EU and Belarus, the EU intends to support democratization and not the regime's stabilization.

In May the EU will host a summit with its Eastern neighbours Ukraine, Moldova, Georgia, Armenia and Azerbaijan in order to formally launch its new Eastern Partnership. An invitation to take part in this initiative could also be extended to Belarus. This would be an opportunity to show once more to the Belarusian regime what are the clear advantages of countries engaged on the path towards democratic reforms in terms of international cooperation. Participation in the Eastern Partnership would also open new possibilities for Belarusian NGOs and the civil society. However, the EU can hardly allow Belarus to take part in the Eastern Partnership on the same level as the other five partner countries; that means fully and unconditionally. The launch summit in Prague should be used to demonstrate to Belarus what it could expect from better relations with the EU, but no promises should be made.

It remains to be seen if the country is willing to engage on the necessary path of reforms. In order to do this, it is however necessary to strengthen dialogue with the government and the opposition at the same time. The European Parliament will remain the EU's strongest advocate of the Belarusian opposition.

Aloyzas Sakalas

Member of the European Parliament

Lithuania

Towards a sustainable and secure energy policy in the Baltic Sea region

By Ville Niinistö

Energy policy has become a vital issue for the European Union countries in the last few years because of several reasons. If European decision-makers are wise, they should tackle the different root causes of energy uncertainty by a coherent strategy that lays the foundation for a sustainable and secure energy policy for the future. The Baltic Sea region countries have much to win in coordinating these efforts.

Firstly, international climate experts are unanimous in asserting the fact that man-made climate change is challenging the very core of our civilization unless we minimize greenhouse gas emissions in a short time period by making drastic changes in our energy production and usage. In other words, concerted action must be taken now in order to save the planet and our civilization.

The European Union countries have agreed to scale down emissions in 2020 from 1990 levels by 20%, and if international agreement is achieved by 30%. They have also acknowledged the fact that in order to limit global warming to 2 Celsius-degrees the industrialized countries need to scale down emissions by 80-95% until 2050 as estimated by the UN climate panel IPCC. It is clear that these goals are not achieved by small adjustments.

Secondly, energy as a vital resource has become once again a tool in international politics and especially in EU's relations to Russia. Energy independence and energy security have been frequently used concepts among decision makers in Europe ever since the gas conflict between Russia and Ukraine in January 2009.

The importance of energy policy is reflected in the Lisbon Treaty. In addition to encouraging member states to increase their use of renewable energy, the Lisbon Treaty now includes a writ of solidarity with regard to maintaining energy security in the Union.

Much can be achieved both in energy efficiency and in energy independence by a better functioning European energy market and a modernized infrastructure. Insufficient energy infrastructure is seen as a spoke in the wheel of attaining the hoped-for energy solidarity. A solution would be to extend the energy transmission networks as widely as possible.

At the same time the European energy transmission network should be modernized to intelligent HVDC grid (High Voltage Direct Current). At the moment almost 10 percent of energy is lost in poor transmission of energy. HVDC super grid would also enhance the competitiveness of decentralized and local energy production such as wind and solar energy. It makes possible a new energy policy largely based on small local energy production which in turn makes us more independent on both foreign resources and the few energy giants in the market.

The energy security situation in the Baltic Sea area is currently somewhat unbalanced, as the Baltic countries are more or less completely dependent on Russian gas and electricity delivery, with the exception of the Estlink-cable between Finland and Estonia. The demand of imported energy to the Baltic countries is expected to increase as the old Ignalina nuclear power plant in Lithuania is shut down. Emphasizing Russia's role as Europe's most important energy supplier, stresses the importance of reaching an exhaustive agreement between EU and Russia, in which the rules of the energy trade game are clearly outlined. Currently, a high level EU working group is preparing the Baltic Interconnection Plan that will map the needs of energy connections in the area. Already the Estlink 2-cable is included in EU stimulation measures.

Lately, the use of the Baltic Sea as a cross-border energy transit has been subject to debate in the area. Nord Stream (owned by Russian, German and Dutch energy companies) recently launched its Environmental Impact Assessment report regarding the construction of a 1200 km long gas pipeline that would run from Portovaya Bay on the Russian coast to Griefswalser Bodden in Germany.

The Nordic countries headed by Finland and Sweden, have chosen to regard the possible construction of a Baltic Sea offshore gas pipeline from an environmental point of view. Proper measuring of the project's environmental impacts has therefore been greatly emphasized. Estonia for its part, did not allow building the pipeline on its side of the sea, as they feared the construction of the pipeline would seize an opportunity for others to gather intelligence on the countries resources.

Is Europe taking a risk by tying the knots with the Russian gas market through a pipeline in the Baltic Sea? Will the pipeline serve the purpose of increasing energy security in the area on the cost of security in other senses of the word? With the recent gas crisis between Russia and Georgia in mind, it became clear that Russia does not exactly fear EU sanctions. What kind of long-term lessons can be drawn from the gas crisis earlier this year?

More important than trying to fulfill the seemingly never ending increase in demand for energy, is to start questioning wasteful usage of it. Investments need to be made in local renewable energy production like wind and solar power, at the same time as financial resources are channeled to energy efficiency measures and innovations. Green solutions also create more jobs and therefore should be an essential part of stimulating the economy.

Europe can achieve true energy independence best by combining its fight against climate change to efficient energy production and transmission solutions. All in all, a decreased demand of energy is fulfilled principally using energy produced through a combination of different, local renewable energy resources.

Also Russia's long term interest is to diversify their economy and therefore seek part in this process. During an interim period Russia can see the EU countries as reliable export destinations of energy, but no country can build its success for long on fossil energy in future low-carbon world.

The Baltic Sea region countries should find cooperation in upgrading energy transmission networks and joining scientific expertise in clean technology together with local renewable energy possibilities. It is there we can also find joint economic opportunities.

Ville Niinistö

MP, Finnish Parliament

Vice-Chair of the Green Parliamentary Group

Chair of the Committee for Citizen and Consumer Rights in the Nordic Council

The Baltic Sea region is crucial to the Konrad-Adenauer-Foundation

By Bernhard Vogel

The foundation's offices in Tallinn, Vilnius, and Riga, Moscow and St. Petersburg, Warsaw and London, where our work in the Nordic countries and Baltic Sea cooperation is conceptualized and organized, reflect the Foundation as an active observer, supporter and co-designer of manifold dialogue and collaboration in the Baltic Sea region. For us this is more than just about bilateral contacts and relationships with Germany. With our programmes and initiatives we furthermore regard ourselves as participants in the effort of ensuring and reinforcing the continuation of the success-story of peaceful development of the countries in the region since the fall of the Iron Curtain. This being in terms of freedom, democracy and the rule of law as well as to ensuring the countries' economic stability in a global competitive environment through close cooperation.

2009 may be a significant year for ensuring just that. The EU-Baltic Sea Strategy will be presented by the EU Commission and advocated by the Swedish Presidency. The form and results, of this first-time engagement in a regional strategy of the European Union, will serve as an example for politics in the Mediterranean, the Black-Sea region or for the countries of the Visegrad Group. In the future, the expanding European Union will need to rely on such regional pillars increasingly if the Union's joint roof is to remain firm and stable, in spite of its diversity and size.

In this respect the Baltic Sea region has made distinctive contributions in earlier years on which we need to build. Nowhere else have opportunities for bridging the gap between "old and new Europe" been used so proactively and successfully. This experience and the attitudes shaped by various histories should be brought together and applied to our dialogue with Russia, meanwhile the only Baltic Sea state that isn't a member of the European Union. The instrument for such a dialog is the Northern Dimension. It has to be combined with the European Neighbourhood Policy and the Swedish and Polish Initiative for an "Eastern Partnership" in order to make a uniform policy vis-à-vis our Eastern neighbours.

With the establishment of the Baltic Sea Free Trade Area (BFTA) in 1993 and following EU enlargement in 2004, the Baltic Sea region provided a unique example of economic prosperity in Europe and for many years it remained the region with the highest economic growth in the world, following NAFTA. Today, in times of failing economic strength and crisis on the financial markets, a dialogue around the Baltic Sea may, in turn, make a contribution towards ensuring that people, in the new EU Member States especially, do not lose confidence in free market systems or in the democratic or constitutional order that initially was achieved with great effort. The German model of a social market economy or the social security systems known from the Nordic countries create a social balance that helps alleviate the risks of a societal division in times of economic and financial crisis.

It is in difficult times the potential of the region needs to be disclosed and made accessible with even more determination. This applies directly to cooperation in research and technology, university networks and the development of traffic infrastructures or joint tourism projects.

In particular, the Baltic Sea region can tackle environmental and climate challenges jointly. Starting with the sea, connecting everyone. The decision of the European Council on 14 December 2007 for the EU-Baltic Sea Strategy is that: "This Strategy should help to address the urgent environmental challenges related to the Baltic Sea". Many state and private organizations have adopted this objective.

From the EU-Baltic Sea Strategy it also must be expected that an even closer agreement on action, with clearly outlined responsibility, is agreed.

This applies beyond the issue of environmental protection. What in previous years has emerged and grown in terms of structures of Baltic Sea collaboration has to be scrutinized in today's joint EU Membership. Less may now be more. The agreed cooperation under the umbrella of the EU makes all Member States partners in Baltic Sea cooperation. This strengthens the region and gives it a role far beyond Northern Europe. The next months are of utmost importance for status and redefinition. In this case it should primarily be the countries of the Baltic Sea region themselves that provide the initiative and indicate the way ahead.

Bernhard Vogel

Dr, Chairman

The Konrad Adenauer Foundation

Germany

Climate crisis requires regional collaboration

By Michael Butler

There is little doubt that the Earth's environment is changing rapidly. Melting glaciers, prolonged droughts and disappearing forests are profoundly impacting delicate ecosystems. No country is immune. In the Nordic region, lighter snow cover has changed reindeer migration patterns. Further south, rising temperatures in the Baltic Sea have led to severe algae blooms, threatening the native fish species upon which local communities depend. Across the Atlantic, American forests are dying from beetle infestations spurred by warmer winters, while coastal cities are battered by longer, more severe hurricane seasons.

President Obama's administration is actively addressing the global climate crisis. We are in the early stages of putting in place a strong, mandatory plan to cut emissions and develop a low-carbon economy. Over the next ten years the US plans to invest $150 billion to bolster private efforts to build a clean energy future by focusing on alternative and renewable energy sources, ultimately saving more oil than the US currently imports from the Middle East and Venezuela combined. This includes putting one million plug-in hybrid cars on the road by 2015, ensuring 10 percent of our electricity comes from renewable sources by 2012, and 25 percent by 2025, and implementing an economy-wide cap-and-trade program to reduce greenhouse gas emissions 80 percent by 2050. This is a bold new vision of America's leadership role in this vital area.

The European Union has also been a vocal advocate for mitigating climate change. In December 2008, the European Parliament approved the EU's Climate and Energy Package which calls for a 20% reduction in emissions and a 20% increase in the use of renewable energy sources by 2020. The EU has pledged an additional 30% emission reduction if all parties at the December 2009 UNFCCC climate talks in Copenhagen agree to similar targets.

Both EU and American energy targets are ambitious. Under the EU package, some of the heaviest burden will fall to the Nordic countries. For example, Finland must reduce emissions by 16% and increase its use of renewable energy sources by a hefty 38%. The Finnish government has already taken the first steps to meet the targets, but the path to success will not be easy. Additional mitigation measures will be expensive and more difficult to finance amid the global economic crisis. Similar challenges exist for the US.

One solution lies in cooperation. Climate change is a global issue that affects all nations, and only by harmonizing our research and development efforts can we make the immediate impact needed to decelerate global warming. Targeted joint partnerships will efficiently harness scientific talent, attract financing and speed-up technological breakthroughs.

Such collaboration is already successfully underway between the United States and Finland. In the summer of 2008, US Embassy Helsinki's Embassy Science Fellows Program sponsored a research exchange for Dr. Alan Rudie, Supervisory Research Chemist from the US Forest Service (USFS) Forest Products Lab in Wisconsin. Dr. Rudie spent three months in Finland collaborating with top Finnish scientists from VTT and the University of Helsinki to advance the production of economical, multi-purpose biofuel from forest trimmings. Dr. Rudie's cooperation with his Finnish colleagues continues to this day. He recently returned to Finland for a biomass conference to provide updates on the USFS's latest biofuel research developments. The USFS Chief Abigail Kimbell and the Deputy of the USFS Forest Products Lab Dr. Ted Wegner have also visited Finland to solidify a more formal biofuel research partnership between the US and Finland. We are optimistic that this field holds many possibilities for US-Finnish cooperation.

In September 2008, the US State Department convened its biennial review of the US-Finnish Science and Technology Agreement (S&T). The meeting, held in Washington, brought together decision makers from the American National Science Foundation (NSF) and the Finnish Funding Agency for Technology and Innovation (TEKES) to discuss tighter scientific cooperation. NSF and Tekes subsequently launched an international research fellowship called the NSF Graduate Research Fellows Nordic Research Opportunity, which supports research visits for advanced American graduate students between three and twelve months to Finland. The program will bring Fellows in contact with leading Finnish scientists and institutions, and expand opportunities for innovation. The first Fellowships will be granted in mid April 2009.

At the Washington International Renewable Energy Conference (WIREC) hosted in March 2008 by the US Government in cooperation with the American Council On Renewable Energy, the US Government pledged to reduce America's carbon footprint. A new State Department-led initiative, the Nordic-US Cooperation on Renewable Energy (NUCORE), is a multi-agency effort which promotes regional cooperation between the US and foreign countries in specified regions by focusing on R&D in renewable energy science and technology. Its objective is to create regional R&D partnerships to address issues and challenges in the rapid scale-up of renewable energies and yield results that are larger than the sum of their parts. The hope is to reach beyond unilateral efforts and even bilateral partnerships to promote a regional approach to searching for renewable energy breakthroughs. At an exploratory meeting between NUCORE administrators, Finnish scientists and policymakers, NUCORE received enthusiastic support, and its official launch is set for spring 2009.

These efforts are just a few examples of US-Finnish scientific partnerships currently underway. Additional collaborations outside of the region, such as the Asia-Pacific Partnership on Clean Development and Climate, are also yielding great results. The climate crisis is not just an environmental or energy issue, it also has health, economic and security implications which require immediate action. Focused bilateral and regional partnerships can be an important catalyst to advance clean technology innovations at the pace required to blunt the effect of global warming. Finland and the US are working together to do their part.

Michael Butler

Chargé d'Affaires

US Embassy Helsinki

Estonian economy in anticipation of the euro

By Andres Lipstok

The world has been experiencing a real economic crisis for more than a half a year. By now it is almost certain that economic recovery in advanced countries is not expected before 2010. Also in medium-term, economic growth may be modest compared to the rapid development of the past decade.

In the European Union Member States, the harsh reality is approaching. The output in the economies of new Member States may also fall more than it is currently expected. So, according to the risk scenario, the decrease of the Estonian gross domestic product in the first half-year might be measured in double-digit figures.

Earlier risk factors have remarkably decreased

In Estonia, economy started to slow down already in the middle of 2007 - considerably earlier than in most other European countries. The most significant change in the Estonian economy over the past half-year is the sharp and rapid decrease in several risk factors, which has been facilitated by the reserves accumulated by the government and banks in earlier years.

Estonia's current account deficit - i.e. the difference between economy's savings and investments or dependence on the current inflow of foreign capital - has decreased very sharply. This year the economy's current income and expenses will probably be in balance for the first time in the last fifteen years and the possibility of the current account surplus cannot be excluded either. The total volume of Estonia's external debt is also very likely to decrease. At the same time, the external debt of banks operating in Estonia should decrease as well because the growth in household deposits and the weak loan demand enable to repay some of the money borrowed from parent banks in previous years.

Here I would like to stress that the balancing of the current account is a correction resulting from the very large investments of previous years. In the medium and long term, the inflow of foreign investment into Estonia will definitely continue. Estonia's capital formation per person is still significantly lower than in the European Union on average and the average return on investment remains higher than in the so-called old Member States.

During the past half-year, the overall price level in Estonia has not increased, which is the first time after the adjustment in prices following the accession to the European Union. The inflation of 2009 is likely to be negative. In the years to come, the fixed exchange rate of the kroon and the currency board system will keep prices stable. That being said, it is worth mentioning that the halt in wage growth and the decline in interest rates of the euro support the real purchasing power of income.

Rapid normalisation of these essential risk factors shows Estonia's flexibility and adaptability. The positive changes in the economy over the past six months have created first preconditions for a gradual economic recovery. The matter of fact is that our households and enterprises have enough resources to look ahead much more confidently than at the moment. We have let some of the doomsayers intimidate us too much. It is rather the question of if and how Estonia can use the current opportunities.

Path to new economic growth

It is characteristic of the today's world that countries relying on the growth of domestic demand as well as economies relying on the export of industrial goods suffer equally. The growth model based on cheap loan money and American and Asian demand is now exhausted both in Estonia and in the rest of Europe. Economic recovery in Estonia and Europe will therefore be based on profound structural changes.

Further development of the Estonian economy must rely on areas with higher value added in order to ensure a future increase in wages and income. Enterprises must review their current business plans, rearrange their activities and, if needed, end businesses with no perspective. The main task of the government is to contribute to these rearrangements. This requires primarily maintaining the economic environment that is open, stable and supports business. As regards the recovery of economy and investments state budget, labour market, credibility of the banking sector, and accession to the euro area are of the critical importance.

Estonia's fiscal policy has so far endured the crisis successfully. The rapid increase in the 2008 budget expenditure contributed extremely strongly to the avoidance of economic recession. This year the deficit accompanying the decline should definitely remain within the limits set by the Maastricht criteria. In the next two years the objective should be the structural balance and surplus of the budget. The government has no easy choices while making short-term fiscal decisions; in any case the financing of social expenditure targeted at vulnerable population groups and at the same time the maintenance of a reasonable volume of state investments should be ensured. Yet the question is not only about the restoration of the budget balance. The changed economic situation is also a suitable time for thinking about the long-term fiscal sustainability.

In the short run, it is appropriate to use flexible employment solutions in the labour market. All in all, employment still has to decline in areas with decreasing demand since this is the only way to create preconditions for growth in other sectors of the economy. Well-functioning unemployment insurance and retraining are clearly supportive measures. But the employment will eventually depend on how easy or expensive the creation of new jobs is and whether wage agreements reflect the economic situation of a specific enterprise.

Economic adjustment and growth largely depend also on banking. As a result of previous years' very high profits and rather strict banking standards, banks operating in Estonia are very well capitalised. Nevertheless, this year the total volume of bank loans will probably decrease. This reflects mainly lower demand for credit, but also the changed situation in global financial markets.

Adoption of the euro

The euro adoption is a natural stage of development in the Estonian economy. Since in the economic sense we have participated in the euro area for almost 17 years through our monetary system, it is an expected and natural course of events that Estonia will join the euro area. In the light of the current situation of the global economy particularly, the clear and concrete perspective of changeover to the euro adds confidence and helps to increase Estonia's credibility.

According to current estimates, by the end of 2009 Estonia will meet all criteria required for the adoption of the euro, including the inflation criterion, which has been a problem so far. But as already mentioned, the budget deficit criterion will certainly become one of the key challenges. The Estonian Government has approved the deadline for the adoption of the euro, which is 1 January 2011 at the latest.

Andres Lipstok

Governor of Eesti Pank

Estonia

The University of Helsinki as an engine of Baltic sea research

By Thomas Wilhelmsson

As one of the leading multidisciplinary research universities in the Baltic sea region the University of Helsinki carries a strong responsibility for generating research concerning the endangered environment. The University in many ways responds to the demand for research-based knowledge and new solutions in this field.

The University of Helsinki has a strong foundation for performing research in this area. In the beginning of the millennium, it was invited as one of the founding members of the League of European Research Universities, thereby assessed to belong to the twelve leading universities in Europe. In research assessments measuring contemporary research performance the University often is considered to be among the ten most excellent universities in Europe. A particular strength of the University lies in its multidisciplinary broadness. Centres of excellence in research can be found on all four campuses of the University: on the campus for arts and social sciences, for medicine, for science, and for biosciences. Self-evidently a broad approach is needed when studying the complex problems related to the Baltic sea.

Climate change is a huge global challenge affecting the Baltic see as well. The uncertainties in this area are large and the demand for research accordingly very strong. In the University of Helsinki researchers on climate change are in the forefront of global excellence. The Finnish Centre of Excellence in Physics, Chemistry, Biology and Meteorology of Atmospheric Composition and Climate Change, headed by Professor Markku Kulmala, is one of the leading international spearheads of research concerning these issues, with collections of series of data that make most researchers full of envy. The research group is also part of a Nordic Centre of Excellence.

The state of the Baltic sea, its eutrophication, requires research responses from various quarters. Strengthening of Baltic sea research in biosciences has been a strategic goal of the University of Helsinki. Internationally valued multidisciplinary research is performed in particular at the research station of Tvärminne, close to the city of Hanko. Research projects are performed in cooperation with the city of Kotka as well. Several ministries and public research institutions are involved in the work.

Another example of research focusing on consequences of eutrophication are the activities of the national Centre of Excellence in Integrative Photosynthesis and Bioactive Compound Research at Systems Biology Level. Research activities carried out in the University by professor Kaarina Sivonen are dealing with cyanobacteria, also known as blue-green algae. Cyanobacteria are well known for the capability to produce toxins and bioactive componds harmful for humans and animals. Therefore, understanding how they react to the environment, extending from genome function through to the protein and metabolic level is of great value.

Typical for the research concerning the Baltic sea is its multidisciplinary nature. Several faculties, including the Faculty of Biosciences, the Faculty of Science, the Faculty of Agriculture and Forestry as well as the faculty of Social Sciences, participate in this work. Only in this way can sufficient knowledge concerning such a complex issue be produced.

In its recently adopted strategy for the years 2010-2012 the University has included a societal promise in its vision. It will actively work to promote the well-being of mankind as well as the development of a just society. Performing its main tasks, teaching and research, the University endeavours to focus in a more systematic manner on its national as well as global social responsibility. This includes working for a healthy relationship between society and nature. Offering strategic support to Baltic sea research is one of the ways in which the University attempts to fulfil this responsibility.

Thomas Wilhelmsson

Rector

University of Helsinki

Finland

Russia-EU relations

By Konstantin Khudoley

For already two decades the relations between Russia and the EU have been extremely important for both sides and for the global stability in general. During this time these relations have experienced both ups and downs. In the early 90s optimism was the mood of political forecasters. The Partnership and Cooperation Agreement of 1994 reflected their optimistic prognosis. However, following the economic crisis of 1998, we began to witness a rising trend in Russia toward another model of socio-economic and political development, namely, state capitalism and full sovereignty. Thus, the development patterns of Russia and the EU have become increasingly different. In this regard, the discussion about a possibility of full or associate membership of Russia in the EU, which used to take place in the 90s, now has virtually stopped. Relations have become increasingly based on principles not only of partnership and cooperation but competition. In terms of financial and economic crisis that is now global, there is a trend toward greater differences between Russia and the EU.

Firstly, Russia and the EU have differing assessments of both the current crisis and the way out of it. The prevalent view in the EU is that the existing economic model must be preserved although significantly reformed and updated. Growing government interventionism in the economy in most cases is seen as a forced, temporary measure.

The Russian approach is totally different. Major part of the political and economic elites agree with the point of view of the State Duma Chairman Boris Gryzlov that Russia is going to come out of the crisis stronger, while the United States and European Union weakened. Many of the Russian initiatives (including the proposals for the G-20 summit) instead of focusing on transforming the existing model of the world economy are calling for its complete overhaul and creation of a new world economic order. This primarily refers to the pitch for a new reserve currency to replace the dollar. During a debate in the State Duma some representatives of the “United Russia” made it quite clear that the Russian proposals were aiming to put an end to the “American financial monopoly.” Increased government intervention in the economy is thought of as an important step, which is sometimes given ideological colors. This is presented as “the collapse of liberalism”.

At the same time, while the financial and economic crisis is getting worse in Russia, other more cautious voices are beginning to speak up. They emphasize the need for cooperation with the EU and the United States as a way to overcome the crisis. They also admit the limited ability of Russia to influence the global financial system. It can be assumed that this trend is likely to grow and some convergence of views between Russia and the EU will occur. However, in all cases, the position of Russia will be a combination of different trends, and complete convergence with the EU will not happen.

Secondly, the crisis has exacerbated tensions and disagreements on a number of economic problems that existed before.

Energy resources are now and likely to remain the main commodity of trade between Russia and the EU and both parties are interested in this trade to continue. However, one cannot help seeing the growing difficulties. Russia has not ratified - and it is unlikely to do so in the future - the Energy Charter. There is still no set of common rules of the game in the energy sector. Formulation of such rules is already facing considerable difficulties and, doubtless, will require a long time. Russia has also negatively reacted to the intention of the EU to diversify its sources of energy. Particularly painful for Russian political and business community are the plans to build an oil pipeline «Nabucco» bypassing Russia.

Adverse trends are also seen in other areas of commerce. Thus, the decrease of Russia's imports of equipment from the EU at the end of 2008 was due not only to the effects of the crisis. The Government of Russia is seeking to adopt policies that support their industries, including the reduction of imports and import substitution.

On this basis, we can assume that the crisis will lead to a reduction in trade between Russia and the EU.

Thirdly, the relations between Russia and the EU in the post-Soviet area have significantly gotten more complicated. After the enlargement in 2004 the EU has been striving to play an increasingly prominent role. This was evident during the «orange revolution» in Ukraine, «gas» conflicts in 2006 and 2009 between Russia and Ukraine and the armed conflict in the Caucasus in August 2008. In some cases, such as the Caucasian conflict, the EU acted as mediator. However, in general, Russia is critical of EU activities in this direction. The program «Eastern Partnership», proposed by the EU to Ukraine, Belarus, Moldova, Armenia, Georgia and Azerbaijan, is perceived even more negatively. Influential circles in Moscow, believe that this is an attempt to tear these states apart from a close cooperation with Russia. In fact, there emerges a large «zone of suspicion» between Russia and the EU, which could significantly complicate their relations in the future. Unfortunately, we can not exclude the spread of «zones of suspicion» to the North, if we fail to reach an acceptable agreement on the future of the Arctic.

Fourthly, there are still great challenges facing us regarding a new treaty to replace the 1994 Agreement. It is quite clear that its development and ratification will take several years.

If to summarize, it is possible to conclude that Russia-EU relations will be not easy in near future. Both sides are not interesting in large confrontation, but the number of various conflicts and mutual suspicion will increase.

Konstantin Khudoley

Professor and Dean

School of International Relations
St.Petersburg University

Russia

Energy cooperation within the Baltic Sea Region. A Kaliningrad perspective.

By Arne Grove

During the years 1996-‘98 the Baltic countries studied and discussed the plans for generation and distribution of energy for the Baltic Sea Region (BSR). One of the most remarkable studies was the “Baltic Ring Study” carried out within the framework of cooperation between leading energy utilities in the BSR. Kaliningrad was represented by the local energy company JantarEnergo, at that time a subsidiary of the RAO United Energy Systems. Within the cooperation a number of recommendations were developed.

Since 1998 the international cooperation within the BSR has changed. The Baltic States are now members of the EU. The energy prices increased in all countries. The importance of mitigating climate change has been recognized on the global scene and the need for dealing with energy efficiency on national, regional and local levels in all countries is now high on the agenda.

The key forum for international cooperation on energy issues within the BSR is BASREC, energy cooperation of the Council of the Baltic Sea States. In this cooperation the Russian Federation is represented by the Ministry of Energy of the Russian Federation. On the regional level there is direct bilateral cooperation on energy between Kaliningrad and Lithuania, Kaliningrad and Poland, Kaliningrad and Belarus.

In December 2006 the agreement on integration of Polish and Lithuanian energy systems in 2011 was signed in Vilnius. After the construction of the “energy bridge” between Poland and Lithuania is completed, the “Baltic Energy Ring” will connect Lithuania, Latvia, Estonia, Finland, Sweden and Poland. Therefore, the Baltic States announced their plans to separate their energy system from the Russian energy system and shift to parallel operation with the United Western European Energy System UCTE. *With the implementation of this project energy supply to the Kaliningrad region from the mainland of Russia will be impossible. This situation appears to be a challenge for Kaliningrad.*

In the Kaliningrad region the energy demand has substantially increased since 1998, when the “Baltic Ring Study” was prepared. The demand is foreseen to increase further due to economic growth in the region. The demand is increasing in both the housing and industrial sectors. There have been cases when the electricity supply could not meet the needs of industrial development.

Russian federal and regional energy companies are working together with the Kaliningrad government to develop solutions and plans for the development of energy-generation capacity as well as concept for energy saving.

As a result it was agreed to increase the supply of natural gas provided to Kaliningrad from Russia through the pipeline via Belarus and Lithuania and pipeline capacity itself. The capacity for production of electricity was increased significantly in 2005 with the establishment of a new gas-fuelled power plant with a capacity of 450 MW. Moreover, a new 450 MW block is being build to meet further demand. Later a heating main from the power plant to the district heating network of the City of Kaliningrad will be build to improve the energy efficiency of the plant.

The draft strategy and program for the development of energy-generation capacity in the Kaliningrad region until 2016 includes the mentioned second unit of the gas-fuelled power plant and a nuclear power plant (“Baltic Nuclear Power Plant”, 2 blocks each 1.150 MW), as well as a number of combined heat and power plants for cities in the region, which have already district heating networks (450 MW electric power). These plants should use local biofuels (peat and wood) as substitutes for coal. The program also includes plans for the development of capacity of small hydropower (17 MW) plants and wind-power (from 50 to 200 MW).

The level of development of the district heating network in municipal and housing sector in majority of cities of the region is relatively low, with the exception of the City of Kaliningrad. Boilers work on gas, coal and black oil. The heat losses in generation, transmission and end use of district heating are well known and significant. Lately, a significant increase in housing construction has taken place. Unfortunately, the construction standards for new buildings allow for high energy consumption, unlike in the Nordic countries. The capacity for energy management was increased in the region; *however, energy auditing is poorly developed as a management tool in several municipalities*. Besides, low fuel-prices, lack of technical and legal standards as well as financial resources constitute the main barrier for reducing energy loss within this sector. The capacity to develop bankable investment projects on improving energy efficiency using local and international financial schemes has not yet been developed in Kaliningrad, as well as in other regions of Russia. This also includes mechanisms under the Kyoto protocol.

The region is currently working on concept and plans for energy saving until 2020, which is coordinated with the mentioned general energy planning for the region.

The concept refers to the experiences from the first program for energy efficiency in the Kaliningrad region from 2001 to 2005 as well as to the order of the President of the Russian Federation “On measures to increase energy and environmental efficiency of the Russian economy, 04.06.2008” and decree of the Government of the Russian Federation “On defining the guidelines of the state policy in increasing energy efficiency by using alternative energy sources, 08.01.2009“.

To improve the program and energy management the Kaliningrad Regional government is taking active part in “Energy cooperation with NW Russia” program supported by the Nordic Council of Ministers’ (NCM) Knowledge Building and Networking Programme for NW Russia. The objective of the program is to facilitate and stimulate transfer of knowledge and development of cooperation between partners from NW Russia and the Nordic countries. As a part of the program, the Nordic Ministers for Cooperation have allocated 2 million DKK to the ‘Energy cooperation with NW Russia’ program, which is coordinated by the NCM Information Office in Kaliningrad. The cooperation includes study visits, seminars and development of a system for benchmarking energy efficiency for regions of NW Russia based on Nordic experiences. The developed tools can be used for analysis of energy efficiency in preparation of regional and local strategies and plans for energy efficiency.

Besides, the Kaliningrad Regional government in cooperation with BASREC, Baltic Development Forum and NCM is engaged in preparation of a conference in Kaliningrad: Energizing the region - Energy cooperation within the Baltic Sea Region, the objective of which is to discuss energy cooperation development within the BSR and consider its various scenarios.

Arne Grove

Nordic Council of Ministers,
Director of the NCM Information office in Kaliningrad

Honorary consul of Denmark in Kaliningrad

Effects of financial and economic instability in Russia

By Lúcio Vinhas de Souza

Background

The financial instability that started in the United States in the summer of 2007 was heightened by a series of developments in the summer of 2008. From a turbulence largely localised in the US, it became a truly global crisis, spreading also to emerging markets that had been initially insulated from the crisis. Russia was one of those emerging markets affected.

This worldwide volatility manifested itself first via a drying-up of international liquidity (which resulted in capital outflows from several emerging markets), and later, as global economic activity slowed, also via a significant fall in commodity prices. Those two elements combined resulted in a major external shock (to respectively its capital and current accounts) to which Russia is still in the process of adjusting.

This article describes in more detail the domestic effects in Russia of those shocks and the policy reactions to them.

Financial effects of external shocks

Arguably the most impressive effects from the external shock to the capital account part of Russian balance of payments are so far to be found in *stock markets*. Russia's main stock markets (the Rouble-denominated MICEX and the dollar-denominated RTS) fell by, respectively, 67% and 78% between the beginning of 2008 and February 2009. Nevertheless, their levels roughly stabilized since November 2008 and have, like other stock markets worldwide, experienced a *relative* recovery since March 2009 (for instance, the RTS grew by almost 30% since). As the trading in stock markets (and consequently the fall) was to a large degree dominated by foreign players, this pattern reflects foreign investors divesting from Russian markets as a reaction to the global credit squeeze.[1] However, concerning the spill-over from financial to real effects, it must be noted that stock markets have a relatively reduced importance in terms of the domestic financing of investment in Russia (during 2007 the issuing of shares financed less than 2% of its domestic fixed investment).

Another aspect of the effects of the global shocks to the Russian balance of payments is to be found in the *exchange rates*. They showed for a long time only relatively small changes, as the Central Bank of Russia (CBR) aim was to stabilize a nominal euro-dollar currency basket (set at 0.45 cents of the EUR and 0.55 cents of the USD). In November 2008, faced with the need to adjust to a terms of trade shock (the fall of oil prices, see below) – which was reflected in a significant reduction of the trade surplus (of 30% in yoy terms in November 2008), and to significant capital outflows (see below), the CBR policy changed towards greater flexibility. It introduced a policy of periodic Rouble "mini devaluations" against the basket, of around 1% per step, which gained speed as the year progressed: from once per week in November 2008, they reached *three* devaluations per week in December 2008, and *four* by mid-January 2009. The total number of devaluations since the new policy was introduced reached 18 by mid January 2009, resulting in a cumulative 25% fall of the Rouble (23% to the USD, 26% to the EUR). On 22 January 2009, the CBR announced another change, now to an apparent "dirty float" with a wide band (26 to 41 to the basket) within which it would let the Rouble float. However, between 22 January and 2 February, the Russian currency suffered an additional depreciation of almost 10%, approaching the lower limit of the band, where it has stabilised since. The total nominal devaluation of the Rouble is around a third since the fall of 2008.

Very significant *capital outflows* have also been observed: the CBR estimates show a *net* capital outflow during 2008 of USD 130 billion, while hard currency reserves fell by over USD 170 billion from their peak in 2008. Further reserves losses were observed in early 2009, leaving foreign currency reserves in early April at around the still rather comfortable level of USD 385 billion, which is in any case 35% lower than their mid-year peak.[2] Also, according to CBR figures, Russia still ended 2008 with both a significant trade surplus (at USD 177 billion) and also a current account surplus (of USD 99 billion), so its' external vulnerability should no be exaggerated at this stage.

Among the *direct* effects of the global credit squeeze, the Russian *banking system* has seen its capacity to extend credit reduced, and several banks have been downgraded by international rating agencies. In any case, the (net) reliance of the Russian banking system on foreign finance, at around 13% of assets at the latest available data, is *relatively* limited and concentrated in a sub-set of banks,[3] but has been growing very significantly, turning from a positive net position into a negative one by 2003 and increasing almost 4 fold since then (albeit the figures for the first half of 2008 indicate a reduction compared to 2007 end of year figures, showing already the effects of a more difficult and costly access to international finance). Additionally, also here one must keep in mind the relatively reduced importance of the Russian banking system to GDP and equally in terms of the financing of investment.

Real sector effects of the external shocks

Russia is a very important commodity exporter. Energy–related products are roughly responsible for around 60% of its' total merchandise exports. Russia is also an important exporter of products like steel, coal and wood. The direct GDP share of the commodity sector in Russia is above 20%. The budgetary importance of the energy sector is also very significant. The Russian budget –still with a significant surplus of 5.4% of GDP in 2007 and an estimated one of 4.2% in 2008– depends heavily on oil- and gas-related revenues. They are estimated to represent close to one third of total general government revenues, and more for the federal budget (close to half of the total).

[1] Non-residences were responsible for 75% of the value of the transactions performed at the largest Russian stock market (the MICEX) during September 2008. By December 2008, their share had fallen to 36%, indicating that those had removed a very significant share of their investment in Russian stock markets.

[2] Those figures include the amounts accumulated in Russia's two oil funds, the Stabilisation Fund and the National Welfare Fund (NWF), which together reached around USD 220 billion as of March 2009.

[3] Namely, they are largely concentrated in the *foreign banks in Russia –which are mostly EU ones*, who have a share of foreign liabilities which is twice as high as their share of assets (i.e., 40% as opposed to 20%). On the other hand, in *the* systemically important –and conservatively run– state-owned Sberbank, responsible for over a quarter of the assets of the whole Russian banking system, they are estimated to be as low as 2% of assets.

Falling commodity prices, especially oil, and their well-documented 75% fall since the summer of 2008, are therefore the most relevant real channels of transmission through which economic instability affects Russia. The retained profits of the commodity sector are a very important *direct* source for investment and for consumption growth in this country.

Hard data on economic activity started to show a truly major economic slowdown only from October 2008 onwards: the GDP growth rate fell from 9.5% in 4Q07 to a still respectable 6.2% in Q308, but other indicators like the "basic sectors"[4] and industrial production indexes *collapsed* between September 2008 and January/February 2009, from, respectively, +7% to *–11.6%* and +6 to *–13%* (albeit those indexes actually *increased* mom in February 2009). Preliminary estimates for the first quarter of 2009 indicate a growth rate of –7%: after a decade of robust growth, 2009 shall clearly be a recession year for Russia (as it will be for the global economy), the real question is how negative it will be.

Policy reactions

Russian policy makers have implemented an extensive set of policy measures. They relate to the provision of liquidity (domestic and external, short-term and long term), to direct support to the stock markets and the banking sector, fiscal support for the maintenance of the level of economic activity and flexibilisation of the exchange rate regime (described above). This policy set is rather similar to what was adopted in many other countries/regions. A rough estimation would indicate that the combined value of all these measures would add up to almost 14% of the Russian GDP, albeit many of those measures overlap and the large majority has a *quasi-fiscal* nature. Also, they are spread out through 2008-2010. In any case, Russia's still strong fiscal position, large hard currency reserves and low *sovereign* debt (external and domestic) likely make those fiscal efforts sustainable, and the severity and speed of the downturn justifies them as policy choices.

Conclusions

Russia has been very significantly affected by the global financial and economic instability. Arguably for that country, given its relative financial underdevelopment, the main channel of transmission is the real one, albeit the financial channel undoubtedly also has significant effects too. The real channel originates in the fall of commodity prices, which, beyond the terms of trade effects, has direct investment, consumption and budgetary consequences.

The policies used to counteract the downturn are very similar in Russia to the ones pursued in the mature economies of the EU or the US: measures to support and re-capitalize financial markets and institutions, enabling credit markets to continue to work, plus fiscal support packages for the wider economy. Additionally, Russia, a country with a more rigid exchange rate framework than the EU or the US (which pursue floating exchange rates), can also easily use a relatively more flexible exchange rate as part of its policy set. Finally, the fiscal space for budgetary support was significantly larger in Russia than in the EU or the US: Russia entered the downturn from a position of large fiscal surplus and reserves, and low domestic and external sovereign debts. The relative effectiveness of those measures is still hard to judge at this stage (as it is in the US or the EU itself).

Lúcio Vinhas de Souza

Official Responsible for Russia

Directorate General for Economic and Financial Affairs (DG-ECFIN)

European Commission

[4] As this index is calculated on the basis of real changes in the production volume of 1) agriculture, 2) mineral output, 3) processing manufacturing, 4) production and distribution of electrical power, gas and water, 4) construction, 5) transport and 6) retail and wholesale trade in Russia, it is considered to be a reliable GDP proxy.

Managing Business in today's crises environment in Russia vs 1998 – a view from the field

By Erik W Helin

In recent months we have all been privileged to read tons of analytical articles of current crises in Russia. Almost without an exception they end up with the same conclusion: it is all about oil and other commodities. With this given cash-flow model and with strong currency reserves, in which every ''dollar'' in M2 is backed by 1.15 US dollar, many economists agree there is no looming ''balance sheet'' recession in Russia.

Having said that, there, however, is a difficult period ahead at the micro level.

Many enterprises, their owners and employees are now for the first time facing the cruel side of the market economy; long period of growth, excessive overheating followed by a rapid drop and then, a lengthy downward cycle. The credit is in short supply or very expensive, and without credit, there will not be a growth in demand.

This will not only hit many individual enterprises, but it will drastically change the old industry structures, which has low productivity, high energy consumption or in some other way have internationally non-competitive technologies or locally non-competitive business models. As an example, this applies to machinery and engineering industries.

Today there are actually many modern production assets in Russia, which will wheather through the crises quite well by implementing cost savings and productivity measures. There, unfortunately, are not so many internationally competitive manufacturing assets. Russia has developed in past decade to be a good place to produce, but not to manufacture.

Under a positive note, very recently and as a surprise to many, the public debate has emerged between politicians, economists, business society and regional elite how to come out of the crises. Most voices are pulling to the direction that the crises will create an opportunity to push Russian industry structures a good leap forward and depart from its out-dated past.

It goes without saying that the process will be painful and will include many restructurings, consolidations, bankcruptcies. Most probably it will result more dispersed ownership structures, because the market is dictated by the equity and investors will follow more diversified and risk-avert policies.

To make comparison between the 1998 and today's situation is not so obvious. Ten years ago the whole market in any industry was small. The customers' number was very limited. The risks at that time were directed almost exclusively to the receivable risks of individual companies. To put it bluntly there was not so much data to analyze than today. The main focus was then to the political unstability in the country.

Now the focus is to the large exisiting market, how its structure will change, demand stimulation, market shares, business models, strategic alliances, how to attract credit, how to improve the usage of working capital, efficiency, M&A opportunities etc.

In 1998 the market was dead or at least in long standstill. Today the market is alive. It just quickly shrank, and will continue to shrink while going through the major reshaping evolution process. The growth figures will be negative or very moderate, but thanks to import substitution like in 1999, the internally driven demand will be large enough to ensure a viable business volumes for many enterprises.

As a general note of the forecasted business volumes in Russia this year, they are at the level of 2004/2005. For good resilient companies that is not a disaster.

As always, the crises will separate the weak ones from the strong ones. In comparison to 1998 there is now a lot more strong ones around. Surely, the quality of the management and local partners matters more than ever, because the market is volatile, risky and has a high dispersion. The strategic agility is a key requirement for today's enterprise management in Russia.

It is well recognized that the biggest issue in today's crises is its social impact in many Russia's regions. There are about 600 mono-cities, where is only one employer-factory. There are many regions, where most factories are old by any standards and will not be able to produce goods, which enjoy competitive demand. Some regions will be deindustrialized.

For businesses this probably means that we will witness the emerging new labour unions and strikes. We saw after 1998 crises when the young, educated or white collar employees were eager to move to growth centers. Now most probably the blue-collar labour force will be moving from poor regions to growth regions.

When evaluating the lay-offs and unemployment in general, it is important to note that there is and will be a prevailing shortage of skilled labour. There is a good number of skillful top and mid-level business managers, which received their education in 1990's and in 2000's, earned experience and track record in the growth years. But already since 1980's the attraction in job market and accordingly in education has not been to become a skilled worker. In recent years for enterprises in Russia it has not been 'headhunting', but 'handhunting'.

Another factor in the labour market is the drastically shrinking population. Every year 2.000.000 Russians die and 1/3 of them in working age. This very sad fact will diminish the possibility for many being unemployed for long term if the person is willing to relocate or learn new skills.

Russians being creative and resilient people, one could foresee also more small entrepreneurs emerging. In this sense Russians do not differ from many other nations: 11-12% of people are willing to take risks and become entrepreneurs. The crises could act as a stimulus to take the step.

In the respect of the whole business society the difference between 1998 and today is evident. To put it simply, it is developed, self-confident and educated business society, which recognizes and accepts the principles of the market economy. Many enterprises have extremely bright management teams, which are now free from old patterns and can implement the necessary changes to ensure further competitiveness. These teams will act as the locomotives for modernization in the next decade.

The younger ones can now be lead by an example and the people in their 30s and 40s do not want anything else than a longterm prosperity. They know what can be achieved by good education and hard work in the vast domestic market. This experience was not available in 1998.

The business society's new values have been re-formed during the past 10 years.

Erik W Helin

CEO
Specta / VolgaStrap Group
Russia

Member of the Executive Board
Association of European
Business, Moscow, Russia

Some institutional factors of securing Europe's supply of natural gas

By Miklos Losoncz

The natural gas supply of the European Union depends to a large extent on imports from and through countries whose institutional system is not fully compatible with that of the European Union. With the specific features of the world-wide distribution of proved natural gas reserves, this dependency is likely to grow in the long term highlighting the limits of geographical diversification in imports in qualitative terms from the point of view of the security of natural gas supply. Dependence on Russia, the major supplying country can be reduced-at least in principle-but there is no guarantee that the alternative source and transit countries would be more reliable and less risky in legal and institutional terms than Russia. Under these conditions the importance of qualitative factors-including institutional ones-of natural gas supply will increase not only in the EU's energy relations with Russia but with other third countries as well.

Although following the transition to market economy a rather sophisticated institutionalised system evolved in EU-Russia relations, this does not work too well in the energy sector. Regarding the legal framework of relations between the EU and Russia in the energy sector, three options are available, at least in principle. The first option is the extension of Community law to third countries, more specifically to Russia, the second one is the Energy Charter Treaty itself, the third one is the incorporation of certain principles and provisions of the Energy Charter Treaty in the new EU-Russia Partnerships and Co-operation Agreement. At present it is difficult if not impossible to predict the outcome of EU-Russia negotiations concerning new institutional solutions on natural gas.

Russia is unwilling to accomplish legal harmonisation on the basis of the acquis communautaire partly because the Russian institutional and regulatory system is incompatible with that of the EU, partly because of political reasons. As it is well-known, Russia had signed the ECT in 1994, but it failed to ratify it, although it has applied some of its provisions and it has been involved in the Energy Treaty process. Russia's major concern about the ECT relates to the EU's reluctance to apply the multilateral Transit Protocol within its own borders.

The existence of the appropriate legal framework alone does not guarantee the security of supply automatically. The adequate legal background is the necessary but not sufficient precondition of the security of supply. E. g., the Ukraine ratified the Energy Charter Treaty but in January 2006 and January 2008 it did not observe its obligations deriving from the Treaty since it did not ensure transit flows of natural gas. The two cases indicate that the Energy Charta Treaty does not contain efficient sanctions against countries breaching its provisions. In the capacity of a transit country of Russian natural gas, the Ukraine enjoys a monopoly position on which it can capitalise in the future as well. The latest offer of the EU to the debt-ridden Ukraine to be involved in the modernisation of its natural gas pipeline system could be a positive move towards more intensive co-operation. In addition,. more transparency is required in energy trade from the part of the Ukraine.

It is fragmented EU natural gas markets that have made possible the establishment and the subsequent development of bilateral relations. The potential of political leverage, too, is based on fragmented and segmented markets. Russia's foreign policy and external energy strategy have traditionally tried to divide EU member states. Gazprom negotiated with energy companies registered in the EU on bilateral basis and concluded with them long-term bilateral contracts in which the Russian firm fixed the terms of deliveries, prices and the principles of price formation. These contracts are advantageous for Russia since thereby it is potentially possible to apply monopoly prices. Russia's bargaining power vis-à-vis individual EU member states is much greater than that deployable in negotiations with the EU as a unit. In 2006 energy companies of the largest importing countries of Russian natural gas (Germany, Italy, France) renewed their long-term bilateral contracts with Gazprom until 2026-2036.

On the part of the European Union the depolitisation of EU-Russia relations in the natural gas sector seems to be reasonable strategy. The first, direct pillar of this strategy is focused on external economic policy. Proposals concerning discriminatory reciprocity clauses and ideas raising Russian concerns over political leverage will certainly inhibit progress in bilateral negotiations. The economic interests of Russia should be considered by the EU more than in the past, also by underlining the interdependence of the parties in the natural gas sector. Nevertheless, due to the fragmentation of its natural gas market, the EU cannot "speak with one voice" in natural gas matters.

The second, indirect pillar of a depoliticised strategy is constituted by the accomplishment of the single natural gas market in the EU by the interconnection of the individual markets of the member states aiming at the elimination of fragmentation and by the introduction of the third gas directive including unbundling, etc. The major limits of this strategy have nothing to do with external economic relations, they are associated with internal EU matters. With the emergence of a competitive natural gas market in the EU and the subsequent reduction of dependency on external supply both at the level of the EU and its most exposed member states, the possibilities of exerting political pressure by Russia are expected to diminish over time, whereas the conditions of the emergence of a coherent energy policy may be brought about at the same time. These issues are more or less independent form large scale projects like Nord Stream or Nabucco. Nevertheless, based on energy demand forecast, such projects will be essential to ensure the supply of natural gas in the EU.

Miklos Losoncz

Jean Monnet Professor at Széchenyi István University, Győr, Hungary

Research Director at GKI Economic Research Co., Budapest

The South-Eastern Baltic Region as a model for European integration and true partnership

By Alexey Ignatiev and Stephen Dewar

The present state of relations between Russia and the EU is poor. A number of issues are involved, amongst which the following are the most significant and/or topical. First, negotiations on a new agreement to replace the PCA were stalled for a lengthy period due to objections from various EU Member States over their bilateral disputes with Russia. The August 2008 conflict between Russia and Georgia set matters further back, while the New Year 2009 interruption to Russia's gas supplies to and through Ukraine, over disagreements on price and outstanding payments due to Russia, reawakened some EU Member States' concerns over Russia's reliability as a principal energy supplier. And so it goes on. Thus, despite the evident successes in achieving agreements in the simplification of visa procedures for certain categories of citizens and the establishment of road maps towards forming four common European spaces, further development of the relationship has basically stopped. The frustrating aspect of all this is that the necessity for more progress is accepted by both sides.

An additional complicating factor is the global economic and financial crisis. Most governments are understandably more preoccupied with getting their countries through these stormy times than treating the EU-Russia relationship as a priority.

Taking all this into account we believe that it is feasible to break the deadlock with a limited, but imaginative, set of concrete actions. It should be limited, since none of the parties has the will or, at present, the capacity to manage anything all-encompassing, but it should be imaginative as we must break out of the confines of current, tired, formulaic thinking. On this basis we propose that the two sides should consider the possibility of speeding up development of integration processes on some of their common border territories where there is a practical basis for the creation of key elements of the European common spaces.

We further propose that what we call the South-Eastern Baltic Region (SEBR), comprising Kaliningrad region and adjoining parts of the EU (three contiguous northern Polish *woiwodeships* and three western Lithuanian districts), should be selected for this role. Already there has been accumulated a great deal of experience of productive cross-border cooperation. This has produced well-established partner relationships and an atmosphere of confidence between regional/local authorities, non-profit organizations, businesses and local communities in all these areas.

As background context, it should be mentioned that in Russia's "Medium-term Strategy towards the EU" of 1999 the Kaliningrad region is defined as a pilot region for cooperation between Russia and the European Union. Later, in 2004, then-President Putin described its mission as setting a pattern for a new relationship between Russia and the European Union. Conversely, for a considerable period of time, the EU has recognized Kaliningrad's special significance by virtue of its geographic location – since enlargement in 2004, as a Russian exclave part-surrounded by EU Member States. Indeed, over the last few years the so-called Kaliningrad factor played a pioneer role in different spheres of Russian-European cooperation. This factor was especially important in concluding the essential approximation of Russia-EU information resources in customs, the agreements concerning visa-free travel (transit) of Russian citizens through the territory of the EU, while the mechanisms for organizing and financing of cross-border cooperation programs were fundamentally changed based on lessons learned involving Kaliningrad.

Furthermore, precisely for the purpose of common development and integration of the territory of the South-Eastern Baltic region, the two sides - Russia and the EU – have for the first time developed a joint program for neighborhood and partnership, based on true partner principles: a common vision of the shared future outcomes, co-financing and a common decision-making and implementation mechanism. This program with an unprecedented amount of financing (around €188 million) and duration of seven years is to start this year.

Thus, in the Southern-Eastern Baltic Region there already exist the necessary pre-conditions for making the SEBR a successful reality, requiring only the political will from both sides.

Here now are our specific proposals for achieving a common pilot project involving an accelerated creation of essential elements of the common European spaces in this area.

The practical focus of the project should be concentrated mainly on the creation of legal and regulatory conditions for lifting the man-made barriers to cross-border cooperation and the creation of common European spaces, in particular:

1. Common European Economic Space:
   - Development and implementation of the conditions for the creation of the elements of a *Russian-European free-trade zone*, in particular, tax-free goods movement based on a jointly determined list of eligible products/services (and taking into account the free economic zone regime operating in the Kaliningrad region);
   - creation of a common organizational and juridical system for *certification of origin for goods and services*;
   - *harmonization of quality standards*: dynamic extension of all-European quality standards for public and business management systems;
   - creation of conditions for the *free movement of labor* and more liberal regulations covering cross-border work-related migration.

2. Common European Space for Internal Security, Freedom, and Justice:
   - extension of the "*small border movement*" regime to the whole area of the South-Eastern Baltic Region, i.e. covering the three Polish *woiwodeships*, the three Lithuanian districts and the whole Kaliningrad region;
   - Russian citizens who are bona fide long-standing residents in the Kaliningrad region should have a right to obtain *free, multiple-entry Schengen visas* which would be valid only for the SEBR area. For example, on the territories of the EU countries which are members of the euroregions where the

Kaliningrad region is a member as well. Citizens of these EU countries should also be granted with *free, multiple-entry Russian visas* valid just for travel on the territory of Kaliningrad region;

- implementation of elements of a comprehensive approach to border management, in particular, the establishment of combined, joint border check points;
- liberalization of Russian legislation in terms of the *border zone regime and registration of foreign citizens* from the SEBR on the territory of Kaliningrad region;
- legalising the possibility of *sailing foreign vessels* (in the first stage only small-sized boats beneath a specified tonnage), including ones under third-country flags, through the inland waters of the Kaliningrad region including the Wisla Bay.

3. Common European Space for External Security:
   - creation of conditions for step-by-step demilitarization of all the SEBR territory, to transform it into a *nuclear-free and missile-free zone* of peace and stability.

4. Common European Space for Science, Education with Cultural Aspects:
   - creation of *common information space*;
   - creation of *European innovation park* (based on technoparks in Gdynya, Klaipeda and Kaliningrad universities) focused on developing new technologies in marine area.

There is a strong case for each of these initiatives which, if implemented, would have a highly positive influence on the quality of the relationship between Russia and the European Union.

The practical realization of the project could be implemented in a special sector agreement as an attachment to the new Strategic Partnership Agreement between Russia and the European Union. This sector agreement could also include other areas of potential Russian-European cross-border cooperation with the SEBR being the pilot region for trying them out, for the reasons stated above.

Alexey Ignatiev

Program and Development Director

Kaliningrad Regional Economic Development Agency

Russia

Stephen Dewar

Independent economic consultant

Ireland

What role for the EU in Finnish security policy?

By Hanna Ojanen

In the Cold War times, Finland's method of approaching Western integration was a slow and meticulous 'wait-and-see' policy. Finland participated in Western arrangements through complicated methods aimed at preserving the façade of uncontroversial economic policies. It often happened that Finland would refrain from joining an organisation as a full member in order to preserve a greater freedom of action. This was seen as useful for both the preservation of neutrality in the eyes of the Soviet Union and the furthering of specific economic interests. Finland became an almost-member, like through FINEFTA where a regular membership in EFTA was substituted for bilateral treaties with EFTA members, that were for all practical purposes equal in content to the actual EFTA treaty.

What also happened was that in time organisations which at their establishment seemed to have too political a profile became less controversial and Finland was able to join them later. For instance, with the establishment of the EEC and EFTA, the OECD was seen to concentrate on purely economic matters, which meant that Finland could join it, while it had not felt able to join the forerunner, the OEEC. Similarly, Finland joined EFTA in 1986, when it clearly no longer was at the forefront of economic integration in Europe and the talk was of EC-EFTA relations.

In the case of NATO this wait-and-see attitude still re-surfaces when it is argued that it would be suitable to wait and see where the organisation actually is going before drawing any definite conclusions as to whether Finnish membership would be beneficial or not. In the end, Finland might join NATO when the organisation no longer is politically controversial – that is, opposed by Russia – and when it no longer is in the forefront of security and defence integration. This would happen when the EU or regional arrangements have reached the same point or surpassed the NATO arrangements.

Are we there yet? At least there has been considerable progress in defence questions both within the EU and among the Nordic countries, so much so that Finland has become again wary of potentially too far-reaching commitments.

Until the common defence clause was inserted into the draft constitutional treaty in 2003, Finland was in the forefront of developing the EU as a security actor. With EU membership Finland had changed gear, becoming a proactive actor in integration. It also reversed its view on the EU's role in Finnish security. Previously security considerations had prevented Finland from joining; now they were seen as a reason for applying as membership would strengthen Finland's security vis-à-vis Russia and open up new security policy options for the country. Security was neither the only reason, nor the most important reason, for joining the Union. Yet, through this new approach, Finland was giving the EU a higher political security profile than arguably any other EU country – in fact, in 1995, the Common Security and Defence Policy did not even exist.

In 2003 however, the Finnish government tried for the first time openly to slow down the development of a common security and defence policy, proposing a watered-down version of the defence commitment. The end result was obviously a compromise; a defence clause that makes reference to the specific characteristics of the policies of certain member states.

The 2009 report of the Finnish Government on Security and Defence has a much less reserved stance on common defence. Still, the report expresses a certain willingness to take time in order to reflect on the practical implications that the EU defence clause might have for Finland.

The new government report on the EU, due in April, is expected to highlight the EU's centrality once again. The very fact that there is a government report on the EU – the first since joining – is a sign of change or of willingness to change in Finnish EU policies. It is expected that the white paper will suggest Finland is a pragmatic country in a pragmatic Union, situated in the mainstream that favours (or, is thought to favour!) deepening integration and a strong, independent Commission, and that will work with flexible coalitions of countries – including potential new ones if Iceland and Norway were to seek membership.

Yet it might be that the EU is not regaining the central role it had for Finnish security policy in the 1990s. There is now more disarray on how best to prioritise and link the bilateral, regional and multilateral arrangements. Now that the EU really starts being a serious security policy actor, it appears challenged by new alternatives. Firstly, an innovative regional setting where the trust between the participants is high and allows for deeper cooperation and specialisation, and secondly, by the slow "banalisation" of NATO that would make joining it a matter of no more political controversy than joining EFTA in late 1980s.

Interestingly enough it is now the Nordic neighbourhood that offers the hitherto most compelling version of a defence clause. The Stoltenberg Report proposes for the Nordic countries a mutually binding declaration containing a security policy guarantee in where the countries could clarify in binding terms how they would respond if a Nordic country were subject to external attack or undue pressure.

Moreover, the latter half of 2009 under the Swedish EU presidency may give ideas on whether the regional initiatives – be they defence-related like in the Stoltenberg report, or environment-related as in the Baltic Sea Strategy, are there to strengthen the EU and anchor it firmly to Northern concerns – as in the late 1990s – or whether these are signs of a trend of regionalisation setting in, with the gradual weakening of the role of the EU as such in regional, and Finnish, security policy.

Dr Hanna Ojanen

Programme Director

Finnish Institute of International Affairs

Finland

The impact of international financial crisis on capital migration into Latvia

By Erika Sumilo and Madara Apsalone

Since regaining independence in early 1990s Latvia as a small, open economy, has always been dependent on the foreign capital. Rapid economic growth, especially in the last years with GDP increase over 10%, membership in the European Union, liberal investment policies and quite favorable business environment made Latvia attractive to foreign investors. At the same time, extremely fast growth, based on loans, construction, financial intermediation and real estate boom, not balanced by a sustainable development, as well as huge inflation in prices and wages and increasing current account deficit already indicated a sharp economic downturn. Combined with the global financial and economic crisis, currency peg and sharp economic downturn in entire Eastern Europe those factors resulted in the largest crisis since independence, fast falling international credit ratings and, naturally, high foreign capital outflows.

Forecasting an economic downturn after several years of rapid, credit-fuelled growth, Latvia's international credit ratings were placed on negative outlook already in the end of 2007. During November 2008 the international credit rating agency Capital Intelligence downgraded Latvia's long-term foreign currency rating to 'BBB-' from 'BBB+' and its long-term local currency rating to 'BBB' from 'A-'. In February 2009, following agreement of a 7.5 billion-euro loan from the International Monetary Fund and wide debates about the political stability in Latvia, Standard & Poor's further lowered Latvia's credit rankings to BB+. Falling from investment grade to speculative grade is most likely to affect Latvia's ability to attract foreign investors, as, especially in times of the global financial uncertainty, when investors redeem cash and try to reduce exposure to such small and risky economies.

Negative outlook in credit ratings and already foreseeable problems in the economy limited the amount of incoming foreign direct investments in Latvia. Investment stocks did not change, however, and in the end of 2008 remained at the level of previous year (figures 1,2).

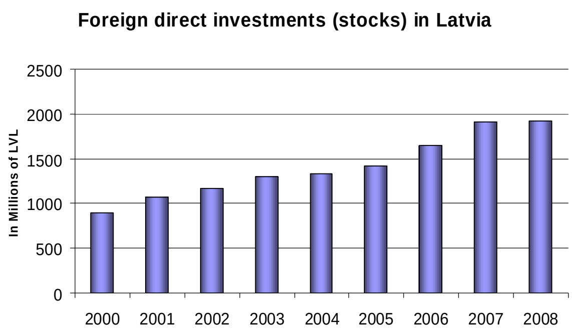


Figure 1 – foreign direct investments (stocks) in Latvia
Source: the Bank of Latvia

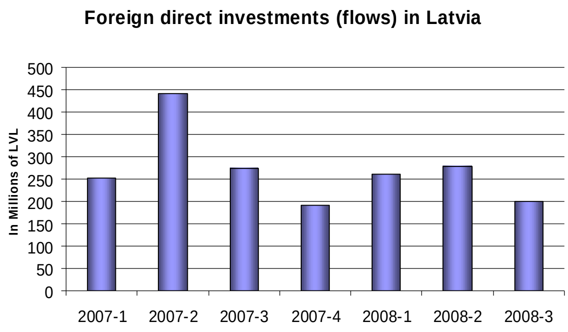


Figure 2 – foreign direct investments (net flows) in Latvia
Source: the Bank of Latvia

Incoming foreign direct investments in Latvia were also supposed to diminish, taking into account that half of investments used to go to financial intermediation and real estate sectors (Figure 3, data corresponding to the third quarter of 2008). Three main foreign investor countries – Estonia, Sweden and Denmark, had concentrated over 40% (over 60% in case of Estonia) of their investment in the sector of financial intermediation, other top investors, among them, Germany, USA and the Netherlands were focusing on the real estate.

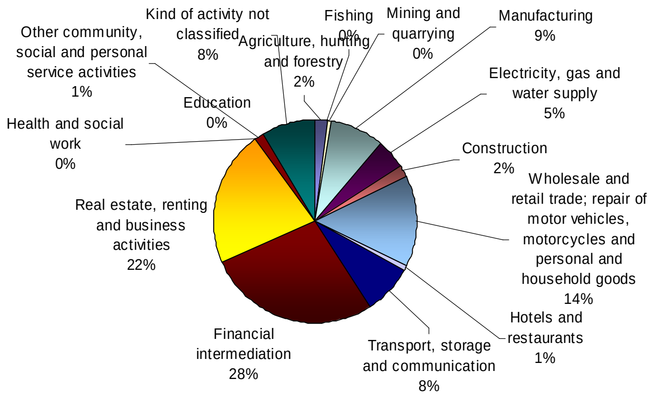


Figure 3 – Foreign direct investment in Latvia (stocks) by kind of activity
Source: the Bank of Latvia

Latvia's ability further to attract foreign investment is therefore affected not only by its credit rating and political stability – currently there is a need for a new strategy, how to attract Latvia's main investors to other fields, how to find competitive advantages that would motivate them to refocus and stay.

Looking at the side of indirect investments and capital flows, most of capital inflows came from banks' long-term and short-term borrowings, as well as a decline in banks' loans and deposits abroad. Most of capital outflows were caused by a decline in non-resident deposits with Latvian banks (10.4% of GDP in the third quarter of 2008).

Figure 4 demonstrates sharp increase in foreign currency capital outflows from Latvia during December of 2008 and January of 2009.

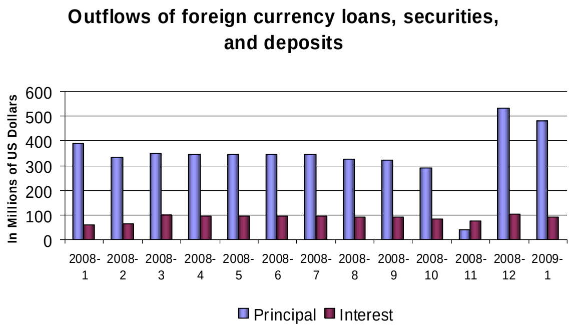


Figure 4 – outflows of foreign currency loans, securities, and deposits
Source: the Bank of Latvia

Latvia's investment market was further challenged, when Parex Bank - the second largest bank by total assets was found heading towards insolvency. The Latvian Financial and Capital Market Commission reported 240 million lat capital outflows from the bank, large share of non-resident capital among it. Parex Bank was nationalized, but rapid capital outflows continued and the government introduced deposit withdrawal restrictions. Consequently non-resident deposits had in general diminished by 19.2 % compared to the end of last year in December of 2008 in Latvia.

Last but not least foreign investors had been affected, either positively though, by the fixed exchange rate of Latvia and the national currency peg. Latvia maintains a fixed exchange rate policy since 1994 and since 2005 the national currency lats is pegged to euro, one euro equaling 0.7028 lats. During the last half year many Eastern European currencies significantly lost their weight: Polish zloty by 28%, Hungarian forint by 20%, Rumanian lei by 17% and Czech koruna by 12%, Latvian lats lost only 1.2%. This has significantly affected Latvia's export ability and currency support has sent Latvia's central bank reserves down 25% last year, currency peg is, in the meantime, in interests of foreign investors in Latvia.

The main issue concerning the currency peg is for how long the Bank of Latvia will be able to maintain the exchange rate. Positions of all three Baltic States have not changed and they are strongly for keeping the peg. There is an economic rationale, as Latvia is not a net exporter, therefore the price increase for import would be much greater than the gains from export, and as most of the resident credits have been taken in euro. But there are also non-economic reasons to be taken in account, such as the stability of national currency giving credibility to government and trust to financial stability at the national level. Peg is supported by the International Monetary Fund, Baltic States have also expressed their will to join the eurozone in the near future. However, investment environment in Latvia stays very uncertain meanwhile.

What are perspectives of Latvia's economic development in future? Which will be the most supported industries? To what extent will the European Union be willing to risk lowering Maastricht criteria for joining euro against taking the risk of Latvia destabilizing the whole East Europe region? How politically strong and united will the country be to overcome the recession and to what extent International Monetary Fund will be also to suggest the most appropriate policies… those are factors that are the most likely to determine Latvia's attractiveness to foreign investors and prevent it from even further capita outflows.

Erika Sumilo

Professor

University of Latvia

Madara Apsalone

Researcher

University of Latvia

From periphery to world politics – the changing geo-politics of the North

By Lassi Heininen

The circumpolar North has been described on a spectrum ranging, from a colonial external point of view and a periphery to an internal image of a homeland of peoples with their identities. In classical geopolitics the North was seen as a reserve of natural resources and a military space for patrolling, training and testing for the sovereignty and economic interests of the arctic states. The industrialized, militarized and divided circumpolar North of the Cold War, however, started to thaw in late of 1980s as a result of increased interrelations between peoples, civil societies and non-state actors. This more human approach of geopolitics in the 1990s meant, on one hand, decreased military tension and increased stability, and, on the other, a raise of wide and deepening international cooperation by the arctic states and those new international actors.

This transformation from the confrontation of the Cold War period into a wide international cooperation can be described to be the endeavour of the post Cold War world society through the sets of interrelated processes of "civilianization", "regionalization" and "mobilization". Correspondingly, as a result of this first significant change in circumpolar geopolitics and international relations the main themes of circumpolar geopolitics and international relations in the early 21st century according to the Arctic Human Development Report (2004) are the increasing circumpolar cooperation by indigenous peoples' organizations and sub-national governments, region-building with states as major actors, and a new kind of relationship between the circumpolar North and the outside world. Further, security in the North is currently implemented by certain special features, such as nuclear safety, the close relationship between the environment and the military, and climate change.

Indeed, Northern-most regions are not isolated, but closely integrated into the world of globalization and geo-economics, and a part of the international community. However, in spite of these points of view, and the discourse on the Arctic as a distinctive region the cold reality is that the circumpolar North is neither a political entity with political unity and economic power nor an international distinctive region. It is a geographical region with a small population, lack of capital and no power centres in a traditional sense, but borders and societies, even nations, divided between eight unified states.

In the international system with armed conflicts and wars, and a state of certain structural inequity, there is a limited space for positive points of view coming from actors, who like Northern populations, are neither states nor intergovernmental actors. However, as a stable, peaceful, advanced and innovative region, the circumpolar North has, or has interpreted to have, some positive developments within the Northern Hemisphere as well as in world politics. Among them are first, it is a highly strategic area due to on one hand, military-political reasons like it is an important bastion area for strategic nuclear submarines, and on the other, its rich energy resources, which emphasizes the importance of energy security. Second, the North has been used as a scientific 'laboratory' and is currently seen as a parameter of climate change and a 'workshop' for multidisciplinary research on climate, nature and societal developments as well on new technologies for clean- up of nuclear waste. Third, the circumpolar North is a distinct component of the diversity of a nature on the Earth on one hand, and on the other, that of northern cultures is remarkable.

Fourth and final, within the region, a number of innovative political and legal arrangements have been developed, which is due to traditional knowledge, (potential) innovations and new ideas, certain devolution of power as well as, flexibility and resilience of Northern communities. As a precondition for this, the region as a whole, and particularly the Nordic Region, hold potential to become an example area of non-violent methods of governance.

Neither international relations nor geopolitics, however, remain unaltered, and consequently, the geo-strategic importance of the region is growing, with significant geopolitical, socio-economic and environmental changes occurring in the North with regard to certain factors, such as strategic energy resources and new global transportation routes. Further, there is a growing world wide, even global, economic and political interest toward the Arctic Ocean and the high North of the globe, particularly toward potential rich and strategic resources, much in the shelves of the northern seas, and visions of new global trans-arctic sea routes. Consequently, trans-national corporations (TNCs) have strong commercial interests to become present for to utilize energy resources, though in the North state-owned, national oil and gas companies, such the Norwegian and Russian ones, control most of the reserves.

Final, there is climate change with its multi-functional impacts as a new and significant factor *per se* to change northern geopolitics by bringing bigger risks to the environment and human security, new threats to local autonomy and sovereignty as well as uncertainty into the societies, politics and governance of the region.

As a conclusion, in the manifold growth in its geo-strategic importance, which the circumpolar North has recently witnessed we can find on one hand, continuity of how in the North "space" has been utilized and treated as "non-political" in geopolitics. Unlike, an alternative interpretation of geopolitics emphasizes indigenous peoples as international actors as well the importance of their identities. Final, this kind of critical geopolitical approach means "politicization" of space, which can be seen for example, in external and internal images on the North, and how knowledge and power are used when defining impacts of climate change, such as uncertainty in the North.

Lassi Heininen

Doctor

University of Lapland

Finland

Russian gas supply and common energy policy

By Chloé Le Coq

The January 2009 conflict between Russia and Ukraine was only the latest of Russia's recent and recurring conflicts with its satellite countries over gas dealings. The effects of these disputes reach beyond Russia and Ukraine to European countries that rely on Russian gas transiting the satellite countries for their own gas consumption. A number of these countries are European Union (EU) member states or are on a path toward EU membership. For many in the EU, such conflicts amount to a serious threat of supply disruption and a lack of security of energy supply in the region, with implications for the debate over a common EU energy policy and, in particular, the inclusion of a solidarity rule.

The solidarity rule would mean that EU members would ensure mutual protection against supply disruptions by promising to redistribute energy from non-affected members to affected ones. But is such a rule feasible, given the diverging interests among the member states? This article takes a closer look at this issue.

The unequal effects of Russian gas disruption on EU member countries

Russia provides a quarter of the EU's gas supply. Any disruption in the supply of Russian gas will affect many countries across central Europe, but the effects among countries will vary depending on locations and energy consumption profiles. In general, there are many factors that can influence a country's risk of, and sensitivity to, gas supply disruptions. Le Coq and Paltseva (2008) construct a general index of EU countries' short-term gas risk exposures, the REES index (Risk External Energy Supply index). It combines measures of energy import diversification, political risk in the supplying country, risk associated with energy transit, market liquidity, and the economic impact of a supply disruption for gas. Note that the REES index includes reliance on Russia and on other non-EU suppliers, such as Algeria.

The figure below gives the estimates for the Russian gas supply of each EU member state, which clearly show the differing risk exposures of member states. The exposure to Russian gas is the REES index when only taking account Russia as a gas supplier.

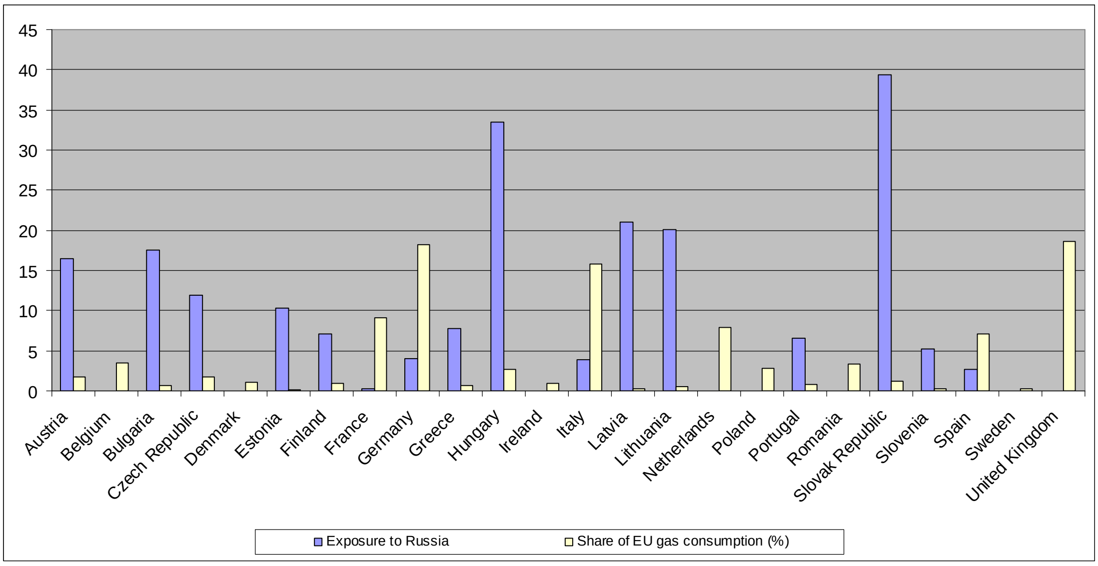
To understand the total EU exposure to Russian gas, such estimates should be compared with the relative gas consumption of each country in the EU. For example, Bulgaria has a relatively high exposure due to its exclusively Russian gas supply. But Bulgaria consumes only 1% of the total EU gas consumption. So, on the EU level, Bulgaria's contribution to European energy risk exposure is relatively low. On the other hand, Germany and Italy have an average exposure but are big gas consumers and therefore are among the largest contributors to the EU risk energy exposure.

In the event of a disruption in the supply of Russian gas, some EU countries might be severely affected, others only partially so, and some not at all. Some could take on the role of alternative gas providers. Because the estimates show the differences in countries' risk of gas supply disruptions, they also reveal the varying motivations among EU members with respect to the solidarity rule.

Consequences for a common European energy policy

A solidarity rule realistically could be part of a common European energy policy, at least in the sense of some EU members complementing each other in terms of supply disruption's risk. If the EU adopts a common policy, member states would share the overall EU energy supply risks. To deal with gas supply disruptions like those of recent years, a solidarity rule would have unaffected member states provide gas to affected ones, by i) using their own sources or ii) using reserves.

There are potential problems at the implementation stage, however. First: with a solidarity rule in place, one group of EU member states would be providers of inter-EU compensatory gas transfers, and another group would be transfer recipients. In the short run, member states would not be able to make big changes in their individual contributions to EU-wide exposure to energy risk. Their individual preferences, therefore, regarding a common energy policy are likely to differ, possibly causing policy tensions. A common energy policy including a solidarity rule, then, should include also a way to compensate the energy donors.



Source: Eurostat and Le Coq &Paltseva, 2008, Measuring the Security of External Supply in the European Union.

Second, a moral hazard problem could arise. The solidarity rule would constitute a mutual insurance system, with member states effectively sharing the costs of a gas supply disruption. This system may make them care less about the disruption in the first place, and could actually lead them to increase (risky) gas consumption. To avoid this problem, a common EU energy policy will need the backing of a strong regulatory agency that takes into account the needs and preferences of individual countries while addressing the EU-wide consumption and energy risks.

See Le Coq and Paltseva (2008) 'Common Energy Policy in the EU: The Moral Hazard of the Security of External Supply , for more discussion of these points.

Chloé Le Coq

Assistant professor

Stockholm Institute of Transition Economics

Stockholm School of Economics

(www.hhs.se/site)

This article is based on an on-going project with Elena Paltseva (University of Copenhagen). I am grateful for our discussions on this topic.

Growing volumes of containers and other unitised cargo go hand-in-hand with the concentration of maritime transport in major ports

By Johanna Särkijärvi

Volumes of unitised cargo are increasing in maritime transport in the Baltic Sea, while volumes of bulk cargo are stagnating or even diminishing. Simply put, this means that a growing share of cargo is transported in containers, trucks and trailers. This development has lasted for some time now and it is expected that the unitisation trend will continue in the future. Growing volumes of unitised cargo reinforce the position of major ports, since they have the lion's share of the unitised cargo markets. These arguments are mainly based on the annual statistics compiled for the Baltic Port List 2007 and 2006 and the results obtained in the Baltic Port Barometer 2008. It should be noted that for the time being there is no unified data available on the recent development of international cargo volumes covering whole of the Baltic Sea. Therefore, the effect of current economic downturn cannot be fully evaluated yet.

International cargo traffic can be divided into three groups: dry bulk, liquid bulk and other dry cargo. The majority of other dry cargo is unitised, being transported either in containers or trucks, trailers (ro-ro) or train wagons. In the Baltic Sea ports, other dry cargo was the fastest growing cargo type handled in 2007. Its annual growth reached almost 10% while the handling of liquid bulk decreased by nearly 1% and that of dry bulk by nearly 4%. The fastest growth in other dry cargo occurred in the biggest ports, defined as those which handle over 10 million tonnes of cargo per year. The average annual growth among these ports reached 16% in 2007. Middle-sized ports, handling 5-10 million tonnes of cargo per year, managed to increase their throughput of other dry cargo clearly less, by 6%. The top 5 ports in the other dry cargo segment handled one third of the total of other dry cargo volumes in the Baltic Sea in 2007.

Containers, trucks and trailers form a significant part of other dry cargo. To a large extent, the container market forms a market for the major ports in the Baltic Sea. The biggest ports, measured by total cargo volume (over 10 M tonnes), had a market share of over 81 per cent in international container traffic. They were the fastest growing group among the Baltic Sea ports, with an annual increase of nearly 17 per cent. Middle-sized ports (5–10 M tonne size class) achieved almost the same growth, at over 15 per cent. Smaller ports, in the 0-2 and 2-5 million tonne size classes, also managed to increase their international container traffic, although more slowly, by over 5 per cent and 4 per cent.

In total, more or less 60 ports handled containers in the Baltic Sea in 2007 but the top 20 ports had a share of 93% of the market and the top 5, namely Saint Petersburg, Gothenburg, Gdynia, Kotka and Aarhus, a share of 57%. Altogether, 7.4 million TEU of containers in terms of international traffic were handled in the Baltic Sea ports in 2007. This was over 15 per cent more than in 2006. The top 5 ports managed to increase their market share by 0.8 percentage points between 2006 and 2007. Of the top 5 ports, Gothenburg grew most slowly, by 3.6%, and Gdynia most rapidly, by 34.3%.

Saint Petersburg was undisputedly the biggest container port in the Baltic Sea, with a total volume of 1.7 million TEU in 2007 and 2.0 million TEU in 2008. In 2007, the top three ports remained the same as in 2006, including Gothenburg and Gdynia alongside Saint Petersburg. During 2007, international container traffic in the Baltic Sea increased most in Saint Petersburg (+247 762 TEU), Gdynia (+158 393 TEU) and Kotka (+110 641 TEU), the greatest fall taking place in Riga (-22 308 TEU), Västerås (-9 189 TEU) and Lübeck (-5 656 TEU). The ports in the top 20 list otherwise remained the same, although in a slightly different order, as in 2006, but Szczecin took Pori's place as the twentieth largest container port.

Alongside containers, trucks and trailers make up a significant part of other dry cargo in terms of international traffic in the Baltic Sea. The overall market for trucks and trailers is more difficult to evaluate than the container market since, in terms of compiling statistics on ro-ro traffic, there are varying practices in the Baltic Sea countries. Nonetheless, it is possible to obtain a good overview of market development if Russian maritime transport is excluded from the analysis.

A total of 7.9 million trucks and trailers in international traffic passed through over 50 Baltic Sea ports in 2007, excluding the ports of Russia. An annual increase of over 10 per cent was recorded. The port of Lübeck/Travemünde maintained its position as the leading port in this traffic segment with an 11 per cent share, followed by Trelleborg and Gothenburg, as in 2006. During 2007, the handling of trucks and trailers grew, in absolute terms, most in Gothenburg (+157 753 units), Trelleborg (at least +133 000 units) and Helsinki (+115 481 units), and fell most in Hanko (-72 555 units), Ystad (-50 795 units) and Uusikaupunki (-15 462 units). The top 20 list was practically the same as in 2006. Over half of all trucks and trailers in terms of international traffic were handled in the seven biggest ports in 2007. The top 20 ports held a majority of the markets with a share of 89%.

The concentration of unitised cargo markets in the Baltic Sea is quite apparent when examining the port statistics from the years 2006 and 2007. The fact that these markets are also the fastest growing in maritime transport implies that the role of major ports is becoming even more important. Many ports in the Baltic Sea expect that some ports will develop into major hub ports in the Baltic Sea region during the next 5–10 years. It remains to be seen whether the current economic downturn will heighten or undermine this development towards more concentrated markets among the Baltic Sea ports.

Johanna Särkijärvi

Project Manager

Centre for Maritime Studies
University of Turku

Finland

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

Specific features of inbound cross-border deals on the Russian M&A mid-market

By Sergey Volchenkov

Recent years have been marked by an increasing number of inbound cross-border deals on the Russian M&A mid-market, which testifies to its improved quality, since cross-border deals are normally conducted under international law and exclude shadow instruments.

Despite the growing number of acquisitions of the Russian companies by the foreign investors, several problems impacting such deals remain in place. This raises the question of key obstacles that foreign investors need to be aware of when they make such deals in Russia. We refer to the so-called "country risk" which remains one of the most significant threats to a foreign investor today. One of the most efficient ways for a foreign investor to minimise this risks is to cooperate with a local investment bank possessing sufficient knowledge and experience in advisory of cross-border M&A deals. Experts at such banks are familiar both with the Russian challenges and the requirements of foreign companies.

The author of this article dwells on basic aspects shaping any specific features of cross-border M&A.

The process of acquiring a company may be broken down into the following main stages, each of which presents specific challenges to a foreign buyer:

- Preparation (acquisition criteria, list of targets);
- Deal implementation (conducting negotiations, analysis of target, LOI, confirmation DD)
- Closing (signing of SPA and SHA, control over observance of precedent conditions for closing);
- Integration (the shaping of the seller's business into a structure corresponding to the buyer's parameters and strategy).

The key challenge for a foreign investor at the preparation stage is forming a correct understanding of the general market trends of the particular industry in Russia, its regional specifics. This challenge is of particular importance to strategic investors. According to Mr Vladimir Gorelov, a partner in the Avanko Capital, "in the present economic environment it is the strategic investors who will show most activity among western players, since present conditions put them in the best position to enter the Russian market or strengthen their hold over it". This is why one of the primary tasks at the initial stage is to conduct a strategic analysis of a respective economy branch.

At the deal implementation stage a foreign company may encounter the following obstacles:

1. Non-transparent accounting and various tax optimisation schemes. This problem is a major one which a foreign investor will encounter in 90% of instances. A vast number of tax optimisation schemes are practiced in Russia. Among the most commonly used schemes are "concealed" dividends paid to owners under the guise of "additional bonuses" or "payments for services rendered".

   In order to meet this challenge it is necessary to normalise financial accounting when conducting an appraisal of the company's value. A sure indicator of a company employing tax optimisation schemes is its very low profitability on the growing market.

   If an acquired holding company has a complex structure (when one company runs several ventures in different areas under a single legal entity) it may have to undergo restructuring at the stage of deal preparation. When restructuring a company it is usually advisable to set up assets in each business area as separate legal entities.
2. Owners of a selling company may not wish to supply full documentation needed to appraise the company at the initial stage of deal negotiations. Additional official inquiries may therefore have to be sent to fiscal and other public authorities in order to obtain the company's official financial statements, titles to real estate properties, etc. Russian legislation allows state authorities to provide this kind of "insider information" on companies. Employing these methods will enable a deal initiator to assess possible risks associated with the acquired company at the initial stage of negotiations. It is also fairly useful to analyse reputation of the company in question and/or its owner. This service is provided by several Russian consulting firms.
3. In most cases owners hold top-management positions in the acquiring companies. In this case the buyer may face the problem of losing control over the acquired business (when major clients linked to previous owners are lost, state authorities show prejudice to new owners, etc.). Possible solutions to this kind of problem should be built in at the stage of structuring the deal. One possible solution is using "earn-out" scheme whereby part of the deal's overall price is paid over 2-3 years based on the company's performance after its acquisition. This solution may be employed only as long as the current owner retains minority shares after the acquisition. Entering into long-term contracts with current managers may provide additional assurance of the company's future performance.
4. In order to gain full control over a company one as a rule needs to acquire over 75% of voting shares or stocks in it. It is Russia's reality that any significant decision on the company's activity may be taken only by ¾ of votes at the general meeting of share holders. In order to gain operational control one needs to secure over 50% of voting stocks or shares.
5. The problem of excessive political involvement may arise when a deal affects interests of various officials linked to the acquired company. This specific problem is as a rule inherent in deals involving acquisition of large regional players with strong influence on the region's or the city's economy. This feature should be by all means taken into consideration when a deal and its future structure is negotiated. Risks of this order may be minimised if the acquiring party makes an effort to meet regional authorities, makes available its plans for developing the company in question, creating new jobs, etc. These activities should commence only once it becomes clear that the deal can in fact be made.

At the closing stage a contract should be structured in such a way as to ensure current owners' responsibilities for the past periods of activity of the acquired firm. Unfortunately, deals involving payment and transfer of title through off-shore countries are still widely practiced in Russia. This is motivated both by the desire to lower tax burden for the seller and by the possibility to apply foreign laws in order to ensure that seller's guarantees are met, to secure transparency, expediency and simplicity of payments.

In closing it should be noted that each cross-border deal is unique. This makes problems and relations between the buyer and the seller unique for each specific deal. Challenges outlined in this article are in fact the most common problems experienced by western parties acquiring Russian companies which this article's author has encountered in practice.

Sergey Volchenkov

PhD of Economics

Associate, Avanko Capital

St. Petersburg, Russia

System crisis of the Latvian society – the reasons, scenarios of development, possibility of overcoming

By Alexander Gaponenko and Michael Rodin

Introduction. The Latvian society was amazed with sharp political, economic and social crisis. This crisis has obviously expressed system character. The present Latvian authority shows obvious inability adequately to answer difficult calls of the present. In many respects, it is connected with bad understanding of the basic tendencies of historical development and absence of vision of the future. In practical activities the power follows more likely not to pragmatical principles but to national mythology and the ideas introduced from the outside. The main thing now - to refuse protection of narrow national, class, group interests and in every way not to admit immersing of the Latvian society in chaos, to prevent its disappearance from historical arena. Let's consider change of own labor, scientific and technical, capital and administrative resources of Latvia which provide economic development.

Shrinkage of labor force. The population of Latvia all time from the date of independence gaining was promptly reduced, due to the high death rate and low birth rate, and big wave of migration. For the period between 1989 and 2008, Latvia's population reduced by 14.5%, not considering 5% of Latvians who are permanently (often illegally) employed in other European countries. More significantly, the percentage of working population shrunk for the same period by 21.5%, despite the artificial increase of the supply of labor force by means of increase of pension age for both men and women. During the 20-year period, the amount of unemployment has never declined below 7%. The qualitative level of labor force has not improved in the same period. School education was prolonged from 10 to 12 years, but higher education was simultaneously reduced from 5 to 3 years. The range of professional skills, taught in Latvian high schools, did not correspond to the requirements of economy. That was an additional reason for the flight of educated labor force.

Extinction of science. The whole succession of Latvian governments has not displayed any interest in scientific research. Former Soviet research institutions lost their qualified cadres, but a new inflow of specialists did not and could not happen, as financial support of science has been miserable, not exceeding 0.25% of the budget expenses (in the EU, expenses for science amount to 3%, and in the United States 6% of the GDP). Between 1991 and 2008, the number of Latvians, employed in science, shrunk from 31,000 to 4,000. Not a single invention was registered in this period (9).Latvian private companies, with the number of personnel exceeding 250 only in 252 cases (the average number comprising 6.6 persons), cannot afford support of science as well. EU expenses, earmarked for Latvia in the framework of structural funds, have dissolved in the bureaucratic machine of distribution.

Depletion of industry. In early 1990s, the governments of Latvia closed all the large-scale industrial enterprises, including such highly competitive scientific-productive associations as VEF (the once famous camera producer), RAF, and Alpha. Major agro-industrial enterprises were exterminated as well, their lands and technique being distributed among small private farms. In the country traditional branches have practically disappeared: fishery, sugar and textiles manufacture, processing of a skin and shoe manufacture, electronics. The government policy did not support formation of the large enterprises. In Latvia in 2007 from almost 130 thousand managing subjects, 398 enterprises had occupied only of 250 persons. Average number occupied at one enterprise in 2007 made less than 7 persons. The micro enterprises cannot provide independent accumulation of means and dynamical development. New capital investments in industry have been since insufficient. In 1989 (in Soviet time) capital investments accounted for 24% of the GDP, in 2007, the most successful year for Latvia, they contracted to 19% GDP from which 8% was the share of foreign investments. So, Latvian economy could generate national investments at the level of not more than 11% of GDP (i.e. less than a half of the level of investments in the late Soviet period). Investments were made only in the sectors with rapid return of capital but with a small or zero potential of productive output – particularly, in the infrastructure of logistics, retail trade, and hotel business. In fact, Latvia has been deliberately shaped as an economy of services. Between 1991 and 2007, the share of productive enterprises in GDP reduced from 60 to 25%, while services expanded from 32 to 75%. Thus, the chosen model of national development did not guarantee even simple reproduction of scientific, technological and labor resources. Meanwhile, investment policy was concentrated on attraction of foreign capitals. In 1990, Soviet Latvia's GDP comprised 6.771 billion lats in comparable 2000 prices. This level was overcome only a year after the country's entry in the European Union, due to massive foreign investments, donations and loans. By 2008, the amount of GDP rose to 8.717 billion. However, this figure was achieved by 50% for expense of the real estate market, construction, and commercial intermediation. Not surprisingly, difficulties of borrowing resulted in a 5% decline of GDP within month. In whole, in Latvia there was an irrational structure of economy which cannot provide dynamic and balanced development.

Administrative resources. Administrative forces of the liquidated state enterprises moved to a private sector and provided its rather successful development. The most part of these forces has got the higher administrative, economic or the juridical education has saved up an operational experience in modern, high-concurrence environment. However number occupied with business was in Latvia nevertheless three times lower, than on the average across Europe. Oligarchs and the most part of those who privatized the enterprises on favorable terms differed low level of enterprise activity and the competence. In state sector, because of a policy of ethnic restrictions, appointment of recruits on political, and frequently on family accessories, level of competence of the administrative personnel has sharply decreased. The inability effectively to operate economy has generated desire carefully to regulate all economic activities of the enterprises. The government bodies have unreasonably increased. So, if in 1990 number of Latvian state officials, public management and credit institutions made only 3 % from an aggregate number occupied in a national economy, by 2008 only occupied in the government device made 7,8 % of all occupied. Along with growth of number occupied expenses on its maintenance grew in officialdom also. In 1991 they made only 2, 9 % of expenses of the budget, in 2007 they have already exceeded 12, 3 % of all expenses of the budget. The regulation of all economic life doing impossible business dealing, together with poor quality of the state personnel potential, have led to corruption development, prosperity of shadow economy. Finishing in the late nineties process of privatization of the state property has sharply raised the question about the further destiny of model of "initial accumulation of the capital". Facing exhaustion of domestic sources of growth, the existing economic model **has increasingly absorbed financial resources from outside**. After entry in the EU, the government, as well as businesses, banks, and households, have been increasingly using relatively cheap access to borrowing. In this connection the stream of the foreign help, investments and cheap credits has been directed to it. These resources have impulse to economy development, but the Latvian economic model used them according to the nature of power elite interests. The powerful part of means from the European funds has been unproductively spent, or directly appropriated by bureaucracy and oligarchy. To foreign investors the highly remunerative state enterprises have been cheaply sold. The certain part of the price underpaid to the state has settled in bureaucracy pockets. Oligarchs have sold to the foreigners cheaply state enterprises. In early 2005, the credit indebtedness of financial and non-financial institutions and households totaled 3.877 billion lats (in then-current prices), or 52.4% of GDP. By late 2008, these figures rose to 14.577 billion lats or 110% of GDP, i.e. almost quadrupled in absolute terms and more than doubled as a share of GDP. Under these conditions, especially in the situation of crisis, return of debts becomes impossible. Overdue debts have already far exceed a 1-2% level which is supposed to be safe. Banks are confiscating property, lands and industrial objects from debtors, but these assets appear illiquid. For this and other reasons, incomes of private banks have collapsed to zero. Foreign, predominantly Scandinavian banks that had excessively pumped money into the Latvian economy, with no regard of its inability to return it back, have also encountered serious problems. Simultaneously, Latvia's external debt was also sky-rocketing: from 25.4% of GDP at the beginning of 2005 to 57.6% of GDP in the third quarter of 2008.

Results of "initial accumulation of the capital". Low efficiency of use of resources of development did not allow providing the stable and balanced economic development of the country. It is visually visible from the analysis of indicators of rates of increase of gross national product. In 1990 of gross national product of the Soviet Latvia, in the comparable prices of 2000, was 6771 million lats. Transition in model of initial accumulation of the capital and rupture of the developed economic relations have resulted, during two three – years, to falling of output of production practically twice. This falling managed to be overcome only in 15 years: a year later after the entering into EU, in 2005, the scope of gross national product of Latvia has reached sizes of 7006 million lats, having exceeded on 3 % an indicator of 1990. From 2005 till III quarter 2008 the involved external resources have provided faster growth of gross national product of the country - on the whole 24 %, in the same comparable prices of 2000, sizes of 8717 million lats. It is separately necessary to note specific model of consumption which has developed in Latvia. The money received by bureaucracy and oligarchy at first from privatization of the state property, and then from use of political resources with a view of personal enrichment, has generated ease of their expenditure. The ostentatious luxury, prestigious consumption became a distinctive feature of the Latvian ruling class. The given class has not been focused on investments into the future of the country. It was promoted by special system of state regulation of consumption: a proportional scale of the taxation of personal incomes, absence of the tax to a capital gain, low taxes to the real estate.

Latvia: interaction of national and world crisis

The economic crisis has begun in Latvia on own basis of that possibilities of model operating in it of "initial accumulation of the capital" have been completely settled.

During recent years, the highest rate of economic growth in terms of GDP in the European Community was achieved by Latvia. Despite reduction of incomes from Russian oil transit, the Baltic republic managed to accumulate impressive gold currency reserves, and to reduce the foreign debt. Pareks Banka, based in Latvia's capital Riga, was the only national banking institution of the Baltic States to develop into a powerful transnational investment bank, extending its influence both to the West and the East.

However, the global economic crisis affected this country most painfully, resulting in massive social unrest and political paralysis. In his public address to his own population, Valdis Adamkus, president of the neighboring Lithuania, tried to explain the social turbulence in both states with deliberate efforts of destabilization, inspired from Russia. However, the Russian political influence in Latvia is less significant than in other Baltic states. In December 2007, local Russian communities complained that they had not received a ruble of support from Russia. It is also noteworthy that Moscow has not used the Latvian crisis for its benefit. Besides, Russia is today concentrated on its own financial problems, emerging from a tremendous decline of oil export revenues.

In fact, the first symptoms of economic troubles were visible in Latvia already in early 2007. They were expressed in a shift in the economic balance that expressed itself in a few branches of economy: real estates, construction, and retail trade. Some of these negative symptoms were in fact presented as success: in particular, the increase of salaries and gross surplus of individual consumption. However, these ostensibly encouraging trends were alloyed with unbridled inflation that questioned the expected entry of the country into the Eurozone.

The anti-inflation program, initiated by the government of Aigars Kalvitis, was ambiguous and inconsistent. Trying to reduce the monetary mass, the government created obstacles for investments in real economy, while financial speculation was still booming. By the end of 2007, inflation was still on the level of 10.1%. In the first quarter of 2008, it rose to 16.4%, and in the second – to 17.7% (21). Restrictions for issuing credits, imposed by the government on the banks, resulted in a rapid contraction of the output of real economy. In the third quarter of 2008, the GDP reduced by 4.5% against the corresponding period of the previous year. The monthly industrial output shrank by 8% between January and August 2008 (22). Meanwhile, unemployment increased by one quarter. Facing an especially significant decline in metallurgy, resulting in a tangible shortage of revenues, the Government increased domestic borrowing. Thus, social instability had been predetermined yet before the international crisis broke out.

Since August 2008, Latvia, as well as other European states, encountered direct influence of the downfall of international stock markets. This influence was indirect, as the national stock market was underdeveloped and the state investments in foreign stocks were not significant. Commercial banks, due to strict regulations, also had not significantly invested in foreign stocks. The delayed debts under the given out credits, according to the Commission on the share markets and securities, have exceeded 15 %, delivery of new credits has practically stopped. Banks have started to take away at debtors of the mortgaged houses, apartments, grounds, production assets. The profit of banks, for the first time for long decades, has fallen to a mark close to the zero. Problems have arisen at foreign, first of all Scandinavian, banks which persistently pumped up before money the Latvian national economy, without paying attention that the economic model operating in it cannot provide their return. The indicator of manufacture of gross national product in Latvia has fallen for IV quarter 2008 on 10, 3 %, and on all year on 4, 6 % (23). Number of the unemployed by the end of 2008 has grown to 118 thousand persons, the rate of unemployment has reached 9, 9 % from number of able-bodied population (24).

The downfall of the national budget system was triggered by the bankruptcy of Pareks Banka that had been massively involved in international speculative operations. For some reason, the new government of Ivars Godmanis decided to accept 100% of the bank's liabilities that amounted to 1.5 billion. lats, i.e. one fourth of the national budget. In order to compensate the budget deficit, the government committed itself for large-scale foreign borrowing. Simultaneously introduced austerity measures included also elevation of the value-added tax from 18% to 21%, increase of excise taxes, suspension of tax relief for basic consumer goods, along with slashing of budget subsidies for redundancy payments, state expenses for medical treatment, and salaries in spheres of science, education, and law enforcement. At the same time, the state budget continued to invest in ambitious projects like the State Concert Hall in Riga.

It is noteworthy that throughout year 2008, foreign investments in Latvian economy did not significantly reduce: their amount was 11% larger than in 2006. Foreign investments partially compensated the negative export surplus. Lending rates did not outrange the rate of inflation. Thus, the banking system did not yet experience a serious shortage of monetary resources (25).

However the government, being focused on the objective of integration into the Eurozone, strictly pegged the national currency to the euro. This commitment deprived the government of crucial levers of economic regulation. At the first signs of international financial crisis, the population hurried to exchange the greatly overvalued lat for foreign currencies, particularly due out flow of qualified labor to more prosperous European states. Only for two months, between September and November, the amount of foreign currency reserves of the Bank of Latvia contracted by 21%. By spring, all the gold currency reserves would have evaporated. The panic was calmed down only in the end of December, when the government managed to reach an agreement with international financial institutions on new loans amounting to 7.5 billion euros (26).

The problems, related to devaluation of national currency, were thus solved. However, foreign liabilities of Latvia increased from a relatively moderate 57.6% to the critically dangerous 100% of the estimated national GDP of 2009 (27).

The errors in managing the economy in crisis, undertaken by the government of Ivars Godmanis, may be explained by lack of professional qualification and its reluctance to listen to financial experts. The Prime Minister introduced ridiculous initiative, destined for prevention of financial panic and related flight of capital. Insisting that the crisis in fact exists "only in the imagination of people", Mr. Godmanis officially introduced criminal prosecution of any arguments in favor of devaluation. Criminal charges were thus imposed on a university professor who just reproduced a piece for a textbook of economics on the subject of devaluation in a 500-copy local newspaper, and on two musicians who ventured to ridicule the Bank of Latvia in a village club.

Under the pressure of the international financial institutions anxious by irrational use of credits given by them, in March, 2009 to the power in Latvia V.Dombrovsky' s government has come. However it could not solve a problem of reduction of charges of an unreasonable officialdom and has chosen a way of a rearrangement of burdens of crisis on socially weak levels of population. The decision to reduce wages of teachers, doctors and policemen, children's allowances was accepted, to refuse indexing of pensions, to direct a part of payments to pension funds on a budgeted deficit covering, to cut down expenses on a science, education, public health services. Despite reduced receipts in the budget plans of the further increase of tax loading for business began to be considered.

In fact, the set of measures, introduced by the incumbent government of Latvia, does not significantly differ from the financial policy of earlier governments. The powers of Latvia have been following the same model that exposed its faultiness under unfavorable international conditions. This model, used since early 1990s, is focused on primary (non-equivalent) accumulation of capitals. It was first used for privatization of post-Soviet public property. However, this source of producing capital could not serve as a guarantee of balanced and durable economic development. As soon as the previously (mainly in the Soviet time) created resources were exhausted, this model started to generate systemic errors.

Conclusions. Crisis observed now in Latvia has system character that is simultaneously covers economy, social and political spheres. The given crisis is promptly evolving towards political and economic bankruptcy of the Second Latvian republic. Crisis of the Latvian society carries has the expressed internal reasons. At the same time, influence of global crisis substantially accumulates on processes and structural changes in Latvia. Without being the political actor in the field of the European and global policy Latvia passes more and more under the unconditional external control and goal-orientation.

Dr.E Alexander Gaponenko

Institute of European Studies

Latvia

Ph.D. Michael Rodin

International University Audentes

Estonia

Entrepreneurship and the Baltic Rim

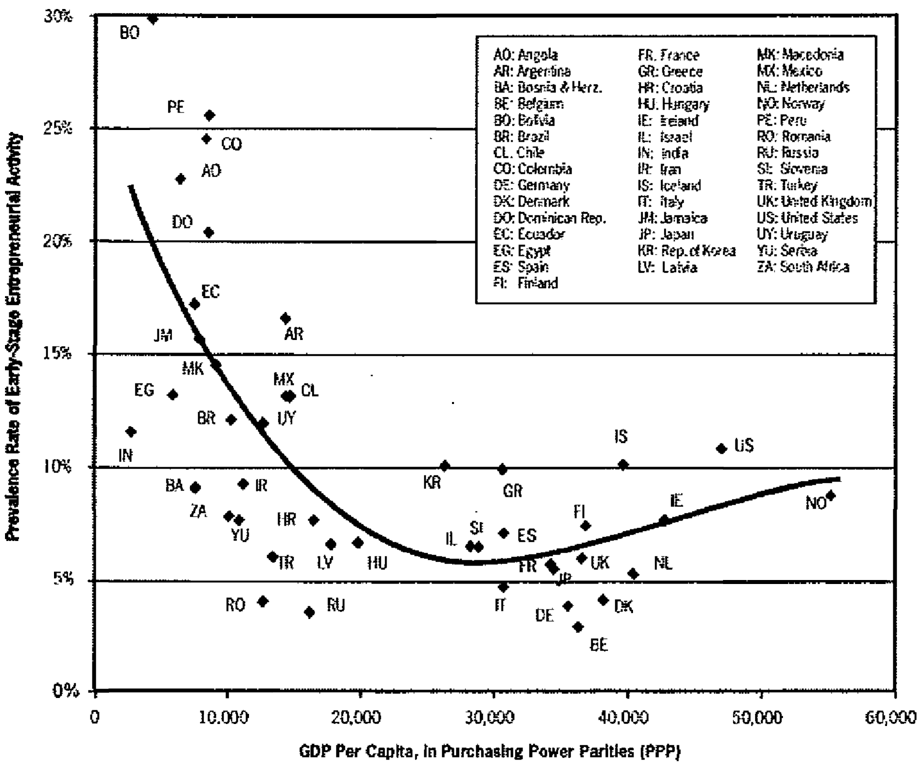
By Jarna Heinonen

The conditions for and nature of entrepreneurship differ across countries. Entrepreneurial activity also evolves in time and is, indeed, heavily embedded in the social, economic and cultural context of the country. Global Entrepreneurship Monitor (GEM) –study conducted in about 40 countries annually takes a broad view of entrepreneurship and focuses on entrepreneurial attitudes, activity and aspirations among adult population. In addition, GEM study provides insightful information on entrepreneurial sector for respective countries.

Unfortunately all the countries in the Baltic Rim are not included in the GEM. However, based on the countries included – Finland, Denmark, Latvia and Russia – it is already possible to demonstrate national differences in entrepreneurship, particularly the fact that entrepreneurship also reflects the phases of economic development of the country. Of these studied countries in the Baltic Rim Denmark and Finland are labeled as innovation-driven economies which are characterized by increasing wealth, a gradual shift from industrial activity towards service sector, and an increasing R&D investments and knowledge intensity opening new ways for innovative and opportunity-seeking entrepreneurial activity. Latvia and Russia, on the other hand, are labeled as efficiency-driven economies characterized by industrialisation and emerging economic and financial institutions to favour large national businesses. Due to increasing economic activity and gradually emerging baking sector the opportunities for the development of small-scale and medium-sized manufacturing sector expand.

Although GEM study provides a number of indexes and figures portraying entrepreneurial activity of the studied countries I concentrate on one example only, namely early-stage entrepreneurial activity (TEA) rate indicating the proportion of people aged 18-64 who are involved in entrepreneurial activity as a nascent entrepreneur or as an owner-manager of a new business. GEM demonstrates a consistent U-shape association between a country´s level of economic development and its level and type of entrepreneurial activity. This U-shaped relationship between per-capita GDP levels and TEA rates for 2008 is illustrated in the adjoining Figure.

What does this pattern tell us about entrepreneurial activity? Countries with high TEA-rate and low levels of GDP per capita are characterized by many small businesses and a lack of job opportunities in larger companies. As the economy develops along with industrialization and economics of scale the role of larger companies may increase accompanied by a reduction in the number of new small businesses. The decrease in TEA rate may actually be a good sign if it is accompanied by economic growth and political stability. After some decrease the role of entrepreneurial sector may again turn into an increase as income level increases and countries move along the curve to the right-hand side where wealthier and industrialized countries outside the EU are found. This shift indicates that individuals are capable of discovering new opportunities in the business environment and due to good access to resources they are also in position to exploit the opportunities and start viable new businesses.



Source: GEM Adult Population Survey (APS) and IMF: World Economic Outlook Database (October 2008 edition)

Figure: Early-Stage Entrepreneurial Activity Rates and Per Capita GDP, 2008

Source: Bosma, N. – Acs, Z. – Autio, E. – Coduras, A. – Levie, J. (2009) Global Entrepreneurship Monitor. 2008 Executive Report. Global Entrepreneurship Monitor Research Consortium (GERA). Babson College, Universidad del Desarrollo, and London Business School.

Eastern European countries, Russia and Latvia, are situated at the left hand side, below the fitted curve. The people in these countries are, thus, not as much engaged with entrepreneurial endeavours as some other countries with similar levels of per capita GDP. This may reflect the historical development of the economies. Finland and Denmark, on the other hand, have higher GDP per capita and they are situated further right-hand side, Finland in the curve and Denmark below it. Both so called innovation-driven countries have already faced some increase in entrepreneurial activity along with income increase. Finland ranks higher than Denmark in TEA rate. Actually, in comparison with other innovation-driven economies Finland ranks at least reasonably high in early-stage entrepreneurial activity. The major challenge in Finland and Denmark is an evident lack of innovative and high-growth entrepreneurship.

The association between the TEA rate and GDP per capita is only one attempt to highlight the country differences in entrepreneurial activity. It is also noteworthy that entrepreneurship is not only a function of economic development but also other factors, such as country´s historical development as well cultural, institutional, economic and demographic reasons. However, the consecutive GEM studies since 1999 indicate that national changes in entrepreneurial activity do take place and that policy measures and programmes may contribute to the development. Most importantly, as GEM study has been able to identify relationship between entrepreneurship and different factors, such as economic freedom, competitiveness and the ease of doing business, GEM gives new insights to policy-makers on how to promote entrepreneurship in different economic and social contexts.

Jarna Heinonen

Professor, Director

TSE Entre

Turku School of Economics

To receive a free copy, print or register at www.tse.fi/pei

ISSN 1459-9759
Editors-in-chief Stefan Ehrstedt and Kari Liuhto

Turku School of Economics, Pan-European Institute
Rehtorinpellonkatu 3, FI-20500 Turku, Finland
Tel. +358 2 4814 522, fax +358 2 4814 268
www.tse.fi/pei

pan-european institute

TURUN KAUPPAKORKEAKOULU
Turku School of Economics