

# Baltic Rim Economies

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

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ISSUE NO.6, 21 DECEMBER 2007

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## Estonia

### GDP growth slows down

According to the preliminary estimates of Statistics Estonia, the Estonian economy grew by 6.4% in the third quarter of 2007 compared to the corresponding period of the previous year. This means that the GDP growth was the slowest of the past sixteen quarters, i.e. four years. Partially the deceleration of growth was influenced by record growth rates in 2006, when the GDP grew by over 11% y-o-y in each of the four quarters. Also the slowdown in the value added in the manufacturing and retail sectors, as well as a decrease in the value added in transport and storage and in real estate activities contributed to the slower GDP growth.

Strong domestic demand has been one of the main drivers of the robust economic growth, but the slowdown in the GDP growth is expected to slacken private consumption as well. The growth rate of domestic demand has already started to decelerate; in Q3 of 2007 the domestic demand grew by 7.2%. The slowdown in the rate of growth was influenced by a sharp deceleration of the growth of household's private consumption expenditures (by 5.1%) and by a decrease in gross fixed capital formation (-5.7%). Also the forecasted slowdown in the global economy has its impact on the deceleration of Estonian economy. According to the Central Bank's estimations, the growth rate will decelerate even more in the fourth quarter of 2007, and the annual growth in 2007 is forecasted to be 7.3%. In comparison, annual growth rates were 10.2% and 11.2% in 2005 and 2006 respectively. The slowdown of growth is expected to help in handling the high current account deficit, which has been caused to a large extent by booming domestic demand and the high growth of imports.

### Trade balance starts to recover

The current account deficit has started to decrease slowly. For the first time in 1.5 years, the growth of exports outpaced the growth of imports in the Q2 of 2007. The foreign trade deficit decreased by EUR 12 mln in August 2007 compared to July 2007. However, the foreign trade deficit in January-August 2007 remained still a bit higher than in the corresponding period in 2006. The total value of trade was EUR 12.6 bln in the first eight months of 2007, of which exports made up 42% and imports 58%.

The main trade articles are machinery and appliances, which contribute 20.2% of total exports and 21.0% of total imports. Other significant export commodities are mineral products (14.2%) and wood and wood articles (10.3%). On the import side, Estonia imports transport equipment (14%) and mineral products (13.9%). Estonia exports goods into 156 countries and imports from 116. In January-August 2007, the trade balance was positive with 97 countries. According to Statistics Estonia, the main trade partners were Finland, Sweden and Latvia in exports, and Finland, Germany and Russia in imports in the first eight months of 2007.

### Real estate market faces a slowdown

In the third quarter of 2007, the number and total value of real estate transactions and building right contracts decreased compared to the previous quarter, as well as to the corresponding period in 2006 announces Statistics Estonia. The total value in the Q3 was EUR 8 mln, i.e. 25% less than in Q2 of 2007. The tightening of loan policies by banks and rising interest rates has been cooling down the real estate market in Estonia. In the beginning of 2006, the interest rates of housing loans were less than 4%, whereas in September 2007 they were up to 5.9%.

The growth in the construction sector continued to slow down in the 3Q of 2007. The total production in the construction sector grew only by 5% in Q3 y-o-y, which is relatively moderate after several quarters of rapid growth. The demand for new dwellings has been reduced by the rising construction prices. The majority of new dwellings are still located in Tallinn and the region surrounding it.

### Change in construction volume

Change compared to corresponding period of the previous year (%)				
Year	Q1	Q2	Q3	Q4
2001	10	5	10	1
2002	26	25	19	21
2003	2	6	8	6
2004	27	16	3	6
2005	7	19	32	28
2006	24	34	21	13
2007	24	7	5	

Source: Statistics Estonia

### Some business highlights

- The Estonian Government has decided to allocate EUR 32 mln in promoting tourism in Estonia. The budget for attracting tourists to Estonia will thus nearly double in the coming years. The aim is to strengthen Estonia's reputation abroad and to increase demand for all Estonian products and services, not just for tourism.
- Estonia's largest ferry group Tallink borrows EUR 144 mln to finance the construction of one of its cruise ferries, Cruise 5. The ferry is planned to be delivered in spring 2009 by the Finnish shipyard Aker Yards. The total cost for the ferry will be EUR 180 mln.
- The amount of Tallink's passengers decreased by 100,000 in a year, which is 6.6% less than in the previous year. The largest passenger loss was in the Finland-Sweden line, where the amount of passengers decreased by 16%.
- According to Finnish-Estonian Chamber of Commerce, many Finnish companies have stopped investing in Estonia in the last three months. Property boom and slowing economic growth are reasons for this.
- Estonia's largest construction group, Merko Ehitus has signed a contract with Logia Estonia to construct a Logistic Centre near Tallinn. The total value of the contract is EUR 10 mln.
- The growth of new car sales has slowed down due to economic deceleration. In the first quarter of 2007, the sales of new cars grew by 50%, but in September-November the sales grew only by 10%. However, 2007 annual growth will be 20% which is record high.

Estonia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	7.9	6.5	8	7.2	8.3	10.2	11.2	6.4	Q3/2007
Industrial production (y-o-y %-growth)	14.6	8.9	8.2	11	10.5	11	7.3	3.3	9/2007
Inflation (CPI, end of period, y-o-y %-change)	5	4.2	3.6	1.3	3	4.1	4.4	6.4	Q3/2007
General government budget balance (% of GDP)	-0.6	0.3	1.5	2	2.3	2.3	3.8		1-12/2006
Gross wage (period average, EUR)	314	352	393	430	466	555	596	697	Q3/2007
Unemployment (% end of period)	13.9	11.9	11.3	9.3	8.5	7.9	5.9	4.2	Q3/2007
Exports (EUR million, current prices)	3445	3698	3642	4003	4770	6190	7647	5299	1-8/2007
Imports (EUR million, current prices)	4615	4798	5079	5715	6704	8213	10576	7330	1-8/2008
Current account (% of GDP)	-5.5	-5.6	-10.6	-11.6	-12.5	-10.5	-14.8	-14.0	Q2/2007

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

## Latvia

### Rapid growth continues – the peak has been passed

The peak of the record fast economic growth has been passed, estimates the Bank of Latvia in its recent report. In 2006, the Latvian economy grew by 11.9% being the year of record high growth after the restoration of Latvia's independence. According to preliminary estimates of the third quarter of 2007, the pace of growth has somewhat slowed down indicating the start of stabilisation in the Latvian economy after several quarters of rapid growth. There have been fears of a hard landing leading to a recession, but if the rate of growth starts to slow down, also a soft landing of the Latvian economy could be possible. For the first time after several quarters, the growth rate of the Latvian economy went under 11% in Q3 of 2007. The growth in the third quarter was 10.9% y-o-y, according to the Central Statistical Bureau of Latvia. The growth rate for the first nine months of 2007 was 11% y-o-y, which indicates that even if the growth has slightly slowed down, year 2007 will still be among the years of strong growth in the Latvian economy.

In the third quarter of 2007, the main economic sectors that contributed the most to the strong growth were trade, which grew by 14.5% y-o-y, business services (10.2%), transport and communications (10.4%) and construction (13.2%). The manufacturing sector, on the other hand, decreased by 0.3% in Q3 of 2007 y-o-y.

### Industrial output in decline

Total seasonally adjusted industrial production output reduced by 1.6% in October 2007 y-o-y. Industrial production in manufacturing declined by 6.7%, whereas electricity, gas and water supply, as well as mining and quarrying increased by 15.4% and 17.3% respectively against October 2006.

October 2007 y-o-y	%
<b>Manufacturing</b>	<b>-6.7</b>
Food products and beverages	-18.3
Textiles	4.1
Wearing apparel	4.9
Wood and wood products	-5.5
Pulp, paper and paper products	16.6
Chemicals and chemical products	-4.6
Rubber and plastic products	8.3
Non-metallic mineral products	-9.0
Basic metals	-9.0
Fabricated metal products	11.1
Machinery and equipment	-7.6
Electrical machinery and apparatus	11.6
Other transport equipment	-7.0
Furniture; manufacturing n.e.c.	-11.2

Source: Central Statistical Bureau of Latvia

The Central Statistical Bureau reports that the manufacture of pulp, paper and paper products increased the most; by 16.6% y-o-y.

The manufacturing of fabricated metal products grew by 11.1% and the manufacturing of electrical machinery and apparatus grew by 11.6% y-o-y. The manufacture of food products and beverages, on the other hand, decreased by 18.3% in October 2007 y-o-y.

### Annual inflation almost 14%

Consumer prices grew by 13.7% in November 2007 compared to November 2006 the Central Statistical Bureau reveals. The prices for consumer goods increased by 12.8% and for consumer services by 16.0% y-o-y. The largest price rises compared to November 2006 were recorded in the following commodity groups: housing, water, electricity, gas and fuels (20.1%), alcoholic beverages and tobacco (19.8%) and food (18.8%). The only commodity group for which prices fell was communication, where a decrease of 6.3% was recorded.

Compared to October 2007, the average price level rose by 1.4% in November. Within a month, prices for goods rose by 1.7%, whereas for services the prices fell by 0.6%. Prices for food rose by 3.4% in November 2007 being the main contributor to a monthly rise in consumer prices. The price increase for bread and cereal products, vegetables, meat, and meat products, milk, cheese and eggs had the greatest impact on rising food prices in November. Also fuel prices as well as rents of dwellings increased compared to October.

The new target date for euro adoption is set to be in 2013. In order to be able to adopt the euro by then, Latvia has to take measures to curb inflation in order to be qualified to take part in the ERM2.

### Some business highlights

- During the first ten months of 2007, long-term housing loans increased by 40% compared to the end of 2006. According to the Latvian Central Bank, Latvian banks had issued EUR 6.5 bln in housing loans by October 2007. Especially housing loans for longer than five year terms increased in their number.
- There are plans to build a multifunctional complex in Riga. The total investment is estimated to be around EUR 100 mln. The new complex is planned to serve as an alternative for Riga railway station and to facilitate passenger transportation and to decrease traffic flows in Riga.
- The owner and operator of the Ventspils oil terminal, the Vitol Group, has announced it plans to transform the terminal into a trading hub, since business is increasingly dependent on seaborne crude deliveries.
- The Latvian Employers Confederation reports that 110,000 people have left Latvia within a year to work and live abroad. A survey reveals that only 10 to 30% of them might return to Latvia at some point. In order to attract skilled foreign labour, Latvia should take its example from the UK or Germany who have been able to attract foreign workers.
- Latvian airline, airBaltic, carried 168,000 passengers in November 2007, which is 53% more than in November 2006. In the first eleven months of 2007, airBaltic carried 41% more passengers than during the same period in 2006.
- Eurobarometer survey has revealed that the Latvians are among the least positive nations regarding benefits from the EU membership. Only 37% of Latvians see the EU membership as a positive thing.

Latvia - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	6.9	8	6.5	7.2	8.5	10.6	11.9	10.9	Q3/2007
Industrial production (y-o-y %-growth)	3.2	6.9	5.8	6.5	6	5.6	4.8	-1.6	10/2007
Inflation (CPI, end of period, y-o-y %-change)	1.8	3.2	1.4	3.6	7.3	7	6.8	13.7	11/2007
General government budget balance (% of GDP)	-2.8	-2.1	-2.3	-1.6	-1.0	-0.2	0.4		1-12/2006
Gross wage (period average, EUR)	268	282	297	298	314	350	430	575	Q3/2007
Unemployment (% end of period)	13.3	12.9	11.6	10.3	10.3	8.7	6.8	6.0	Q3/2007
Exports (EUR million, current prices)	2020	2232	2416	2559	3204	4085	4594	4166	1-8/2007
Imports (EUR million, current prices)	3453	3910	4284	4634	5671	6879	8828	8158	1-8/2008
Current account (% of GDP)	-4.8	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-23.5	Q2/2007

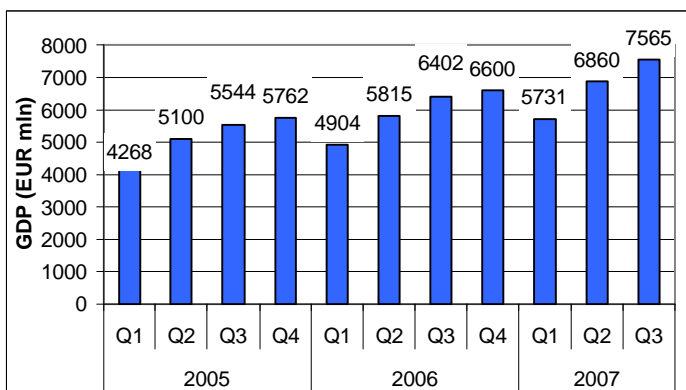
Sources: Central Statistical Bureau of Latvia, Bank of Latvia, Eurostat, author's calculations

## Lithuania

### GDP growth gains pace in the third quarter

The Lithuanian economy grew by 10.8% y-o-y in the third quarter of 2007, according to revised estimates by Statistics Lithuania. The growth rate of the GDP has varied between 6 to 9% for several quarters, so this is the highest growth rate of the Lithuanian economy for years. The largest increase of value added was recorded in agriculture and forestry, which grew by 29.6% in Q3. Other economic sectors that grew strongly were construction (16.7%), trade, hotels and restaurants, transport and communications (9.6%) and financial intermediation and real estate (9.4%).

### GDP by quarters 2005–2007, in EUR mln



Source: Statistics Lithuania

The total value of Lithuania's GDP reached a bit over EUR 7,500 mln in the third quarter of 2007. It is the highest value in several quarters.

### Inflation rate accelerating towards the end of 2007

The monthly inflation rate has remained at a relatively low level in Lithuania throughout the first eight months of 2007. However, the data for September and October show that the consumer price inflation has started to accelerate somewhat. According to Statistics Lithuania, consumer prices rose by 1.4% in September and by 1.5% in October 2007 compared to the previous month. The inflation recorded in October is the highest monthly inflation in 2007. In November, the monthly inflation slowed down a bit, being 1.1%.

The annual inflation, in turn, was 7.8% in November 2007 compared to November 2006. Prices for consumer services went up by 8.3% and for consumer goods by 7.8% y-o-y. The largest rises in consumer prices were in the prices for food products and non-alcoholic beverages, which grew by 15.4% y-o-y. Prices for housing, water, electricity, gas and other fuels went up by 11.3% and transport goods and services by 10.2%. The prices for clothing and footwear, as well as for communications goods and services, on the other hand, fell by 5.5% and 7.1% respectively in November 2007 y-o-y.

### Earnings of workers grow rapidly

Also the wage level has been rising fast in Lithuania. According to Statistics Lithuania, the average monthly gross earnings were 17.9% higher in Q3 of 2007 compared to the corresponding period of the previous year. Average monthly wages in the public sector grew by 12.2%, whereas in the private sector the increase was as high as 21.7% y-o-y. The average monthly gross wage in the public sector was EUR 562 and in the private sector EUR 566 in the third quarter of 2007.

On a monthly basis, gross wages grew by 6.8% in October compared to September 2007. The wages augmented by 5.1% in the public sector and by 7.7% in the private sector. A high number of working days in October, as well as rises in the minimum monthly wage and minimum hourly wage were behind this relatively rapid rise of wages in October.

In Q3 of 2007, male workers earned 26.8% more than female workers on average. Average monthly gross wages earned by men were EUR 632 and by women EUR 500. In the public sector, the difference was even higher, since the average earnings received by male employees were 29.2% higher than those by female employees. The minimum monthly earnings were raised by 16.7% and the minimum hourly wage was raised by 14.5% in the third quarter of 2007 compared to the previous quarter. Now the minimum monthly earnings are LTL 700 or EUR 200 and minimum hourly wage is LTL 4.19 or EUR 1.21 reports Statistics Lithuania.

### Some business highlights

- The number of new cars registered in Lithuania increased by 40% in the first eleven months of 2007 y-o-y. Almost 100,000 new cars were registered in the Baltic States in January-November. The most popular cars are Toyota, Volkswagen and Honda.
- In January-September 2007, the Lithuanian insurance companies reported a five-fold increase in profit compared to the corresponding period of the previous year. The market for life insurances grew the most; the y-o-y increase in life insurances was 90.4%.
- Lithuania and Russia have agreed on setting up a business forum. The first meeting of the permanent business forum is planned to be held in the first half of 2008 in Vilnius. The two countries have also discussed economic and commercial cooperation and agreed on navigation in the Curonian Lagoon and waterways of Lithuania and Kaliningrad.
- A group of Danish and local investors has announced their intentions to build a mega business centre in Vilnius. The plan is to build a 12-storey World Trade Centre by 2010. The cost of the project is estimated to be EUR 580 mln.
- Lithuanian Prime Minister Kirkilas and the Vice President of the European Commission, Verheugen met at the end of November in Brussels to discuss energy and industry issues. There might be an energy shortage in Lithuania after the Ingalina nuclear plant will be closed, and before the new nuclear power plant will be built in 2015. Also there are uncertainties over the timetable and capacity of the construction project, noted PM Kirkilas.
- Profit and profitability of Lithuanian companies went up in Q3 of 2007 y-o-y. Companies' profits experienced a 1.7-fold increase and whereas their profitability went up by 9.2% y-o-y.

Lithuania - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	4.1	6.6	6.9	10.3	7.3	7.9	7.7	10.8	Q3/2007
Industrial production(y-o-y %-growth)	2.2	16	3.1	16,1	10.8	7.3	8.9	6.1	10/2007
Inflation (CPI, end of period, y-o-y %-change)	1.4	2.0	-1.0	-1.3	2.9	3.0	3.8	7.6	10/2007
General government budget balance (% of GDP)	-2.5	-2	-1.4	-1.3	-1.5	-0.5	-0.3		1-12/2006
Gross wage (period average, EUR)	263	274	293	311	335	421	459	565	Q3/2007
Unemployment (% end of period)	16.9	17.9	13	11.6	10,6	8.3	5.6	4.3	10/2007
Exports (EUR million, current prices)	3841	4778	5526	6158	7478	9502	11250	9316	1-7/2007
Imports (EUR million, current prices)	5650	6767	7943	8526	9959	12446	15384	13020	1-7/2007
Current account (% of GDP)	-5.9	-4.7	-5.1	-6.8	-7.7	-7.2	-10.8	-16.1	Q2/2007

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

## Poland

### Strong growth continues

According to the Central Statistical Office, the Polish economy grew by 6.4% in the third quarter of 2007. Even though the peak of 2007 growth has already been passed in the first quarter, the growth rate of Q3 of 2007 was faster than previously expected. According to estimates by the Ministry of Finance, growth will be approximately 6% in the last quarter of 2007, and the annual growth rate for 2007 is estimated to be 6.5%. However, even if the estimates promise strong growth for 2008, there are also reasons to fear that the strong growth is not necessarily sustainable. As the Polish currency, the zloty, keeps on appreciating it will eventually dampen exports and thus decelerate economic growth. However, the Economy Minister Pawlak sees that Poland has the necessary foundations to maintain the strong economic growth in coming years as well.

### Slight increase in consumer prices

Consumer price inflation accelerated slightly in November 2007. Consumer prices grew by 3.6% in November 2007 compared to November 2006. The prices for food, beverages and tobacco increased most, namely by 7.2% y-o-y. Prices for transportation grew by 6.2% and for housing by 3.7%. On the other hand, a number of commodity groups experienced a decline in prices. Prices for clothing and footwear decreased by 7.1%, prices for communication by 2.1% and for recreation and culture by 2.2% y-o-y.

Compared to October 2007, prices grew by 0.6% in November 2007. On a monthly basis, the largest price increase was again for food, beverages and tobacco, which grew by 1.3%. Price increases for food have been the main contributor to changes in consumer prices, both on the annual and monthly levels. According to the Finance Ministry the rising level of food prices can be a persistent problem, mainly due to dry summers and increased global demand for food. However, despite the slight acceleration of consumer prices, the central bank is positive that Poland will reach its inflationary target set for this year, which is 2.5%. If inflation continues on accelerating, it may decelerate economic growth next year. There was only one commodity group for which prices fell in November, namely recreation and culture, whose prices fell by 0.1% compared to October 2007.

### Moderate price changes for industrial production

Prices for industrial production, on the other hand, fell in October 2007 compared to the previous month. The total price index for sold industrial production fell by 0.2%. Prices for mining and quarrying increased by 1.0%, and for manufacturing prices fell by 0.2%. The prices for electricity, gas and water supply remained the same. The annual price development of the sold production of industry has been relatively modest. On the annual level, prices for sold industrial production grew by 2.2%. Prices for mining and

quarrying increased by 1%, for manufacturing by 2.0%, and for electricity, gas and water supply by 3.7%.

### Unemployment rate decreases

The unemployment rate of the Polish economy keeps on decreasing. The data by Central Statistical Office show that the unemployment rate was 9.0% in the third quarter of 2007. By comparison, the rate was 9.6% in Q2 of 2007. The unemployment rate decreased by 4% compared to Q3 of 2006 and by 0.4% compared to Q2 of 2007. The unemployment rate for male workers was 8.4% thus being lower than for female workers, 9.8%. The highest unemployment rates are among workers with lower secondary, primary or incomplete primary education (14.9%). The lowest rate, on the other hand, was recorded in the group of workers with tertiary education (4.7%). In total, there were 1.53 mln unemployed people in Poland in the third quarter of 2007, which is 71,000 less than in Q2 of 2007.

Unemployment rate (%)	Q3 2005	Q3 2006	Q3 2007
	<b>Total</b>	17.4	13.0
<b>Males</b>	15.9	12.0	8.4
<b>Females</b>	19.1	14.3	9.8
<b>Urban areas</b>	19.0	14.1	9.6
<b>Rural areas</b>	14.7	11.4	8.2

Source: Central Statistical Office of Poland

### Some business highlights

- APolish media group, ITI, reported net losses of EUR 26.1 mln in the first three quarter of 2007. A year earlier the company reached net profits of EUR 69.5 mln. In the first nine months of 2007, ITI generated EUR 319 mln in revenues, up 33.2% y-o-y. Cinema chain Multikino boosted its revenues by almost EUR 32 mln, up 51.8% y-o-y.
- The number of building permits increased by 50.1% in January-October 2007 y-o-y. In the first ten months of 2007, over 101,000 apartments were completed: up by 15.3% y-o-y reports Central Statistical Office.
- US computer maker, Dell, has built a new plant in Lodz. The launch of notebook production in Poland has cost EUR 200 mln so far. At the moment, there are 500 assembly-line workers making Dell notebooks and the plan is to have 1,100 employees by January 2008. Dell sees a major increase in demand for computers in former Soviet countries in the near future.
- Poland's second largest energy corporation, Lotos Group, is planning to start exploring for oil in the Norwegian Shelf. The company plans to extract 2-3 mln tonnes of oil per year from the Norwegian Shelf. Lotos also plans to borrow c. EUR 1 bln to finance its projects in 2008 and 2009. The plan is to process 10 mln metric tonnes of crude oil and to focus on diesel fuel, which is in increasing demand.
- Foreign direct investment reached EUR 9.7 bln in January-September 2007, up by 33% compared to corresponding period of the previous year.
- Chinese computer maker Lenovo has chosen Poland as the place to build its first manufacturing plant in Europe. The factory will be located in the Legnica special economic zone and the cost of the project is USD 20 mln. The factory will offer 1,000 new jobs.

Poland - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
GDP (y-o-y %-growth, constant prices)	4.2	1.1	1.4	3.8	5.3	3.5	6.1	6.4	Q3/2007
Industrial production (y-o-y %-growth)	6.7	0.6	1.1	8.3	12.6	4.1	5.7	5.2	9/2007
Inflation (CPI, end of period, y-o-y %-change)	8.5	3.6	0.8	1.7	4.4	0.7	1.4	3.0	10/2007
General government budget balance (% of GDP)	-0.7	-3.7	-3.3	-2.9	-3.3	-6.1	-3.9		1-12/2006
Gross wage (period average, EUR)	472	557	544	496.8	505	591	692	770	Q3/2007
Unemployment (% end of period)	16	18.5	19.7	19.3	18	16.7	12.2	9.0	Q3/2007
Exports (EUR billion, current prices)	34.4	40.4	43.4	47.5	59.7	71.4	87.5	83.1	1-10/2007
Imports (EUR billion, current prices)	53.1	56.2	58.3	60.4	71.4	80.6	99.99	96.2	1-10/2007
Current account (% of GDP)	-6.0	-2.9	-2.6	-2.1	-3.5	-1.7	-2.3	-4.5	1-3/2007

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

## St. Petersburg

### One-sided industrial growth

In the third quarter of 2007, regional industry grew, mostly due to export-focused industries, namely oil and gas production and metallurgy. Several oil and gas producers became the residents of St. Petersburg at the end of 2006, and made a significant contribution to regional industrial growth. Extremely high oil prices at the international markets stimulated these companies to increase production, and their output more than doubled during January-October of 2007. These firms brought their management to St. Petersburg, while their production facilities remained in other resource-abundant regions of Russia. Despite this very fast growth, oil and gas companies are responsible just for 6% of St. Petersburg's total industrial output, but occupy 72% of regional commodity exports. The second-largest exporting branch, namely metallurgy, experienced a 24.7% increase and its share of the output during the reviewed period was 12.9%. Food production with its biggest 36.8% share of regional industrial output had an insignificant 3% y-o-y growth, being suppressed by rapidly increasing food imports. Knowledge-intensive but domestically-focused electric and optical machine building experienced a 2% decline during the first ten months of 2007 y-o-y. The industrial sector of St. Petersburg economy is facing some sort of "Dutch disease" phenomenon, when the high growth of raw and primary production and exports leads to accelerating inflation and a decrease of domestically-focused local production, which becomes uncompetitive compared to imports.

### Inflation continues to accelerate

Real incomes of St. Petersburg residents continued to grow, by 11.5% in October 2007 y-o-y, and this led to an acceleration of inflation.

Changes in prices for selected commodity and services groups in 10/2007 as compared to		
	9/2007	12/2006
<b>Total CPI</b>	<b>1.8</b>	<b>10.0</b>
Food products	4.0	13.0
Water and electricity	1.2	17.9
Transport	-3.7	4.6
Communication	0.0	20.3
Consumer services	0.3	11.7
Petroleum fuel	0.0	2.3

Source: Petrostat, 2007

Moreover, increasing world prices for agricultural raw materials raised the cost of foodstuffs, both imported and produced domestically. CPI increased quickly not only in St. Petersburg, but in most Russian regions. A sharp price rise in October 2007 attracted the attention of newly appointed Russian prime-minister Victor Zubkov, who negotiated this issue with the largest national retail networks, persuading them not to increase prices for several socially important goods, e.g. foodstuffs. As a result some prices were frozen until the end of 2007. However, these measures seem to have just a temporary

effect and are linked to the parliamentary campaign now. The only exception was the regional fuel sector. Despite increasing wholesale prices for petroleum, the oil companies tried to keep retail prices as stable as possible, because the threat of getting above the solvent demand after the price records of 2006 became rather visible.

### Construction fuelled by mortgages

Despite comparatively high prices on real estate construction kept on growing in September and October 2007; during 10 months of 2007 the building sector increased by 24.7% y-o-y and residential space finalised during January-October 2007 was 49.1% bigger than that of January-October 2006. The main engine of this growth was the development of mortgage bank credits, which became less affordable but easier to get for St. Petersburg residents. The mortgage crisis in the USA had a minor impact on the regional market, as the share of risky mortgages was assessed by the local banks as less than 5%.

### Foreign investors choose portfolio

During September and October 2007 positive expectations threatened by an unexpected cooling of the economy in August returned back to the investors. In the first three quarters of 2007 non-financial large and medium enterprises invested almost EUR 4 bln into St. Petersburg's economy, which by 32.0% exceeded the corresponding sum for January-September 2006. Construction and transport were the most attractive sectors for the investors. Foreign capital inflow constituted the bulk of all investment, totalling EUR 3.4 bln. The share of foreign portfolio investment continued to grow, comprising 10.9% of all FI, much higher than the small 1.2% share it had a years ago.

### Some business highlights

- St. Petersburg developer StroyMontazh announced ambitious plans to build two skyscrapers, 100 and 300 meters each, in Paris, France. The buildings would be constructed by the company's French subsidiary Hermitage SAS, planned investment is EUR 1.9 bln.
- A new Congress Hall would be created near the Constantinovski Palace in Strelna, St. Petersburg. The Hall would accommodate 2,500 delegates at once; planned investment is nearly EUR 350 mln.
- St. Petersburg construction company Setl City won a tender on building and renovating a Mikhailovskaya Dacha complex in Petrodvorets, which would accommodate a High School of Management. State investment in this complex is nearly EUR 200 mln.
- Russian holding Nazionalnaya Konteynernaya Kompaniya (NKK) started to construct a new logistical complex in Shushary, south of St. Petersburg. It would include a large container terminal, several warehouses and a trade centre. NKK invests a total of EUR 190 mln into this project.
- Bank Russky Standart, one of Russian leading retail banks, announced its relocation from Moscow to St. Petersburg. This can bring up to EUR 150 mln annual tax payments or 2% of total regional budget revenues.
- The St. Petersburg government adopted a new state support programme for regional SMEs. It plans to allocate nearly EUR 80 mln on SME support during 2008-2011 and to create 11 new business incubators in the city in addition to the first one recently opened.

St Petersburg - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
Regional GDP(y-o-y %-growth, constant prices)	10.5	4.5	17.7	8.4	7.2	8.4	8.4		1-12/2006
Industrial production (y-o-y %-growth)	26.2	0.2	31.4	5.8	14.1	4.2	-7.0	8.3	1-10/2007
Regional inflation (CPI, y-o-y %-change)	23.5	16.3	16.6	13	12.7	12	10.0	10.4	1-10/2007
Gross average wage (monthly, EUR)	n/a	n/a	217	209	285	344	407	474.5	9/2007
Unemployment (% average annual)	7.9	4.4	3.5	4.3	2.8	2.4	2.4	2.4	H1/2007
Exports (EUR million, current prices)	2736	214	1839	2428	3210	3953	5499	9166.1	Q1-Q3/2007
Imports (EUR million, current prices)	2693	4423	5158	5123	5560	8081	10299	0621.3	Q1-Q3/2007
FDI inflow (EUR million, current prices)	158.4	126.8	88.9	62,1	90.0	200.5	512.4	403.3	Q1-Q3/2007

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

## Leningrad region

### Industrial sector's changing structure

In September-October 2007, the trends of previous months remained and developed further. On the one hand, the visible reduction of the industrial growth rate was in line with investment, decreasing by 15.4% y-o-y. Food and tobacco production, giving the largest 22.6% share of regional industrial output, was falling during January-October 2007 by 11.2% y-o-y. The traditionally strong pulp and paper industry declined by 1.2% y-o-y, and producers of petrochemicals experienced a 3.6% y-o-y reduction due to temporary repair works at *Kinef*, the largest gasoline producer in the region. On the other hand, the branch structure of regional industrial output is slowly shifting towards more knowledge-intensive and added value sectors. In the same period automobile industry output grew by 25.7%; electronic and optical machinery production increased 9.7% y-o-y. Some smaller branches showed, however, even more outstanding results in this period: rubber and plastics producers raised their output by 41.2% y-o-y. Domestic demand for durables and intermediate goods is growing faster than that for primary products like foodstuffs and cigarettes, and that fuels growth in more knowledge-intensive industrial branches, even given the low added value at local automobile plants.

### Foreign sector grows fast

In the first three quarters of 2007, foreign investment and foreign trade turnover grew by 22.5% and 25.8% y-o-y respectively. Foreign investment increased significantly in a segment of long-term loans, while the share of FDI fell to 50.8% in January-September 2007 from 63.4% in the corresponding period of 2006. Foreign trade was rising so rapidly due to imports which grew by 40.8% y-o-y, while exports increased 16.5% y-o-y. Imports keep on booming, driven by prominent growth of real disposable incomes in Leningrad region: e.g., in September 2007 they went up by 23.4% y-o-y.

Leningrad region's main foreign trade partners in Q1-Q3/2007, as % of total			
EXPORTS		IMPORTS	
Great Britain	36.8	Germany	19.9
Switzerland	35.6	Great Britain	12.7
Finland	7.0	Belgium	8.4
Netherlands	7.0	Sweden	6.9
Estonia	3.2	Spain	6.0
CIS	2.8	Finland	5.4

Source: Petrostat

The list of foreign trade partners of the region in the first three quarters of 2007 shows a clear dominance by EU countries. Exports, mostly oil products, were directed to low-taxation trading countries, namely Britain, Switzerland and the Netherlands, and to closest neighbours, Finland and Estonia. Imports originated from large EU countries, producing consumer appliances and transport vehicles, which accounted for 60.7% of their total imports.

### Agriculture revives

The end of harvest season of 2007 showed some positive developments in regional agriculture. The grain harvest in

November 2007 increased 19% y-o-y, and the vegetable harvest grew by 14% respectively. Especially impressive were the results of hog-breeding with its 28% y-o-y rise. This branch is becoming the leader of regional agriculture compared to poultry farming and cattle breeding which lag far behind.

### Construction and transport

Construction continued to fall in September-October 2007. The total decrease in the sector in January-October 2007 reached -11.2% y-o-y. The oversaturated real estate market of the Leningrad region gave no incentives for construction companies to start new projects. The bulk of construction work executed during the ten months of 2007 were continuing and finalising earlier started projects. As a result, the number of residential apartments finalised in January-October 2007 doubled compared to a year ago, and the total residential space of buildings completed in the reviewed period of 2007 grew by 80% y-o-y.

Nevertheless, large construction companies are moving from residential towards commercial and industrial estate markets. A large investment in the Ust-Luga seaport infrastructure resulted in increasing construction activity in the port; a recently completed ten kilometre railway linked the new seaport with Russia's railway network. In addition to the half-completed St. Petersburg Automobile Ring-road (so-called KAD), federal authorities launched an initiative to create automobile "Ring 2" around the city, doubling KAD and connecting the northern and the southern shores of the Finnish Gulf. The new road would pass through the territory of the Leningrad region, linking Gostilitsy, Gatchina, Pavlovsk, Nikolskoye, Sertolovo, and Zelenogorsk. Thus, the construction sector of the region becomes more dependent on the transport sphere. Transport, in its turn, grew in the first ten months of 2007 by 10.1% y-o-y. The greatest contribution was made by marine companies, increasing the volume of cargo transported 40.8% y-o-y.

### Some business highlights

- Leningrad region's government approved the project of building a new cargo railway from St. Petersburg via Kamennogorsk to the Vysotsk and Primorsk seaports. The new route would have a branch to Svetogorsk-Imatra and would serve as a backup cargo railway for the St. Petersburg-Vyborg-Buslovskaja high-speed passenger route. Russia's railway monopoly RZD invests over EUR 500 mln in building the new cargo route, and EUR 700 mln in the renovation of existing St. Petersburg-Vyborg-Buslovskaja railway.
- Russian metal company Maksi-Group announced its plans to invest EUR 300 mln in creating a plant producing metallic articles and armature. The plant would supply its products to St. Petersburg construction companies.
- British producer of automobile components Stadco Ltd got a permission to build its production plant in the Vsevolozhsk district of Leningrad region. Stadco plans to start supplying components to regional and St. Petersburg auto producers from 2009 onwards, and invests EUR 208 mln in this new plant.
- KLPK, a forest industry company from Kazakhstan, started to build a new timber processing plant in Mga, Leningrad region. The plant would be launched in 2009, planned investment totals EUR 150 mln.
- Russian meat producer Meatland Food Group plans to invest EUR 60 mln in a new meat plant in the Leningrad region, thus increasing its daily production from today's 100 up to 400 tonnes of meat.

Leningrad Province - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
Regional GDP (y-o-y %-growth, constant prices)	12.8	8.5	16.3	14.6	8.8	8.3	8.1		1-12/2006
Industrial production (y-o-y %-growth)	26.8	10.7	35.6	20.9	10.3	5.9	26.9	8	1-10/2007
Regional inflation (CPI, y-o-y %-change)	23.5	19.6	14.8	13	14.9	12	9.9	8.6	1-10/2007
Gross average wage (monthly, EUR)	106	141	152	173	190	259	324	367,8	9/2007
Unemployment (% average annual)	12.7	10.8	9.6	9.2	7.5	7.8	6.2	5.5	H1/2007
Exports (EUR million, current prices)	1786	2350	2301	2580	3886	4862	5443	4365,2	1-Q3/2007
Imports (EUR million, current prices)	328	810	939	1061	1372	2562	2858	3313,2	1-Q3/2007
FDI inflow (EUR million, current prices)	222.5	266.0	121.9	104.5	106.6	178.7	288	163,7	21-Q3/2007

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

## Kaliningrad region

### Manufacturing growth still strong but slows down

Manufacturing growth in Kaliningrad remains strong but continued to slow down. While manufacturing output grew by 97.6% in January-October 2007, its growth in October was a more modest 64.8% (y-o-y basis). Car production has been the main driving force behind manufacturing expansion so far this year but the situation around Kaliningrad car producer Avtotor remains uncertain. The Russian government still considers changes in regulation that would revoke customs benefits that Avtotor enjoys according to the SEZ law. The US ambassador and the American Chamber of Commerce in Russia have sent letters to the first deputy prime-minister S.Ivanov asking him to keep the existing customs regime for Avtotor (Avtotor assembles several models for GM).

Some other manufacturing sectors also grew very rapidly in 2007: textiles – by 170%, wood processing by 100% (in the year to October) but in many sectors production actually fell. Food manufacturing and the pulp and paper sector, a foundation of the Kaliningrad industry in the recent past, were among the sectors with falling production.

The imbalanced growth in manufacturing and weak growth in industrial production outside the manufacturing sector – extractive industries posted an increase in production by 1.8% and utilities – by 3.6% in the year to October – suggest that the current performance of the Kaliningrad's industry is unsustainable and is based on a rather shaky foundation.

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

	2006 Jan-Oct 2007	
Industrial production	68.2	42.5
Mining	17.0	1.8
Manufacturing	40.6	97.6
Utilities	370	3.6
Construction	-8.9	14.7
Retail trade	16.1	18.2

Source: Kaliningradstat

### Construction and investment

Construction activity in Kaliningrad has also shown signs of slowing down. The volume of contract construction works was 14.7% in the year to October, down from 22.1% in January-August. Residential construction is still booming – growth in the first ten months of the year was 47.4% but it is also lower than 57% growth in January-August this year. It is unclear whether the worldwide liquidity crisis has had an impact on construction activity in the region but anecdotal evidence suggests that it will – Russian banks became more demanding in their mortgage financing.

After a fall last year, investment in fixed capital has been growing strongly in 2007 – by 27.5% in the first nine months of 2007 y-o-y. However, according to an initial estimate, investment dropped by 8% y-o-y in October. Extracting industries, food manufacturing, transport and telecommunication were the most active investors and accounted together for 60% of all fixed capital investment.

Kaliningrad - main economic indicators	2000	2001	2002	2003	2004	2005	2006	2007	as of
Regional GDP (y-o-y %-growth, constant prices)	15.2	3.4	9.5	9.4	12.9	12.0	11.6	n/a	
Industrial production (y-o-y %-growth)	32.4	12.9	10.2	4.7	26.6	18.9	68.2	42.5	1-10/2007
Inflation (CPI, end of period, y-o-y %-change)	17.5	21.0	9.8	17.5	11.7	11.1	7.9	10.6	10/2007
Gross wage (period average, EUR)	67	99	125	137	155	193	285	352	10/2007
Unemployment (% end of period, LFS data)	15.6	10.6	7.1	7.5	6.4	5.9	5.9		Q4/2006
Exports (EUR million, current prices)	514	508	497	507	876	1470	1973	1578	H1/2007
Imports (EUR million, current prices)	947	1169	1701	1894	2419	3283	4187	2341	H1/2007
Exports (sales) to Russia (EUR million, current prices)	459	691	802	989	1449	1901	2471	1606	H1/2007
FDI inflow (EUR million, current prices)	7.1	3.6	6.3	12.4	18.0	15.1	16.9	20.7	1-9/2007

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

Despite problems on the world financial markets, inward foreign investment jumped in the third quarter of the year: the total flow of inward foreign investment was 82.8 mln EUR in the year to October – 94% higher than a year before. 2007 will be a record year for foreign investment to the region. Foreign direct investment (FDI), in the first 9 months of the year is already bigger than in the two previous years combined. While these results are undoubtedly a significant improvement for the region they should be viewed against the background of the foreign investment boom in Russia (FDI to Russia increased by 91% in the 9 months of 2007) and as such, is more or less ordinary for Russian regions.

Two sectors of the regional economy were primary destinations for FDI: wholesale trade (including trade in oil and oil products) – 27% of the total and financial intermediation – 62%. Poland was the main source of FDI for the region – more than 63% of the total.

### Wages and consumer prices

Consumer inflation has become one of the main worries for economic policy-makers in Russia in general and in the region in particular. While normally inflation in early autumn has been constrained by a seasonal decline in food prices, this year it was the other way round: food prices (except alcoholic beverages) rose by 12% in the year to October and 1.4% in October alone. Prices for many basic food products like eggs, milk, butter, bread, flour, poultry, etc have grown especially rapidly and it makes consumer inflation a serious social problem. The consumer price index in January-October increased by 8.8% and is already higher than CPI for the whole 2006 (7.9%).

Other prices have been also growing rapidly – manufacturing prices increased by 11.1% in the year to October, construction prices – by 14.4% and agricultural prices – by 18.0%.

### Some business highlights

- Kaliningrad Railways is planning to invest about RUR 33 bln (EUR 940 mln) by 2030 to upgrade its carriages, trucks and railway tracks. Its investment in 2007 will amount to RUR 1.5 bln.
- Swedish IKEA announced its decision to invest at least 100 mln EUR and build a store in the Kaliningrad region with a total area of 140 thousand sq. metres.
- Sadia from Brazil has invested USD 78 mln in a poultry processing plant in Kaliningrad and will open it by the end of the year.
- In October 2007, German company Wiesenhof started construction of a meat processing plant in Guryevsk near Kaliningrad that should sell its products in Russia and in Europe.
- Investment fund Renaissance Capital bought a trade and entertainment centre Epicentre in Kaliningrad for about USD 40 mln. It was marked as the first deal when an institutional investor bought commercial real estate in the region.
- Gazprom and the Kaliningrad region finally reached an agreement on supplies of natural gas to the region. It opens way for renewal construction of the second plant of Kaliningrad CHPP which was frozen because of uncertainties regarding fuel supply.

## The Baltic Sea region: the region in global competition

By Ene Ergma

The Baltic Sea region has benefited from the political developments of the last 15-20 years more than any other region. The global standoff between the East and the West, which had its most visible manifestations in our region, has ceased. The Baltic Sea has become a uniting waterway rather than a hostile environment of distrust and conflict.

The change has been both fast and vast. We have all had to cope with it and manage it. It has been a positive challenge because the majority of changes have brought peace and prosperity to people, businesses and countries.

Still, even greater challenges lie ahead. While we have enjoyed the change of ourselves and the region and Europe as a whole, the pace of changes elsewhere in the world may have been even faster. The united Europe has been a magnificent goal to achieve, but it is an ever moving target. In order to realise what we want Europe to become in the global competition, we should start by acting locally to shape our region as a part of the strong Europe and as a pillar of European regional diversity.

### The Baltic Sea region in the European Union

The EU should have its own Baltic Sea region Strategy. *The EU Baltic Sea strategy should be an internal issue of the EU whereas the instruments such as the Nordic Dimension, four common areas of cooperation with Russia and the Council of the Baltic Sea States will secure the EU foreign policy interests in its cooperation with Russia.*

On 16th November 2006, the European Parliament adopted a report on a Baltic Sea strategy. The aim was to increase the EU internal focus on the region to make most of the opportunities to develop the region into one of the most attractive and competitive areas in the world.

Many reasons speak for this outcome. Eight littoral states are members of the EU. There is both a need and the opportunities to address the challenges in the region through EU policies and instruments available for the EU and EEA members. Specific challenges are related to the vast size of the region and concurrently its connections to the rest of the EU.

The main aim of the strategy should be to strengthen the actual cohesion and integration of the EU in the region. It would reinforce the region's growth and competitiveness and thus contribute effectively to the fulfilment of the Lisbon targets.

One of the key objectives could be long-term planning in areas crucial for economic growth – such as major infrastructure projects and environmental projects.

### Challenges yet to be answered

#### Saving the Baltic marine environment

The Baltic Sea countries have to come to an agreement by the end of this year over an ambitious Baltic Sea Action Plan as has been agreed in HELCOM.

The Action Plan, which the HELCOM Member States decided to jointly draft in 2005, sets an ambitious target of achieving by 2021 a good ecological status of the Baltic Sea - a sea with diverse biological components functioning in balance and supporting a wide range of sustainable human economic and social activities. This plan has been set as a pilot project for the European seas under the EU Marine Strategy. It could become a model to be followed by other regional marine conventions around Europe. It is designed to solve all major environmental problems affecting the Baltic marine environment.

There is a great variety of environmental challenges: eutrophication caused by excessive nutrient pollution loads

of nitrogen and phosphorus to the sea originating from agriculture and untreated sewage, algal blooms, dead sea-beds, depletion of fish stocks. This calls for immediate wide-scale action to put an end to further destruction of the Baltic Sea environment to avoid an irreversible disaster.

### Nord Stream pipeline

But instead – we witness today an attempt to put at risk the Baltic Sea environment by creating a superstructure at the bottom of the whole sea at extent never seen before. The preparations to build the Russian-German gas pipeline go ahead as if the experts' outcry over its dangers has gone unnoticed by the governments and politicians. The attempt to avoid partners and the need for co-operation while building reasonable European infrastructure has led to pipeline plan that should have been rejected in the first place. Why would we allow putting our common sea at risk for the unwillingness of gas suppliers to co-operate with certain partners? Do we have to bear the environmental burden because Gazprom does not like the fact that it has to cooperate with Poland? Should the Baltic Sea be polluted for the profits of a pipeline company?

The European Union has pointed out other viable options for building gas transmission systems between Russia and the rest of Europe. In fact, these routes already exist and can be taken to use with minor efforts and much less environmental impact. The Yamal gas transmission pipeline does exist and can be expanded in capacity. Another option would be to build the *Amber pipeline* through the Baltic States and Poland. Ministers of Economy of Estonia, Latvia, Lithuania and Poland have requested the Commission to co-finance the feasibility study of this project. Unfortunately, as has been proved a number of times Russia prefers to avoid cooperation on these issues with some countries. Thus – what we have to achieve is taking the neighbors in the region as logical partners rather than avoiding them.

The Baltic Sea in general has become a major hub for shipping hydrocarbons. In a few years, transit will double to 150 million tons of crude oil alone annually. To deal with this acute threat is not just an environmental, but also a security issue. A major tanker accident could lead to rising tensions with the main transit source – namely Russia, which has strategic interests connected to this transit. Preventive measures to minimise this kind of risk are essential.

### Russia as a responsible actor in the Baltic Sea region

Keeping Russia engaged as a responsible player in the region is a complex task. Part of the potential of the Baltic Sea region is definitely connected to the possibilities offered by the Russian market, resources and people.

At the same time Russia has global interests and will have to pay attention to all geographical directions of its neighborhood.

It will take all the cooperation frameworks that we have to develop the relations with Russia. (EU-Russia partnership agreement that needs to be renewed, EU-Russia common spaces, Northern Dimension, Council of the Baltic Sea States, other regional organisations). At the same time we should also frankly require full cooperation in these fora.

Attempts by Russia to brake with the cooperative ties in place within our region should be firmly rejected.

Ene Ergma

President, The Parliament of Estonia

## Think neighbourly, create value added

By Gediminas Kirkilas

Our Europe is a certain derivative of values. In general, ideals in politics are inseparable from our identities, interests and finally, political behaviour. Our principles and beliefs lead us through life, and finally constitute what we call 'ourselves'. There should be no room for double standards. Unfortunately, very often an uncompromising strife for benefits and pursue of interests can easily shake our values. Europe is also a confluence of our common ideals, principles and contribution. Having joined the EU in 2004, Lithuania contributed with fast growing economy, successful post-communist transformation and good neighbourly relations.

The EU enlargement has become of vital importance to the countries aspiring for the EU membership and, at the same time, has provided more opportunities and benefits for the EU itself. The expanded internal market has created conditions for the European economy to become stronger and more dynamic. Enlargement must be based on successful reforms, which should deserve appropriate stimuli. The validity of the Copenhagen criteria is unquestionable. Hence, principles of rigorous, yet fair conditionality serve for assessing readiness of candidate countries. Besides, the European Union is becoming stronger with each round of the enlargement, thus entailing positive internal reforms. I hope that the Lisbon Treaty will also encourage further EU enlargement. We had a strategic debate on EU enlargement in December 2006, where the EU leaders reached a renewed consensus on the enlargement policy. These should be our guiding principles, and there is no need to establish dividing lines in our continent.

With the EU enlargement in 2004 the question of regulated relations between the Union of 27 member states and its neighbour states to the east and the south moved to the centre of European politics. Launched by the EU in 2004 as a new policy framework, the European Neighbourhood Policy (ENP) aims at the political and economic stabilisation and the modernisation and democratisation of the EU neighbours in Eastern Europe and the Mediterranean region. The ENP gives an emphasis to the European interest "to promote a ring of well governed countries to the East of the European Union and around the Mediterranean with whom we can enjoy close and cooperative relations".

Thus, our aim in relation to the ENP is to create a "ring of friends" attaining European stability, strategic security interests and effectively promoting European values beyond its borders. The overall aim would be to bring these countries closer to the EU through the development of structural dialogues at all levels, including sectoral cooperation; through economic integration and closer participation of these neighbours in the Internal Market, as well as facilitation of people-to-people contacts.

Lithuania has been cherishing good neighbouring relations for many years. Our country has officially declared its commitment to pay a special attention to EU cooperation with neighbourhood countries and supported far-sighted policies, which might open the European Union (to the extent possible) to the outside world in general and to its neighbours in particular. We consider such openness both a benefit to our ENP partners as well as to the EU citizens. Politically stable and economically healthy neighbourhood is

a condition for a long-term stability and prosperity of the EU. A more strongly differentiated approach on the part of the EU to the Eastern and Southern dimensions of the ENP is needed. Our understanding of basic differentiation is that ENP-South countries are "neighbours of Europe" and ENP-East countries are "European Neighbours".

In order to promote further geographic and political differentiation between the two regions of EU neighbourhood, we most likely need to walk off the existing ENP framework and opt for a structure that would exist independently from the progress (or the lack of it) on the ENP track (just like the Barcelona Process exists in parallel to the ENP). Further structuring of the ENP format would only limit the EU's focus on Eastern Neighbours to the issues already inherent in the ENP debate – namely, trade, transport, energy, visa facilitation and other. Meanwhile, our goal is just the opposite – to establish the ENP-East agenda more broadly on the European scale.

We therefore suggest finding a niche for Eastern Europeans in a broader European debate. The discussion launched by the French on future challenges to the EU creates a favourable environment for all of us to act in this line. Eastern countries would thus have possibility to participate in discussions on energy and other topics as equal subjects rather than offshoots of larger EU interests. In terms of framework, our proposal would be to exploit the concept of 'European Neighbours' more extensively and seek to establish a 'Europe-to-Europe' dialogue which would include – theoretically – the EU and all its European neighbours in the north, in the east, and the south-east. The actual membership may vary depending on how many European countries would buy this idea. Russia could be included or not, depending on the agreement among ourselves.

The major obstacle to the creation of such a dialogue seems to be the established frameworks of EU cooperation with its European neighbours (EEA, ENP, and Stabilization and Association Process). Among other things, these frameworks promote independent identities. We need to break down this kind of mentality. It must be clear from the outset that the new framework is not about EU membership or enlargement but, rather, about addressing together the common challenges to Europe at large. But we do not exclude the possibility that the outcome of this discussion will be the decision to enlarge.

It is also evident that the launch of this idea will need intensive preparatory work. First of all, we will need to convince the sceptics in our West and the East that a Europe-to-Europe dialogue is necessary. We should also promote Eastern Europe as a 'success story' (high growth, consolidation of democracy etc.) in the context of other EU policy directions (Middle East, Africa, North Korea etc.). We need to de-construct the prevailing image of Eastern Europe as an area of instability, depression and 'frozen' conflicts. Faster implementation of ENP Action Plans by Eastern Neighbours and successful conclusion of renewed partnership agreements would help us substantially in this effort.

It is also important to encourage regional cooperation and especially those regional initiatives which transcend the established geographical lines (GUAM, BSEC, Black Sea Synergy, Baltic-Adriatic, Central European Initiative and other). Every successful outcome in each format would only boost this region's European identity. Cross-regional ties should also be promoted, including those among the Balkan and East European/South Caucasus nations.

The long term effect of successful cooperation in a Europe-to-Europe format would be the new understanding of what Europe is and, perhaps, Europe's greater cohesion within those new limits. Europe-to-Europe cooperation could translate into three strategic partnerships: 1. Political and Security Partnership, providing for a closer political dialogue in such areas as human rights, development, and foreign policy, as well as for a closer EU's involvement in conflict resolution; 2. Economic and Financial Partnership, which

would remove the existing trade barriers and establish free trade with EU. Full integration would also evolve in such areas as energy, transport, and, perhaps, financial institutions; 3. Social, Cultural and Human Partnership, resulting in free movement of people and the eventual integration of European Neighbours with the existing EU academic and social programs and instruments. All in all, greater cooperation and cohesion with the EU neighbourhood gives a value-added to our Europe of Tomorrow.

*Gediminas Kirkilas*

*Prime Minister*

*Lithuania*

## European Neighbourhood Policy

By Benita Ferrero-Waldner

The European Neighbourhood Policy (ENP) was born of a vision first articulated five years ago. On the eve of the biggest enlargement in its history, the EU dreamed of a zone of stability, prosperity and co-operation shared with all its 'new' neighbours-to-be.

Building on the great success of the EU's enlargement process, the idea was to deepen our relations with our neighbours and in so doing to encourage them to strengthen their own political and economic reforms. The EU's neighbours are particularly important to the EU: by bolstering their stability, prosperity and security, we also bolster ours.

That vision has today become a reality. We have opened the policy to all eastern and southern neighbours who share our commitment to democracy, open society and economic prosperity - 12 countries around our borders, from Georgia and Ukraine in the East to Jordan and Morocco in the South.

The key to our approach is differentiation. Every country individually determines the nature and strength of its relationship with the EU. It's a policy of more for more: as countries go further down the reform path, more possibilities for closer cooperation with the EU open up to them: more financial support (approximately €12 billion from 2007 to 2013, an increase of 32 percent in real terms); integration with the EU's internal market; and participation in the EU's policies and programmes.

We have already seen ENP's first results: a border monitoring mission in place along the Moldovan-Ukrainian border to help address the frozen conflict in Transnistria; an agreement on easier visa procedures for Ukrainian citizens and others in the works; and a large number of twinning and TAIEX projects in place with countries across the neighbourhood.

We have also set up a Neighbourhood Investment Facility, which will provide an important new source of funding for the neighbourhood, and a Governance Facility which provides additional support to countries that have made most progress in implementing governance reforms. Neighbourhood countries are also beginning to join the EU's programmes and agencies, so that Israel, for example is shortly to join the Competitiveness and Innovation Programme.

But we have even greater ambitions. In September 2007 we held a major international conference to discuss our proposals for strengthening ENP still further. This was an important demonstration of how established the policy has become in a short space of time. It underlined the emphasis we place on joint ownership of the policy, and provided a

forum to discuss how to make ENP even more effective, attractive and focused.

Building on that conference we released on 5 December a new Communication entitled "A Strong European Neighbourhood Policy". It sets out a concrete list of actions for the EU's Member States and the Commission to take in order to keep our promises to our partners of providing concrete and credible incentives for reform.

We have four objectives for 2008 and beyond:

- Greater political commitment to foster **economic integration** and improve market access. We will help our neighbours access the EU's 500 million-strong market, an area where goods, services and capital flow freely; opening up new possibilities and greater opportunities for us all.
- The **facilitation of legitimate short-term travel**, as well as more ambitious longer term developments in managed migration. We know that the freedom for people to travel to and around the EU is enormously important. At the same time the EU needs migration to cope with our ageing shrinking population. So we want less complex visa rules. But we also want all migration to be legal and managed.
- Further engagement with ENP partners in tackling frozen conflicts, using the full range of instruments at the EU's disposal to stabilise conflict and post-conflict areas.
- Intensified EU support for partner countries' sectoral reforms in areas such as: energy, climate change, fisheries, transport, maritime policy, research, information society, education, employment and social policy.

We hope that our Member States will join with the Commission in the coming year to ensure we make a reality of these proposals. And of course there is also work to be done by our partners; we will issue progress reports on their implementation of their commitments under ENP in spring 2008.

ENP is an ambitious policy, but one which has the potential to make an enormous difference to the prosperity and stability of both the EU and its neighbours. The vision contained in ENP is a radical change in the way the EU relates to its nearest friends and its nearest friends relate to us. And this Commission is fully committed to making that vision a reality.

*Benita Ferrero-Waldner*

*Member of the European Commission*

## Nordic-Baltic defence cooperation

By Jyri Häkämies

Since 1991, the Nordic-Baltic cooperation has become a daily routine between eight democratic countries in Northern Europe. This cooperation takes place on all sectors from economy and labour policy to foreign and defence policy.

Defence cooperation was for a long time a grey area among the Nordic countries, probably because these countries had very different defence solutions. This was particularly clear in the case of Finland. Finland had become a UN member already in 1955, but in spite of that it had to adopt a very cautious line in its relations with other Nordic countries. Still in the late 1960s Finland had to abstain from closer economic cooperation among the Nordic countries (NORDEK).

After the end of the Cold War, intergovernmental cooperation in Northern Europe has rapidly increased. In 1994, Finland and Sweden decided to join the European Union and the Partnership for Peace -arrangement with NATO. A few years later Estonia, Latvia and Lithuania joined both organizations. New forms for the Baltic Sea area and Nordic-Baltic cooperation were also developed.

### Infrastructure support

Nordic-Baltic cooperation in the defence sector was launched immediately after the Baltic countries regained their independence in August 1991. Estonia, Latvia and Lithuania had to start the construction of their national defence systems virtually from the zero point. After the withdrawal of the Soviet (Russian) troops from the Baltic countries only partially demolished empty military bases and buildings were left behind.

The Baltic countries had not had national defence forces since the Second World War. Instead, Soviet garrisons were filled with conscripts and soldiers from distant parts of the country. The assistance provided by the Nordic countries was therefore welcome. During the first half of the 1990s, the possibility of the NATO membership was not taken too seriously by the Baltic countries. Neither NATO at first cherished such an idea. National defence system in the Scandinavian style was therefore at that time the most natural choice.

Extensive assistance programmes were launched quickly by the Nordic countries from 1992 onwards. The reasons for this were obvious. It was thought that a military vacuum in the Baltic countries would create instability for the whole Northern Europe. Finland, Sweden and Denmark were active and had each a target country of their own. Finland provided Estonia not only materiel assistance but also started to train future Estonia officers in the National Defence University (Maanpuolustuskorkeakoulu) and other military institutions. A similar procedure was adopted for the training of Estonian border guards. Later Baltic military training institutions have been provided different types of support.

It was first during the latter half of the 1990s, when the possibility of the Baltic countries to join NATO became a topic of political discussion. After the admission of Poland, Czech Republic and Hungary to the alliance it was realized that there could be a continued extension process, where the three Baltic countries and other countries of the former

Eastern bloc would also have their place. Along with this development, assistance programs started to pave the way towards filling the membership criteria that NATO had put for its potential new members.

One element in the defence sector cooperation has been joint ministerial meetings between the eight Nordic-Baltic countries. These meetings were organized since the latter half of the 1990s both as internal events and as meetings with external parties. One of the high moments was the meeting of the Nordic and Baltic defence ministers in Turku in May 2001, with the US secretary of defence Donald Rumsfeld as a special guest. Later on another similar meeting was organized in Estonia.

### Towards Operational Cooperation

During the last few years, Nordic and Baltic countries have launched new cooperation projects directed to militarily less developed new democracies. One example of this is the training program arranged for Ukraine to support it in building more effective national defence. Joint development programs deal with such issues as strategic planning, parliamentary control of the military, procurement processes, training, technology and research and public policy. There are some plans to widen this cooperation soon to new countries such as Moldova, Georgia and Armenia.

As said before, the content of Nordic-Baltic defence cooperation has developed remarkably. If the 1990s was the decade of support and assistance programs, after 2001 we have entered an era of more equal operational cooperation, both at the bilateral and multilateral level. As my predecessor Seppo Kääriäinen pointed out in the joint article with the Estonian defence minister Jaak Jõerüüt, different defence solutions are not an obstacle to mutually beneficial cooperation.

What does this era of operational cooperation mean? Estonia, Latvia and Lithuania are sharing with the Nordic countries the idea of peacekeeping and crisis management cooperation. Quite soon after finishing the first stage of building national defence forces, all three countries volunteered to international operations. For them it was quite natural that they sought particularly cooperation with the Nordic countries. In addition to joint operations in places like Kosovo, the Baltic countries gave their contribution to both NATO and US-led ad hoc -coalitions for example in Iraq.

On the first of January 2008, the so-called Nordic EU Battle Group will become operational for the next six months. It will include troops from the lead nation Sweden, Finland, Norway, Estonia and Ireland. The Nordic battle group had in November its last exercises and now waits, if it will be called into action in one of the crisis areas of the world. Latvia and Lithuania are participating in the same spirit in other battle groups. It is also quite possible that the Nordic battle group will become operational in 2011 again. In addition to the EU battle groups, Baltic countries are participating in exercises and operations of NATO's reaction forces (NRF). Finland will analyze experiences gained from EU Battle Groups and, on the basis of this analysis, will consider the participation in the NRF.

The integration of the Baltic countries into European and North-Atlantic defence structures has now been more or less completed. In spite of their relatively small sizes they have found themselves a role in common operations and structures. Estonia can again be an example. Estonia's defence minister Jaak Aaviksoo has recently announced that his country will inside NATO specialize in the preparations against the cyber war. This is a wise decision, for several reasons. Estonia has been exceptionally advanced in creating an information society. Last spring Estonia was also a target of cyber attacks against its vital systems and infrastructures. The United States is NATO's leading country

in military capabilities, but smaller members can have strong niche areas as well. It is obvious that Estonia's specialization will benefit all countries in its vicinity, including Finland and other Nordic countries.

*Jyri Häkämies*

*Minister of Defence*

*Finland*



## A EU-Strategy for the Baltic Sea region: making a success of the 2004 enlargement

By Christopher Beazley

The European Union is, and always has been, a framework through which its members receive mutual support and solidarity. As the Union has developed the areas of support and solidarity have also evolved. The Union is now the world's largest market with almost half a billion people living within its borders. The EU is a global actor, in trade and aid, and its shared border with Russia offers new challenges and opportunities for the EU structures and its Member State Governments. The Baltic Sea Region is central to the challenges and opportunities of a well functioning EU of 27 states operating in the global economy. There is much the region can offer the EU both in terms of economic focus and in contributing experience to the developing relationship with our largest neighbour.

The EU enlargement of 2004 finally ended the division of Europe which began in 1939. This however is not the end of the story. Membership of the EU of 27 is the beginning of the re-unification process in the Baltic Sea Region. There is much to be done to re-unite the economies, infrastructure and geopolitical focus of the EU Member States around the Baltic Sea. 60 years of division have resulted in differing experiences, perspectives and economic performance between the 8 Member States. For EU membership to be seen as the answer in itself is too simplistic; of course the economies of the region will begin to look and perform alike eventually by the very fact that they are operating in the same market, but this will take time. In the 1930s for example, the economies of Finland and Estonia were roughly the same size, now Finnish GDP is around €148 billion whereas Estonian GDP is €11.5 billion, even with impressive growth rates recently seen in Estonia, as with the other newer Member States in the region, it will take a considerable time to reach parity if it is just left up to the market. That said, the accession of Estonia, Latvia, Lithuania and Poland to the EU has afforded the EU and the Baltic Sea Region with a new competitive advantage. The region boasts economies with hi-tech companies able to compete on the global economic stage and points the way for the rest of the EU to follow. The region also has much to contribute to European growth and competitiveness thanks to the highly skilled workforce that is a common feature across the region. Therefore it makes clear sense, to further develop specific EU projects and programmes, not only to help re-unite and re-balance the region but also to maximise the economic potential which is latent in the region for the benefit of the Union as a whole.

The EU does support many significant projects in the region through the EU budget, and indeed the work of INTERREG is notable in delivering specific projects to the benefit of the region, such as the EcoForum Baltic. EU support for cross-border territorial co-operation is also noteworthy as is co-operation across sea borders, thanks to the wider scope under Regional Policy rules allowing co-operation across coastlines separated by up to 150km to be supported. While the detail of EU programmes has been adjusted in many areas of EU activity to reflect the realities of the 2004, enlargement it is at the level of over-arching policy that requires attention in order to bring about the necessary

reforms of EU policy towards the Baltic Sea Region. At the beginning of the current mandate of the European Parliament, MEPs from the 8 Member States surrounding the Baltic Sea and some others from further afield formed an Intergroup in the European Parliament to examine and discuss EU policy towards the region. It quickly became apparent that in order to right the balance and encourage the recovery from economic dis-location that was a by-product of the divided Baltic Sea, a specific strategy was required. In 2005 we formed a Working Group, chaired by Toomas Hendrik Ilves, to draw up such a Strategy. The document which emerged from this process "An EU Strategy for the Baltic Sea Region" was presented to European Commission President José Manuel Barroso in November 2005 and was followed up the following year with a European Parliament Report, written by Alexander Stubb MEP on "a Baltic Sea Strategy for the Northern Dimension". The central idea in both of these documents was that the Baltic Sea Region is now re-united within the EU and with 8 out of 9 of the littoral States as EU members the potential of the region should be maximised at EU level.

The Strategy envisages EU action in four areas; the environment, the economy, culture and education and security and solidarity. With the Baltic Sea almost an internal EU Sea, the special and fragile state of the ecology of the Baltic Sea is in need of particularly urgent EU action and support. The Northern Dimension programme has done much in the St. Petersburg region to improve water quality and reduce pollutants. However, the effect of eutrophication and concerns over the increasing levels of oil tanker traffic are matters of considerable significance for the whole region. On the economy, a policy area of crucial importance to the Union's employment and growth agenda, the strategy calls for the full implementation of the EU's Single Market Four Freedoms throughout the region in order to fully tap into the rich seam of dynamism and opportunity the Baltic Sea Region has to offer, energy security and supply is also of note in the Strategy. The Culture and Education category celebrates the vibrant culture of the Baltic Sea Region and encourages EU policy to support the creation of centres of excellence to further develop the region's advances into the new economy. Under Security and Solidarity the Strategy, the Strategy focuses on the problems of human trafficking and an increased level of co-operation with Europol on smuggling as well as action to reduce the queues at the border with Russia.

The European Parliament's Baltic Europe Intergroup is now liaising with both the Council of Ministers and Commission to encourage the formal adoption and implementation of the EU-Baltic Strategy so that it may be in place and well under way during this Parliament's term of office.

*Christopher Beazley*

*Member of the European Parliament*



## Elections in Russia - what turn in the relations to the EU?

By Henrik Lax

The Russian parliamentary election concluded as every forecast had predicted; United Russia, headed by President Vladimir Putin, won a landslide and will have a two-thirds majority in the state Duma. The overwhelming victory of United Russia is a sign that the West has failed to understand Russia. The Russian society is very complex and hard to understand for a non-Russian. President Putin has used every possible means to exploit the insecurity experienced by fellow Russians. The election outcome clearly shows that his strategy to put emphasis on security, stability and restoration of national pride has paid off.

I think the reason why Mr Putin and United Russia not only had to win the election, but get a high voting turnout has to do with Mr Putin's own future. This result will give Mr Putin a mandate to remain in power after he steps down as president in 2008, a totally new situation that would entail opportunities, but also threatening risks. How will this effect the cooperation between Russia and the European Union? What will the impact be for the Baltic Sea Region? Can we in Finland feel secure with the far-reaching plans for the Nord Stream pipeline to be drawn in Finnish territorial waters?

Just prior to the Russian election I visited Moscow, as a member of a three-man's delegation from European Parliaments Liberal Group. The aim of the visit was to get an idea of the chances to reach a new partnership agreement between the EU and Russia. The old agreement will soon expire.

Our visit was of course heavily affected by the upcoming elections. I must admit that I was appalled by the harshness of action on behalf of the authorities. Many opposition demonstrators were arrested and brutally terrorized. United Russia, the main pro-Kremlin party, pushed the government authorities to use their power to threaten both the opposition's candidates as well as campaign workers. Mr Putin's accusation that the oppositions parties are anti-Russian and that they are forming coalitions with Russia's "evil" neighbouring countries definitely surprised me.

Despite these atrocities and the fact that the elections in Russia failed to meet any standards for democratic elections, we need cooperation. If we want to have a secure future in the Baltic Sea region, I realize that it is crucial not to close the doors between Russia and the EU. With a secure future I refer to safety, but also to stability in energy supply and legal ways of doing business. Both Russia and the EU emphasize the importance of having a new partnership agreement. The recent parliamentary election, however, may obstruct a sincere dialogue between the two parties. The question that remains is: "How will the two partners come to an agreement" if not even fundamental notions such as human rights, democracy and the rule of law are equally defined?

The Russian business indeed understands that the rest and the west is a huge marketplace, with harsh competition. Important to note is that the commercial interest of big businesses is closely linked to the foreign policy of countries,

and therefore a partnership agreement between Russia and the EU is crucial for the business.

At the moment, power in Russia is synonymous with the president. This might change after the presidential elections in March 2008. All the businesses, the financial institutions, the bureaucracy, and everyone else nervously await how the power will be divided after the presidential elections. How should one position one-self to be able to keep the business and the power of today?

What turn will the relations between Russia and the EU take? The official Russia claims that it can do without the EU. Russia is not interested in strong formal links with the EU but prefers to play out countries against each other. The Russians cannot see why human rights should influence discussions on energy supply.

Many experts with whom I spoke clearly stated that Russia indeed is in need of western know-how to solve its deep societal issues. I agree with the experts. The future of the Baltic Sea region is dependent upon how these relations will evolve. One thing is sure, much depends on how Putin will play the hand he has won. Equally important is how Finland and other EU-member states play their cards.

Business wise both Russia and the EU are dependent on each other. The EU is in sincere need of gas and Russia needs export revenues, thus the birth and geographical placing of the Nord Stream project is understandable. The Baltic Sea is the most important export route for Russia.

The pipeline plans, though, have terrified the citizens of the Baltic Sea region. I do understand this feeling, but instead of regarding the Nord Stream project as a treat, we should seize this opportunity and see the pipeline as a first step in a confidence building exercise between the EU and Russia. Before the project can become reality, the EU shall demand a thorough environmental impact assessment. Furthermore, the EU must demand a guarantee that will secure the Baltic Sea region if the pipeline will cause any damage to it. Finally, the operation of the pipeline should be made transparent by appointing a supervisory board with representatives from all the countries bordering the Baltic Sea.

There is a clear need of confidence building measures between Russia and the EU. It could be tactically wise if the EU started this process by putting emphasis on soft security issues, such as the environment, in order to get Russia on board. It will still take a long time before Russia will become strong, countable and predictable. To find a common path between the EU and Russia, the EU will have to show firmness, patience, unity and consistency.

*Henrik Lax*

*Member of the European Parliament*

## The Baltic Sea – beauty in serious danger

By Pertti Salolainen

The Baltic Sea is a sea of contradiction. On the one hand, being a product of the last glacial period, the Baltic has many unique characteristics. It is a sea of beautiful coasts and archipelagos and unique species. On the other hand – and what is frightening – is that the ecosystem of the Baltic Sea is very fragile and at the same time it is one of the most polluted seas in the world. Over the past 100 years the Baltic Sea has changed from a clear-water ecosystem to a eutrophic, nutrient-rich marine environment.

The Baltic Sea is very seriously sick and in need of intensive care. The most serious symptom is the continuing eutrophication. Nowadays, the Baltic Sea contains four times as much nitrogen and eight times as much phosphorus as it did in the early 1900s. This causes severe environmental degradation of the marine ecosystems. The most obvious effect is the yearly occurrence of algal blooms. In the summer, vast areas of the Baltic Sea are covered by greenish toxic slime which makes it impossible to swim in many places. On top of that, a staggering 70 000 km<sup>2</sup> of the Baltic sea-beds are totally or almost totally free of oxygen and by that biologically dead.

### Causes of the disease

A good starting point for the curing actions is that the causes of the malaise of the Baltic Sea are well known. A significant amount of the nutrients come from agriculture in the region. For example in the case of Finland, agriculture is the worst polluter of the coastal waters. And this necessitates major reductions in the release of nutrients.

In addition to agriculture, cities and other human settlements, heavy industry, traffic and shipping are important sources of nutrients. Moreover, oil shipping, especially from the Russian harbours in the Eastern Gulf of Finland but also from many other harbours, causes a very severe threat. The Baltic Sea is one of the busiest oil shipping routes in the world. A big oil accident at sea would cause tremendous and long lasting damage to the Baltic marine environment.

In the near future, the greatest threats to the Baltic Sea include for example Poland and St. Petersburg. If no concrete measures are taken in use, the release of the Polish agriculture into the Baltic Sea is expected to be doubled in relation to the present level once the farming subsidies from the EU begin to really affect Poland's agricultural production. Both the Common Agriculture Policy and the Baltic Sea Strategy need to tackle this problem.

Another ticking time bomb in the Baltic Sea Region is St. Petersburg. A lot of valuable work has already been done for the sewage treatment but this work could go down the drain if the waste from the growing agriculture and food production in St. Petersburg and in its neighbouring areas may run straight to the water systems. Given the massive size of and the number of animals in the piggeries and poultry farms in the area, they put a huge strain on the Baltic environment if measures are not taken.

### Cooperation and political will needed as medicaments

In order to tackle the disease of the Baltic Sea, more cooperation and political will is needed. For example in the Finnish Parliament, the worry about the Baltic Sea is common to all political parties. Recently, the Foreign Affairs Committee announced its report on the Baltic Sea and the Northern Dimension. The report was a strong statement from the Committee to the Government for renewing its policy towards the Baltic Sea.

Finland has been active in promoting the politics of the Northern Dimension within the European Union. According to the Foreign Affairs Committee, both a Baltic Sea Strategy and Northern Dimension Policy are needed and any dispute about their interrelationship should be forgotten. The European Commission and Parliament are working on the Baltic Sea Strategy which would be an internal policy. It needs to concentrate in the activities of the European Union in the Baltic Sea Region and one of its main objectives has to be to unite the Baltic Sea Region into a strong entity within the EU. Especially large countries such as Germany and Poland have to be closely involved in the rescuing process of the Baltic Sea.

The Member States located on the coast of the Baltic Sea need to find a single voice with which to speak in the European Union in order to make a difference and to emphasize the importance of the Baltic Sea for the whole Union for example economically. After all, the Baltic Sea region is one of the most dynamic parts of Europe. In particular, Finland and Sweden, which holds the EU Presidency in 2009, should cooperate and take an active role in pushing for a Baltic Sea Strategy within the EU and promoting cooperation in the Baltic Sea Region as a whole.

The Northern Dimension creates ways for effective activity in the North Western areas of Russia in the fields of environment, social and health policy and traffic and energy efficiency politics. After the reform carried out during the Finnish EU Presidency in 2006, the Northern Dimension Policy works rather well at the moment. In relation to the Baltic Sea Strategy, the Northern Dimension could act as EU's external interface with Russia. It is crucial to recognize Russia's role as one of the key players in the Baltic Sea Region. Stating this, both the economical and environmental aspects should be taken into account.

The recent adoption of the HELCOM Baltic Sea Action Plan in Krakow is a significant sign of the political will of the countries in the Baltic Sea Region to work together to reduce the pollution to the Baltic Sea by 2021. The plan puts its emphasis especially on curbing eutrophication, preventing pollution involving hazardous substances, improving maritime safety and accident response capacity and halting habitat destruction and the decline in biodiversity. One of the main objectives of the HELCOM Baltic Sea Action Plan is to achieve "clear water" which involves proposing provisional country-wise annual nutrient input reduction targets for both nitrogen and phosphorus.

The HELCOM Baltic Sea Action Plan is a result of active participation of all major stakeholders in the region, and it realizes that close cooperation with Russia is crucial for progress to be made in rescuing the Baltic Sea. Russia is the only country in the region that belongs to the HELCOM but not to the European Union. From the point of view of the Northern Dimension Policy, the HELCOM Baltic Sea Action Plan can be considered instrumental to its implementation. Overall, what is important now is that all parties commit themselves to the implementation of the Action Plan. Adopting the plan was an important step but a lot of work is required in order to assure its implementation.

In conclusion, the rescuing of the in many ways precious and unique Baltic Sea requires ever stronger political will and cooperation. For this, action and commitment of every one of

the nine countries surrounding the Baltic Sea, the whole EU and Russia are needed.

*Pertti Salolainen*

*Minister*

*Member of the Parliament of Finland*

*Chairman of the Foreign Affairs Committee*



## Investment climate in Russia: a Russian paradox?

By Blanka Kalinova

Russia's FDI inward stock amounted to more than USD 270 billion by the end of 2006 and inflows have continued to grow in 2007 to reach probably a record level (USD 37 billion from January to September 2007 according to the estimates of Russia's Central Bank). At the same time, most investor surveys and international comparisons continue to see Russia's investment climate as uncertain and risky and less favourable than in many other emerging economies. The question is how to explain this contradiction and understand why foreign investors, despite their reserved views on Russia's business environment, are ready to increase their commitments in the country. One possible explanation is expected high returns on investment, especially in the energy and natural resources sector which represents an important part of Russia's FDI, make foreign investors somewhat less "sensitive" to traditional investment barriers such as red tape and even corruption. However, this is obviously only a part of the answer.

What exactly do recent investor surveys and international comparisons say about Russia's investment climate? Some of these analyses are typical business surveys, based on questionnaires addressed to business representatives in the countries analysed. These include the EBRD/World Bank Business Environment and Enterprise Performance Surveys, regular questionnaires addressed by the Russian Centre for Economic and Financial Research (CEFIR) to firms operating in Russia and the World Bank Survey of Competitiveness and Investment Climate in Russia. Some others, such as the World Bank Worldwide Governance Indicators, the Index of Economic Freedom, the Competitiveness Indexes by the Institute of Management and Development and the World Economic Forum are essentially perceptions-based indicators based on experts' evaluations of various elements considered relevant for political and economic developments. These studies present country rankings allowing for international comparisons and provide time-series that assess and compare the evolution of the business climate in individual countries. The World Bank "Doing Business" database belongs to the category of facts-based indicators, which compare selected measurable facts considered to be important elements of the business climate, such as costs, time and number of procedures for starting or closing a business in analysed countries.

Although it is difficult to sum up findings based on diverse methodologies and data, certain patterns characterising recent developments in Russia's investment climate can be identified.

Since 2000, two periods of perceptions of Russia's business environment have been observed. Most surveys confirm that favourable developments took place between 2000 and 2003, reflecting the gradually improving macroeconomic situation after the 1998 financial crisis and the government's sustained reform efforts, in particular with respect to reducing the tax burden and facilitating licensing and inspection requirements. However, from 2004 onwards, the favourable trend appears to be less straightforward and several surveys indicate deterioration in the perception of Russia's regulatory environment by both insiders and external observers. For example, Russia's performance has worsened since 2004 according to the World Bank Governance Indicators of Government Effectiveness and Regulatory Quality and has not significantly evolved for the Rule of Law and Control of Corruption. The diminishing of the favourable trend means that the Russian government

has not fully taken advantage of positive economic developments to pursue a more ambitious reform agenda.

Another observation that can be made from recent business surveys and assessments is that despite some progress, especially between 2000 and 2003, Russia's business environment is still perceived as inferior compared to the benchmark represented by developed countries. It is also less favourable in certain respects than in the countries which are Russia's main potential competitors, in particular Brazil, China and India. For instance, Russia's 2006 scores for the World Bank Governance Indicators of Government Efficiency, Regulatory Quality and Rule of Law are considerably lower, both compared to the OECD average and in relation to Brazil, India and China. A number of other international comparisons also show Russia's ranking behind these three countries (i.e. Economic Freedom of the Heritage Foundation, Bertelsmann's Management Index) or behind at least two of them (i.e. World Economic Forum's Global Competitiveness and Institute for Management and Development's World Competitiveness).

The third and perhaps most striking observation is that many available surveys and comparative assessments reveal particular features which, though not specific to Russia, are particularly pronounced in this country. One such salient element is the large gap observed between formal restrictions, which could be considered relatively moderate, and higher than usual informal barriers faced by business operators and investors in Russia. This feature is usually reflected in Russia's very low rating in corruption and elements relating to the rule-of-law which are reported by most available studies. Some surveys capture specific difficulties met by various types of firms in Russia. The World Bank Survey of Competitiveness and Investment Climate in Russia highlights that more acute barriers are faced by small and medium-sized enterprises than by large firms, in particular with regard to regulatory and policy uncertainty. The regular surveys by the Centre for Economic and Financial Research (CEFIR) show persisting regional differences in the implementation by regional and local authorities of legal and regulatory measures. Unequal treatment of different types of firms at the regional and local levels thus appears to be one of the most serious problems in Russia's business environment.

Existing investor surveys do not yet adequately cover responsible business conduct practices, although these have become an increasingly important element for evaluating reliability and credibility of investment partners. Weak observance of standards of responsible business conduct could be one of the other reasons why some emerging market economies, especially Russia, are not perceived as fair and reliable investment partners, even if their investment conditions are considered relatively favourable.

The ambivalent attitude of the Russian government toward foreign investment could be another reason why Russia is not yet seen as an investment-friendly destination. The 2005 legislations on Special Economic Zones and on Concessions have been viewed as a positive sign towards private, including foreign, investment. However, these initiatives have brought only limited results to date. The law on strategic sectors, proposed by President Putin in April 2005 but still waiting for approval by the Duma, was initially welcomed by foreign investors hoping to see ad hoc decisions being replaced by more predictable and clear authorisation procedures. However, in its current form the draft bill has a large sectoral coverage going beyond the

traditional areas of national security interests as it also includes, for example, natural monopolies. Finally, the most controversial aspect of Russia's investment climate is growing state-control over large segments of the Russian economy.

The "Russian paradox" thus seems to reflect the dual character of the Russian economy and some ambivalence in Russia's international economic opening. Some segments of the Russian economy have become increasingly open to private, including foreign, investment and internationalised through their investment abroad. This is the case, for instance, for mobile telephones, retail distribution and, to a certain extent, the electricity sector. At the same time, some other sectors, especially oil and gas upstream activities and energy transport have been increasingly subject to state control and political interference and their governance structure has become less transparent, with negative consequences for their business credentials abroad.

The remedies to deal with the Russian paradox are relatively easy to define in general policy terms: enhancing policy transparency and predictability, accepting liberalisation commitments in particular in the WTO and the Energy Charter Treaty, clarifying the legal investment framework, especially for strategic sectors and energy investment and,

last but not least, promoting an active competition policy to ensure a level playing field for all firms. This is of course easier said than done but, without reinvigorated reform efforts, Russia's modernisation and diversification process will have difficulty advancing.

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The article is partly based on material collected for the next OECD Investment Policy Review of the Russian Federation, which will be published in 2008. The article does not necessarily reflect the views of the OECD and its member countries.

## Russia forerunning EU in power sector forum

By Seppo Remes

Russia is the fourth largest user of electricity in the world, with roughly 210,000MW of capacity. A large part of the capacity is co-generation, adding heat to electricity generation. Until now practically all of the distribution, transmission and supply has been controlled by one company, RAO UES; in generation, UES controls almost everything except nuclear power. It is in a separate legal entity, Rosenergoatom, which will also in the future remain a 100% state-owned company. UES was organized as a holding structure, with subsidiaries in more than 70 regions – all of them vertically integrated monopolies with generation, distribution and supply businesses – and some 40 federal power stations as well as all Russian transmission lines. UES itself is 52% state-owned and its subsidiaries are owned 49-100% by UES. Mostly, the ownership of UES and the subsidiaries differs. UES was, and still is, everywhere in Russia; there is no corporation or any other institution comparable to it.

The reform of the Russian power sector started at the beginning of this decade, on the initiative of Anatoly Chubais, CEO of RAO UES. The very core of the reform has been to separate competitive businesses from natural monopolies, both legally, functionally and regulatory. Consequently, competitive parts – generation companies, supply/sales companies and service companies – have been separated into legally different companies from natural monopolies – from transmission company, distribution companies and system operator company. The competitive sector is in the process of full and complete market and price liberalization: all legal and regulative decisions have been already taken and confirmed by the Duma and Government. Thermal generation, supply and service companies will also be fully privatized.

The reform task was extremely difficult and complicated, in all respects. More than 70 vertically integrated regional companies - Energos - had to be divided into generation, distribution, transmission lines, supply and service companies on pro rata basis. After this, regional generation companies that were close to each other, were merged; the same took place with regional distribution companies. And you should remember that almost all of these companies had different shareholders, from whom it was necessary to gain support for the restructuring. The fact that the support was received has in turn provided evidence that valuations of different shares for mergers were done in a fair way. Thus, 14 regional power and heat companies were created. In addition, federal power stations and some of the largest stations inside regional Energos were merged into 6 thermal generation companies, combined by the extraterritorial principle and in a manner where each of them include both gas and coal-fired power stations. Average capacity of wholesale generation companies is 9.000MW and for regional power companies varies between 2.000 – 10.000MW. Furthermore, one big hydro generation company was created, putting together both federal hydro stations and larger hydro stations from regional Energos, with a capacity of more than 23.000MW. We can conclude that 14 regional and 7 federal generation companies, plus Rosenergoatom, will guarantee the existence of competition in power generation.

The Russian government has decided to fully privatize 20 of the 21 newly-created generation companies. Roughly half of them have already been privatized, usually by a combination of a sale of the government stake and a new share emission to attract money for necessary new

investments. New owners are both Russian and foreign: Enel, E.On, Fortum and probably also French, Czech and Asian companies. Income from privatizations is re-invested in power grids, distribution and hydro generation. I do not have any reasons to doubt that the process of privatizations will be finalized: there is an urgent need for huge investment in the power sector – a figure of USD 100bn in 5 years has been on the table - and it is not rational to burden only the state budget with those investments. Market and price liberalization is meant as a kind of guarantee of attracting private investments. Today, already 20% or so of electricity is sold at liberalized prices and the figure will gradually increase, twice a year, to reach 100% at the beginning of 2011. The new domestic gas prices system, netback pricing, tied to export prices, is being introduced in a synchronized manner along with the power market liberalization, to enable an increase in gas production and sales to domestic markets, including power stations.

The high-voltage grid will be 75% owned and controlled by the Russian government: it is the skeleton of the wholesale markets and cannot be in the hands of market players if fair access to the net for all generators and sales companies is to be guaranteed. The Russian state also wants, at least for the time being, to control distribution companies via national distribution holding, under which 11 inter-regional distribution companies will be created. Because of the monopolistic nature of the business, direct regulation is needed. However, it will no longer be the cost-plus method (which punishes those who are more effective), but a system of RAB; a regulatory asset base tariff system. RAB guarantees each distribution company a certain IRR, let's say 11% annually, which enables new investments; tariffs are defined for 5 years and those able to be more efficient will improve their profits. For the next 5-year period, the regulator defines new tariffs from the more efficient production levels achieved by companies during the last time period. Thus, the market mechanism functions even in a monopoly sector, and in the interests of consumers and businesses.

Russia will have some special features in its power sector, not typical for example in well-functioning Nordic markets. The first is the existence of a centralized System Operator, which is responsible for the demand/supply balance, safety and security reserves in the system, including the assessment of the need for new investments. Its supervision systems are already synchronized with the Russian trading system, ATS, thus enabling market signals to be directly channeled to system balance and security management. The other element is a capacity payment system: as well as electricity trading, existing and yet-to-be-constructed capacities are traded on markets. Capacity payments cover the fixed costs, while electricity payments cover the variable costs. Capacity payments allow markets to react earlier to foreseeable capacity deficits; selling yet-to-be-constructed capacity beforehand gives "investment guarantees" for new construction, and thus, most probably, greatly smoothens market volatility. Markets do not need to wait until there is deficit of capacity but can start to build it earlier than in a system of pure electricity sales. System security will also improve.

It is of utmost importance for the future, to prevent the creation of any monopoly structures on the markets. UES is suggesting a change in the law allowing the Antimonopoly Agency to interfere immediately when the share of any company in any regional free-flow markets (perhaps some

10 areas in Russia) grows over 20%, including measures such as very high penalties and the spin-off of some power station(s) from the company. It is also very important to get binding guarantees and an absolutely transparent system of third party access to trunk and other gas pipelines. We are convinced that the Russian government shares our worries of the risks of monopolization and will support these UES proposals.

It is no exaggeration to conclude that Russia is ahead of the EU in the reform of the power sector and power sector monopolies. We have been able to create very sophisticated markets, with new elements, and with rational elements to

the regulations. 1 July 2008 UES ceases to exist, giving thus impetus both for economic growth and market reforms in Russia.

*Seppo Remes*

*UES, Member of the Board*

*EOS Russia, Chairman of the Board*

*Russia*

## A Baltic perspective on OMV's bid for MOL

By Kalman Kalotay

Activities of the Austrian oil company OMV and its Hungarian peer MOL seem to take place faraway from the Baltic region. Therefore, for a Baltic observer, their fierce fight for market leadership in Central and South-East Europe could be a distant event. But the Baltics and Central Europe are linked by countries such as Poland and Germany, and share various common characteristics. If Russia is counted apart, both subregions are home of fairly small net oil importing countries; and the relatively small oil companies of both areas focus mostly on downstream activities. In the same vein, in many of these companies, State ownership is important (just like in the case of Russian firms). Moreover, in the transition economies of both subregions, foreign investors are important players in the downstream oil and gas industry. Hence the outcome of the fight between the largest State-controlled and private oil firms of Central Europe could influence Baltic thinking on similar issues.

### A glimpse at the Baltics and Central Europe in the European oil industry

The European oil industry consists of three types of companies (see table):

- in Western Europe, there are large privately owned transnational corporations (TNCs), such as Royal Dutch Shell (UK/Netherlands) or BP (UK), of market values and turnover in hundreds of billions of dollars;
- in Russia, State-owned Gazprom rivals in size with privately owned TNCs; and so do fast growing Rosneft (again State-owned) and Lukoil (private), with market capitalizations of over \$50 billion;
- compared to these Western and Eastern giants, even the most advanced champions of the Baltic region or Central Europe are dwarves (with the exception of Norway's Statoil, and Germany's E.ON – but the latter is usually classified as a public utility firm, and not an oil and gas company per se). Another specialty of the Baltics and Central Europe is the importance of foreign direct investment in the downstream oil and gas industry in their transition economies (including Estonia, Latvia, Lithuania, as well as the Czech Republic, Hungary and Slovakia). As for the list of lead investors in oil and gas, they are somewhat similar: the three Baltic States are split between Germany's E.ON and Russia's Gazprom (and Poland's PKN Orlen in Lithuania), while in Central Europe, they include E.ON again (in Hungary's natural gas industry), Poland's PKN Orlen again (in the Czech Republic), as well as Hungary's MOL (in Slovakia).

Size differences mean that even if the smaller TNCs of the Baltics and Central Europe envisage fast growth in the near future, and two of them combine their resources through a merger, they still can not compete with the size of either Western or Russian giants. No wonder that with the exception of the Hungarian State, which in 2004 took the risk of selling all but one of its remaining shares in MOL, the governments of these countries are hesitant to divest from their national champions.

Within this European context, Austria's OMV and Hungary's MOL have followed different corporate strategies.

- Founded in 1956, OMV, the larger of the two competitors, has remained a company controlled and

influenced by the State (31.5% ownership as of today). In addition, the International Petroleum Investment Company of the Abu Dhabi State controls more than 17% of the shares.

- In turn, MOL, the smaller but faster growing company, which was founded only in 1991 from various elements of the State-run petroleum industry of Hungary, has become a company partly owned by management itself, and partly by institutional investors, mostly from abroad.

The geographical reach of the two companies also varies. Some of the key affiliates of OMV include OMV of Libya (exploration and production), Ring Oil (Russia, exploration), Petrom (Romania, integrated oil and gas company). OMV is also minority, but important, shareholder in the Bayernoil Raffineriegesellschaft (Germany, refinery), Petrol Ofisi (Turkey, retail and wholesale), and MOL proper, in which it owns a 20% share. This picture indicates that OMV has a broad geographical spread in exploration than MOL, and its geographical interests include both the area West of Austria (e.g. Germany) and South-East Europe.

In turn, MOL's key shareholdings include BaiTex (Russia, exploration and production), Italiana Energia e Servizi (Italy, refinery), MOL Romania (retail and wholesale), Slovnaft (Slovakia, refinery and trade), and Energopetrol (Bosnia and Herzegovina, retail and wholesale). It is also a minority shareholder in Croatia's INA. Compared to OMV, MOL explores more in Russia, and focuses its downstream interests in a geographical area spanning from Slovakia through Hungary into Croatia and Bosnia and Herzegovina. This way, it plays an important role in countries in which OMV has a relatively weaker position, plus it is a major competitor to OMV in Romania.

It was not in the autumn of 2007 that MOL has been mentioned for the first time as a potential participant of a merger. In 2004, it was thought to be in merger talks with Poland's PKN Orlen, a company with roughly equal size of MOL (table 1), and a complementary profile, with a presence both in the Baltics and Central Europe (owning the Mažeikių Nafta refinery in Lithuania, the oil company UniPetrol in the Czech Republic, and petrol stations in Germany). It is also understandable from the point of view of MOL that a marriage of equals with PKN Orlen would have been preferable, while seen as a potential threat for OMV's geographical ambitions. In addition, MOL, as well as OMV, have been rumoured from time to time being a potential target for Russian oil and gas firms.

MOL is an attractive target for OMV because it is a new and very dynamic private company; it has modern and efficient refineries near Budapest and in Bratislava (Slovakia); it has an attractive geographical presence in fast growing markets; and thanks to its good management, it is one of the most profitable oil and gas companies in Europe (table 1). Indeed, in 2006 only global gas monopolist Gazprom could boast a higher net income ratio (21%) than MOL (13%). Conversely, OMV was in the low profitability ratio, with 7% only. Hence, once taken over by a less efficient firm, MOL would risk being the cash cow for bankrolling the less efficient activities of the buyer and dominant partner.

### The OMV “bid” and the lex MOL

While the open battle for the control of MOL started in September 2007, the two parties began discretely their preparations at least two months before. MOL management started buying back its own shares, in order to exceed 25%, a threshold that enables them to block any change in the charter of the company. In turn, OMV began to increase without fanfare its share (from 10 to 20%) in MOL. OMV's purchases were this time made secretly and hence the first speculations were that it was acting as a front man for a Russian firm.

OMV did not make an official bid for MOL in a legal sense but published, on 25 September 2007, a “Declaration of Intent to combine OMV and MOL”. It offered a significant premium over MOL's share price, in exchange for letting it control the firm. In particular, it invited the company to drop from the charter of the company the special provision stipulating that no stakeholder may have a voting right in excess of 10%, even if its ownership share is above that level. OMV claimed the merger would result in major synergies in a company that would be equally controlled and traded in Austria and Hungary.

In response, MOL criticized OMV for not presenting a formal offer to shareholders according to relevant capital market regulations. It also argued that OMV's approach substantially undervalued MOL and would destroy value, due to potential losses arising from a disposal programme that would be required by anti-trust authorities. MOL pointed at two areas of value destruction: refineries; and petrol stations in Austria and Romania. In general, MOL argued that they are a more modern and efficient private firm, and for this reason, being bought by a State-owned entity, with its strategy influenced strongly by the home government, would be a step back in development. In addition, that would lead to another type of value destruction, as well managed assets would pass into the hands of less efficient managers. Although the Austrian minister of economy suggested that Hungarian State, too, should buy 25% of MOL before the merger, the Hungarian Government did not accept it, not just because the State had no \$4 billion in the budget to do so, but also it could be asked why to go back in history if the fully privatized firm performs well.

In a controversial counter-move, the Hungarian parliament decided instead to promulgate in October 2007 a new law on strategic companies (gas and electricity firms). This law dubbed “lex MOL” mandates that the sale of principal assets of strategic companies require approval by the highest body of the company, plus any official takeover bid should include a business plan, submitted to the Securities and Exchange Commission. In addition, management of the target companies would be entitled to carry out certain measures, such as buy more treasury shares or raise equity, even after learning about an official bid. This law is under investigation by the EU. However, it is not expected to change radically after eventual objections from Brussels, as it does not directly affect the right of establishment of EU companies, nor does it discriminate by nationality. In turn, it is legitimate to ask if this reaction to the OMV bid was excessive, and would hinder future efforts towards the consolidation of the industry.

The conflict seems to be in a long-run stalemate:

- OMV has indicated that it can wait for a long time. It can also convince the institutional shareholders of the MOL to take advantages of the short term gains offered by the OMV bid. With that, it can further increase its shareholding in

MOL up to 25%. (Beyond that, it would be legally bound to make a public bid.) However, it can do nothing to eliminate the 10% voting cap unless the companies general meeting votes so, and consequently, the 25%-plus blocking share owned by MOL management. That may be a costly use of financial resources, and detrimental to OMV's already not-so-high profitability.

- In turn, MOL's management may be obliged to hold on to its shares in order to block OMV permanently, and this can affect its plans to continue growing abroad quickly. Alternatively, it can search for another, more equal merger partner, such as PKN Orlen of Poland, which, as mentioned above, was already thought to be in merger talks with MOL in 2000.

### Consequences for the Baltic region

The Baltic region is probably faraway from the OMV-MOL conflict, although it may feel its implications:

- To varying degrees, E.On and Gazprom are both present in Austria and Hungary, and hence will be affected by the outcome of the MOL/OMV case.

- If PKN Orlen, which is already present in both the Baltics (Lithuania) and Central Europe (Czech Republic), were brought into the consolidation of the industry, the Baltic region would further be involved in the solution of the MOL/OMV competition.

- Independently of the final outcome, the OMV bid should have far reaching consequences for the future of privatization and private ownership of oil and gas companies in the Baltics (as well as other parts of Europe). In brief, it should have a major negative, chilling effect on privatization plans, prompting governments keeping or increasing their shares in strategic companies, instead of selling them. We should also take into consideration that, while in various transition economies such as Lithuania and Poland, the state has kept only minority interests in oil companies, Neste of Finland and Statoil of Norway are still majority State owned.

- The lex MOL and its acceptance or rejection in Brussels will have far reaching implications for EU member countries' similar legislations on hostile takeovers. In other words, it will indicate to the Baltic members of the EU how far they can go with severing the legal protection of “strategic” companies.

- The MOL/OMV case can also affect eventually how many future takeovers will take place in the Baltic region, and under what conditions.

- The OMV/Mol case can also affect the ways how in the future private oil companies will design their own internal rules aiming at preventing hostile takeovers. Voting caps, in particular, may become popular.

- Finally, the MOL/OMV case has also implications for the attitude of small national oil companies of net importer countries with large Russian TNCs. They can better understand that it is illusory to believe that a Central European, or Baltic, downstream champion, created from the merger of two, or various, national firms, would stop the expansion of Russian firms into the subregion. On the contrary. These “champions” would be still too small compared to the Russian giants, but sufficiently large enough to be attractive for them in their quest of better controlling the downstream activities. Moreover, even if these firms grow their exploration activities quickly, they will not match the huge upstream reserves of Russian companies.

• Baltic and Central European oil firms are obliged to cooperate closely with Russian (or CIS) upstream firms, independently of the level of consolidation in the industry. Russian companies can also prefer cooperation with, rather than takeover of, local firms if that is a less costly, more stable and more efficient solution to the question of control over the downstream market. They may also take into consideration that more State interest in oil and gas firms is not a Hungarian, or Central European, or Baltic, specialty but a global trend, started by some countries including Russia itself. Hence, conflict minimizing strategies are needed to placate increasingly heated national interests in host countries, prompting all TNCs, including Russian ones, to

adopt the cooperation/joint venture route with local partners, whenever possible.

OMV promised it could wait up to two years for MOL's answer. A sequel to this analysis is then due in late 2009.

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Note: The views in this analysis are those of the author and do not necessarily reflect the opinion of the United Nations.

Table 1. Financial performance of selected European oil and gas firms, 2006

Company	Home	State ownership	Market value end 2006 (\$bn)	Turnover year 2006 (\$bn)	Net income (\$bn)	Profitability
Gazprom	Russian Federation	50.1%	271.8	60.1	12.6	21.1%
Royal Dutch Shell	United Kingdom /Netherlands	-	214.0	318.8	25.4	8.0%
BP	United Kingdom	-	208.8	265.9	22.0	8.3%
E.ON*	Germany	-	93.2	85.6	6.7	7.9%
Rosneft	Russian Federation	50.1%	83.9	33.1	3.5	10.7%
Lukoil	Russian Federation	-	73.6	67.7	7.5	11.1%
Statoil	Norway	64.0%	59.4	69.6	6.7	9.6%
OMV	Austria	31.5%	18.7	25.3	1.8	7.3%
MOL	Hungary	0.1%	15.0	14.2	1.9	13.2%
Neste Oil	Finland	50.1%	8.8	17.0	0.8	5.0%
PKN Orlen	Poland	10.2%	7.1	14.2	1.6	11.1%
Lundin Petroleum	Sweden	-	3.6	0.6	0.1	18.0%
Lietuvos Dujos	Lithuania	17.7%	3.3	1.4	0.1	9.2%

Source: The author's collection, based on company reports, and data derived from the FT-Europe 500.

## Imatra – a Finnish border town in the economic region of St. Petersburg

By Pertti Lintunen

Imatra became a self-governing municipality when the rural municipalities of Ruokolahti, Joutseno and a small part of the Jääski rural community were joined together after the WWII 60 years ago. Later on, Imatra was granted town rights. The greatest part of Jääski including the industrial community of Enso, which is today known as Svetogorsk, was left on the Soviet Union's side. Being both situated close to the border, Svetogorsk and Imatra are neighbouring towns. Currently, Imatra has approximately 30,000 and Svetogorsk 16,000 inhabitants. Approximately two per cent of the inhabitants of Imatra have an immigrant background, most of them originating from Russia.

### The border

Southeastern Finland boasts three international border-crossing points (Vaalimaa, Nuijamaa, and Imatra) for road traffic, one international border-crossing point for rail traffic (Vainikkala), and the Saimaa Canal for water traffic. Every year, the volume of traffic increases at all border-crossing points. A significant proportion of imported goods passes to Russia through Finnish ports as transit traffic. For example, an estimated number of 700,000 cars will be imported via Finland to Russia this year. The increasing heavy vehicle traffic is placing pressure not only on the roads in Southeast Finland but also on the border-crossing points, where they create queues and other inconveniences. Not only do these problems continually increase in severity, but it also appears that no quick solutions are to be found. Currently, a daily average of 1,500 vehicles crosses the border at the border-crossing points in Southeast Finland, of which the proportion of Imatra is approximately 300. The Finnish Road Association has estimated that the border traffic will increase 50 per cent by 2012.

Imatra has a unique location at the Finno-Russian border. The border-crossing point is located in a place, where the urban structure and services are immediately available on both sides of the border. No similar conditions exist anywhere else at the Finno-Russian border. The border-crossing point is unique also because it features both road and railway connection. In addition to this, border can be crossed by using a bicycle, which enables quick visits to the neighbouring town. The border-crossing point is open 24 hours a day apart from the railway traffic. The railway connection does not yet serve international traffic but is mainly used as a timber transportation route from Russia to Finnish wood processing plants, to which separate contracts are applied. In the near future, the objective is to start a 24-hour international border-crossing point also for railway traffic.

The location of Imatra facilitates the development of trade and business operations by utilizing the advantages offered by the border region. At its best, this cooperation promotes employment and welfare on both sides of the border. The giant American International Paper (IP), the owner of a big pulp and paper combine and a major employer in Svetogorsk, offers a good example. In addition to providing

jobs, the mill supports the repair of streets, kindergartens, schools, and the hospital in the town. Every day, approx. 30 persons commute to the mill from Finland, most of them from Imatra. In addition to this, the mills buy subcontracting services from Finnish companies, especially in fields of maintenance and construction.

### St. Petersburg

Imatra is situated only approx. 200 kilometres from St. Petersburg, which together with its neighbouring regions forms a metropolis of almost 7 million inhabitants. Measured by its population, St. Petersburg is by far the biggest economic area in the Baltic Sea region, while being the 4th largest city in land area. Since its foundation a good three hundred years ago, St. Petersburg has generated job opportunities, entrepreneurship, and vitality in its surrounding areas, which has also benefited the people living on the Finnish side of the border. The 70-year period of communism – referred to by one Finnish expert as “a temporary market disorder” – and the compulsory deliveries after the WWII broke off this natural and historical connection between the border regions. These bitter memories live on in the minds of the people, but the times are changing and the historical connection is about to be revived.

Throughout the 2000s, the Russian economy has been growing an average of 6 per cent a year. The fast development of the economy in St. Petersburg and the growth of consumer demand in particular are reflected in the trade and tourism sectors of Southeast Finland. When an international border-crossing point started in Imatra in 2003, some 50,000 Russian tourists visited Finland. During the past four years, the number of tourists has tripled, almost reaching 150,000 in 2006. The amount of tax-free sales in Imatra and the nearby City of Lappeenranta has increased to over 20 million euros a year. From this, the proportion of Imatra is approximately one third. The strong growth continues. In the period between July last year and July this year, tax free sales increased over 70 per cent in Imatra and over 50 per cent in Lappeenranta. It should be noticed, however, that the share of tax-free sales only account for one fifth of the total volume of sales made by Russians in Finland. Imatra also ranks high in the accommodation statistics. Studies show that the occupation ratio of hotels in Imatra is one of the highest in the entire country, which is the result of the growing number of Russian tourists in particular. For instance, the occupation ratio of Imatra Spa, a popular tourist destination, has during the recent years constantly been over 80 per cent.

*Pertti Lintunen*

*Mayor*

*Town of Imatra*

## Russia's policy towards Central – Eastern Europe after the EU enlargement

By Marek Menkiszak

The year 2004 has brought historical geopolitical change in Europe. Double, NATO (March) and EU (May), enlargement to the east has symbolically ended, after almost 60 years, artificial division of Europe bringing countries of Central and Eastern Europe (CEE) back to the family of democratic Western nations. This made the relationship between the enlarged EU and its major eastern neighbour - Russian Federation even more important. In Moscow these events were received without enthusiasm. The Central – Eastern Europe couldn't play any more a role of a buffer zone between the West and CIS area as some Russian politicians and experts suggested in the 1990s. Russia, counting its hypothetical losses, made a lot of effort for the last few years, and especially last months, before the 2004 enlargement to encourage Brussels to make as many economic and political concessions as possible. Moscow cared first of all about its delivery of energy resources and steel products to the new member states, its transit to Kaliningrad enclave and further to the west, EU veterinary and antidumping procedures, visa regime and the situation of Russian-speaking population in the Baltics. These concerns were partly addressed by the EU in joint statement of April 2004 paving the way to end the crisis over protocol on extension of the PCA to the new EU members, signing of which Russia made conditional on accepting its postulates.

Contrary to some Russian prognosis, new environment of CEE – Russia relations has helped to increase dynamic of the economic and political relationships. Moscow, after some time, has reacted to the EU enlargement by the activation of its policy towards the countries of the region. It was reflected both by the diplomatic exchange and economic activity. Between the beginning of 2005 and spring of 2006 Russian president Vladimir Putin paid visits to Poland, Slovakia, Hungary and Czech Republic (except the first case, it was the first visit of the Russian leader after more than 10 years). Between the end of 2004 and mid 2005 Russia and some CEE states (Poland, Hungary, Slovakia and Czech Republic) signed new framework agreements on economic cooperation. During the next one year period intergovernmental committees on economic cooperation were reactivated between Russia and Hungary, Czech Republic, Slovakia, Poland and Slovenia, often after few years of inactivity. Moreover, the Russian investment has grown visibly in most of the countries of the region, especially in energy, chemical sector, steel and machine industry. Trade volume has boomed (144 % rise with 6 CEE major partners between 2003 and 2006), however partly due to rise of prices for the Russian energy resources exported to the region. These all has marked kind of “return of Russia” to the CEE.

Worth to note was certain evolution of Russia's approach to the CEE states after the EU enlargement. In Russian official political rhetoric relations with CEE in the period immediately after the enlargement were often associated with crisis in the Russia – EU relations, which became visible especially since the end of 2003. New member states, sometimes described in Russia as the “newcomers”, were often collectively blamed for this crisis. They were accused for bringing to the EU its “Russophobia” and burden of prolonged problems with Moscow.

As Russia – CEE / EU relations has developed, after some one year period we could speak about a certain division of CEE in Russia's eyes. “Good neighbours” were those who pursued policy labeled in Moscow as pragmatic:

they made no serious attempts to decrease their energy resources dependency on Russia, were open for Russian business and for infrastructural projects, not rising problematic issues originated in turbulent history, avoiding criticising Russia's internal and foreign policy, open for Russian postulates towards EU and NATO and not very active in the Russian/EU “common neighbourhood”. Hungary, Slovakia, Bulgaria, Slovenia and Czech Republic could be to a large extent place in this group. Other group of “bad neighbours” were those whose policy was largely the opposite. Poland, Estonia, Latvia, Lithuania and to some extent Romania could be seen as the part of this group. Moscow has publicly complemented the countries of the first group sometimes rewarding them by the certain opening of its market (in energy, consumer and agricultural products) and some symbolic political gestures (like Moscow's expression of moral responsibility for Soviet military interventions in Hungary in 1956 and 1968 in Czechoslovakia, return of Sarospatak library to Hungary or placing Russian – US summit in Slovakia). Countries of the second group were often sharply criticised and most of them faced different types of economic sanctions from Russia (like blocking Russian oil transit in Latvia, oil supply disruption in Lithuania, temporary rail transit disruption and cyberattacks in Estonia, embargo for export of Polish meat and agricultural products).

During 2007 however, along with visible warming up of Latvian – Russian relations (as common border was legally regulated and economic relations developed) and certain cooling down of Russian – Czech relations (because of Russian campaign against projected radar deployment in Czech Republic as an element of the US strategic missile defence system) the picture has become more complicated. What is the result is rather Russia's individual approach towards particular CEE states based on Moscow's balance of interests. The region has been ultimately fragmented for Russia. On the other hand Moscow clearly tested EU solidarity with its campaign against Estonia and conflict over meat ban and new PCA with Poland. Futility of such Russian attempts to undermine this solidarity has become apparent.

Concluding, it is worth to note certain trends of Russia's policy towards CEE. Moscow to some extent “has discovered” CEE making its policy towards countries of the region visibly more active in the last few years. It was obviously connected with their membership in the European Union. Russia improving its, already important, economic position in the CEE to some extent has used countries of the region as a gateway and an instrument of its expansion in the EU common market. As a consequence CEE region is losing its former specific for Russia becoming integral part of Moscow's European policy. Certain specific however still linger in the security sphere as Moscow tries to maintain old, partly legally non binding, limitations of military activity in the CEE (no nuclear arms, no large foreign troops or military facilities).

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## Russia tries to control the transport routes of its own products itself

By Yrjö Myllylä

After the independence of the southern oil producing countries once belonging to the Soviet Union, Russia has become a more northern country seen from the energy producing point of view.

As a result of this change the importance of Ukraine, Byelorussia and Estonia is emphasized in the export of energy from Russia. This is due to the fact that in Russia the increasingly important oil and gas producing areas in West Siberia are connected with pipelines which go through these countries to Western Europe.

In southern Russia on the Black Sea only a hundred kilometres of coastline is left which the country can use for its energy transport and control itself. In oil transport through the Black Sea there is the risk of heavy traffic in the Bosphorus Straits in Turkey.

The countries of the EU form by far the most important buyers of Russian oil and gas products. The growth of the world economy, among other things as a result of the growth of the economy in China, as well as the unstable situation in the Middle East, raise the prices of oil and gas. These factors also increase the possibility of conflicts and accelerate the development of new transport routes for the needs of European buying countries.

Russia is trying to avoid economical and political risks in the export of energy by developing competitive, lucrative alternative transportation routes. Conflicts caused by the increased price of oil and gas pose risks to Russia. These conflicts are seen for example in disputes in transit payments when trying to adapt to market prices.

Russia has the right and obligation, for example along with the possible WTO membership, to avoid subventions and move to market based pricing in different products. Oil and the gas products get subventions in Russia. The country has sold gas and oil to the countries of the former Soviet Union clearly below the world market price.

However, Russia cannot avoid transit through Ukraine, Belarus or the Baltic States, as the oil and gas lines built during the Soviet regime form the central transit routes to Europe.

The Russian government decided in May 2005 on an approved traffic strategy to emphasize such transport routes, which the country could control itself and thus avoid economical and political risks influencing its economy.

The same pattern of development could be seen when Russia developed new oil pipeline and transportation infrastructure. As a manifestation of this trend can be seen the harbour of Primorsk (Koivisto) becoming the most important individual oil export harbour and the planned gas pipeline between the Finnish Gulf and Germany.

In connection with the Bronze soldier statue dispute in Estonia, Russia announced moving of [the oil transportation away from Estonian railways. This is also connected to the logistical change now taking place in Russia.

The logistical change in Russia is understandable, when studying the map. The country is the largest in the world measured by area. It is also a continent, so the transportation distances are long. North West Russia is an important gateway to world markets.

Russia has in North West Russia in practice two logistical points, which it can control. One is the innermost part of the Gulf of Finland and the other is the Murmansk Area. The role of the Gulf of Finland is the [most] more important in trade with Europe and already more than one third of Russian oil is exported through the Gulf of Finland. Ocean going tankers cannot come in through the shallow Gulf of Finland. The Murmansk direction is important especially in the overseas transportation as this is the only open sea harbour in North West Russia which is ice free round the year. Also restrictions in the traffic in the Baltic Sea may produce emphasis on Murmansk.

The European Union has a historical opportunity to influence development in Russia, because Russia is economically dependent on countries in the EU. As Russia's commercial relations with Asian countries grow stronger along with the new infrastructure, Europe's influence on Russia may decrease.

The EU must recognize Russia's rights to act on the terms of the market economy when it develops lucrative logistical routes. The political and economical risks are for Russia actual costs, which have to be taken into consideration. There should be a possibility to influence these costs through the Union in order to avoid problems, which arise for example during the transition period of energy prices.

Preventing of the threat of an oil disaster forms one of the areas for co-operation. Russia should be influenced in the direction that it fulfils the stipulations. At the same time it ought to be possible to contribute to that any agreement already made cannot be changed by one part for money or for example based on the political situation; corruption and along with this the impossibility to predict the situation is one of the biggest problem in Russia.

In my opinion, the most important task of EU is to integrate Russia in the Union using agreements. At this moment Russia strives to make energy delivery and investment related agreements directly with the largest European nations, such as Germany and France. The agreements do not necessarily take the interests of the small coastal states of the Baltic Sea into consideration. Due to this, it would be in the interest of the small nations to create a common will in the EU in respect to Russia and especially to energy co-operation with Russia. The historical task of the whole Union has in the past been to avoid energy disputes in the form of the earlier founded Steel and Coal Union.

Finland, as well as the other Northern European countries, has to take into consideration change in the geopolitical situation in Russia, which has increased the significance of the neighbouring areas to Finland and the area of the Baltic Sea in Russia's energy transportation.

In addition to preventing environmental threats, Russia's efforts to ensure vital transportation should be taken into consideration. From Finland's point of view, the most important is a policy, which increases the stability of Northern Europe. Disputes and threats related to energy transportation should be prevented in advance.

A practical way of creating a common sense of will between Russia and the countries belonging to EU in energy politics, is by using such methods in future research, where participation, analysis of results of interest groups and common learning of the future actors taking part in the research, is emphasised. One such method is the feedback-Delphi model created in my dissertation.

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*An expert on regional foresight*

*Oy Aluekehitys RD*



The author has carried out research on the future of North West Russia, especially the Murmansk Area, in this project financed by the Academy of Finland and led by Prof. Markku Tykkyläinen at the University of Joensuu during 2004-2007

## Baltic Europe 2050 challenges of the future, heritage of the past

By Antoni Kukliński

The Finnish Ministry of Foreign Affairs and the Finnish Institute in Rome have organized a Conference and have published a charming and path breaking book – Europe 2050 – Challenges of the Future – Heritage of the Past.

The conference and the book should be seen as an inspiration to discover a new perspective to analyze in a philosophical and holistic way the experiences and prospects of Baltic Europe. The most valuable contributions published in the Baltic Rim Economies are following the title of publication formulated inside a broad and yet restricted disciplinary field of economic and institutional sciences.

Maybe *hinc et nunc* it is possible to enter a transdisciplinary field inspired by philosophy, history and futurology.

In this context I would like to propose to organize a Conference and publication: Baltic Europe 2050 – Challenges of the Future – Heritage of the Past. The proposed Conference and Publication would have four features:

1) It will be a follow up of the book Europe 2050 with a specific orientation towards Baltic Europe.

2) It will be a creative laboratory of transdisciplinary thinking integrating the historical and prospective approaches.

This creative laboratory will incorporate:

- *primo* – the dynamic diagnosis of the transformation of Baltic Europe at the turn of the XX and XXI century,
- *secundo* – the visions of Baltic Europe as an element of the global scene of the 2050,
- *tertio* – the scenarios of the development of Baltic Europe in the years 2010-2050.

3) It will face the challenges to compare two civilizations – The Mediterranean and the Baltic Civilization.

For quite a long time I was trying to say that the experiences of Baltic Europe should be seen as a civilization analyzed in Braudelian perspectives. Maybe the proposed Conference could be organized by the Finnish Institute in

Rome (Villa Lante). I am expecting that the comparative reflection related to the Baltic and Mediterranean Civilizations will create a new bridge in the interpretation of the European Past and the European Future.

4) It will be an input into the grand debate “Europe 2050” which is emerging on the global horizon

This grand debate has not yet gained a strong intellectual and institutional take off. The European Union is still not ready to look into the mirror of the global scene of 2050.

This is not a deficiency of knowledge or even imagination. It is a deficiency of intellectual courage to discover the expected and unexpected faces of the future. The proposed Conference Baltic Europe 2050 could provide a demonstration effect promoting a pluralistic stream of thinking related to the Future of Europe *in toto*.

I am convinced that the brilliant Finnish diplomacy, science and culture will see in this suggestion an inspiration for our knowledge and imagination to see Baltic Europe in a new transdisciplinary brainstorming perspective. Especially important in this proposal is the comparative reflection related to the holistic vision of the past and the future of the Mediterranean Civilization and the Baltic Civilization.

The proposed Conference is not outside the open minded interpretation of the experiences of the Baltic RIM Economies. It is only a proposal to see these economies in a holistic transdisciplinary perspective of philosophy, history and futurology.

This preliminary outline should be seen as a starting point in the process of creative thinking related to the Conference – Baltic Europe 2050. The next stage in this process is the preparation of a Feasibility Study which is naturally outside the scope of this short note.

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## Management challenges - what is in the air?

By Pirjo Vuokko

What kind of management is needed today and tomorrow? This question is present all the time in my job. Our unit TSE exe designs and produces development programmes, e.g. the executive MBA programme for private and public sector organisations, and the participants in our courses are middle to top level managers. When developing these managers and through it their organisations, we have to consider what is needed today and what is needed in the future.

There are, in fact, a lot of different issues in the air. I have selected here five of them, i.e. communication and decision-making skills, tolerance and the power of diversity, innovativeness, future-orientation and visionary skills, as well as self-leadership. Each of these five are analysed below.

The three c's of management are said to be communication, communication - and communication. Furthermore, it is stated that in the future the rhetoric skills will be highly emphasized as the essential features of a manager. Good rhetorics are needed especially in relationships between both internal and external stakeholders. Last year there was in the Harvard Business Review an article titled 'Five messages leaders must manage'. These five messages are the following: organisational chart, its changes and their impact on employees' work; organisational culture and its elements; financial results and the connections between the results and employees' behaviour; the leader's sense of his/her role as an asker of right questions and not as an "answer man"; time not as a threat but as a resource among others; and corporate culture that encourages performance. In addition, the decision-making skills are emphasised more and more. A manager has the power to make decisions but also the responsibility for the decisions made. This responsibility means the ability and motivation to communicate and implement the decisions. A good decision executed quickly beats a brilliant decision implemented slowly.

Secondly, tolerance is important. Richard Florida, the person who has talked a lot about the creative class and its importance to national success, states that the essential conditions for success are our capacity to employ technologies, the importance of and support for highly skilled people, and tolerance. Nowadays, we already face the challenge of tolerance when working in multicultural or virtual teams that might include people with highly different ways of saying and doing things. And, in the future, the challenge for us is, for example, how we accept elderly people or immigrants as our equal colleagues or even as the vitally important resource in our organisations. Diversity can be regarded as a threat or as an opportunity. It is the manager's job to regard it as an opportunity and make his/her own staff

to see it in the same way. The trust between people does not necessarily mean that they are alike each another. It means that they understand each another.

Innovativeness is perhaps the most often mentioned element of a successful organisation. But usually we mean by it in this connection the function of R&D, i.e. innovativeness that helps to create new products, services or ways of producing these. In addition to these, management innovations are important: how to create new ways to organize, lead, coordinate, or motivate. And to combine these two; how to create an organisational climate that supports and nurtures innovativeness, questioning, and ability and motivation to see far from where we are now?

This brings us to the fourth issue: future-orientation and visionary skills. Jack Welsh, former president of General Electric, says in a recent interview that the most difficult feature of and a challenge for a manager is the competence to see the future. This presupposes an ability to listen with highly responsive ears and to smell with a sensitive nose. But it also presupposes that the organisation accepts that there are different scenarios and is ready to make its own future.

Finally, what I wish to present here is the importance of leadership and self-leadership as its one essential element. Knowing yourself helps you to understand others. What do you see in the mirror? In our programmes, for example, we use both peer mentoring and senior mentoring as methods to develop people's leadership skills through developing their self-leadership skills.

In fact, management today or in the future has the same elements. That is so because management is about getting things done. This is the eternal challenge. But the world changes and we face new situations all the time; that brings us to the challenge of flexibility. Are you sensitive toward each individual situation and do you have in your tool kit more than just a tool. A good manager needs a rich tool kit and, in addition, a motivation, ability and opportunity to select and use them all depending on the situation, problem and challenge faced.

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# Baltic Rim Economies

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



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