29.12.2006 Turku School of Economics

Baltic Rim Economies

Estonia – Latvia – Lithuania – Poland

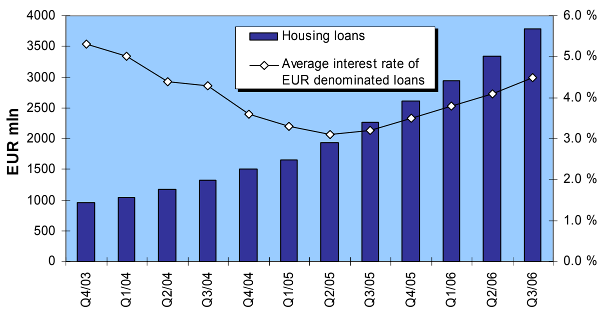
Bimonthly Review 6▪2006

Estonia

Estonian economy continues its fast growth

The rapid expansion of the Estonian economy is continuing. According to Statistics Estonia, the economy expanded by 11.6% over the third quarter of 2006 compared to the corresponding quarter of 2005. A record high GDP growth was generated by the rapid growth of the wholesale and retail trade. The manufacturing sector also exerted a large impact on economic growth, transport and storage and construction activities. Besides the non-financial institutions sector, financial institutions had a substantial role in the economic growth as well. Furthermore, housing loans have increased almost fourfold in three years.

Housing loans in Estonia



Source: Bank of Estonia

All signs show that the Estonian economy is at its peak at present. According to the Bank of Estonia, economic growth can only decline from their current high rates, although no rapid economic downturn is expected. Furthermore, the current economy is growing on the back of the construction sector, real estate and trade. Risks related to strong domestic consumption are still present. If growth slows down it could have a negative impact on these sectors, which have become accustomed to high growth figures, and could bring about a loss of investments. Forecast for GDP growth for 2007 is 8.3% and 7.6% for 2008.

Household's economic wellbeing has improved

A new survey by TNS Emor shows that one in every three households in Estonia say that their economic wellbeing has improved during the last year. Whilst in Tallinn and Harjumaa county 40% of the respondents said that their economic wellbeing has improved during the last year, the lowest figure was in South Estonia where 30% of respondents said they were better off than a year ago.

Rise of salaries highest in the last eight years

The increase in wages and salaries was the highest of the last eight years in the third quarter of 2006. The average gross monthly wage increased by 16.5% compared to the corresponding quarter in 2005, reaching EUR 579. The increase was influenced by a lack of workforce, the high profitability of enterprises and an increase in productivity. Most employers admit they were unable to forecast that wages would rise so much in 2006. In some companies, the pressure to increase wages has been higher than the growth in productivity. At the same time recent statistics show that owing to price rises and an increase in production output, profitability has remained high. Thus, rapid wage growth is expected to last throughout 2007 as well.

The Estonian unemployment rate declined in the third quarter of 2006. The unemployment rate stood at 5.4%, whilst the respective rate was 7% a year earlier. The rate was influenced by emigration, employment growth in the service and construction sector. The total production of Estonian construction enterprises in Estonia and abroad grew by 21% in Q3 year on year.

Estonia improves ranking in corruption perception index

Estonia has once again improved its ranking in the international corruption perception index, published annually by Transparency International. Estonia ranked 24th among the 163 countries surveyed, tied with Barbados. Last year, Estonia's ranking was 27th. Estonia scored the best results in the 9 years that the country has been included in the charts. Estonia showed the best performance among the post-socialist countries. According to the index, the least corrupted countries were Finland, Iceland and New Zealand; Lithuania ranked 48th, Latvia 49th and Poland 61st.

Some business highlights

- Government has approved a transport strategy for 2006–2013 and several hundred millions of euros will be invested in roads, ports, railways and airports. In addition a special transport committee will be set up in the Ministry of Economy to discuss and solve transport issues in a comprehensive context.
- Submarine power cable between the Baltic States and the Nordic countries was introduced in December. It connects for the first time in history, the electricity markets of the Baltic States and the Nordic countries. It is the first common project between Baltic and Finnish energy companies and costs a total of EUR 110 mln. The cable was built mainly to provide the Nordic countries with electricity produced in the Baltic states.
- Elcoteq Tallinn has won the Estonian Excellence Award 2006 of the Estonian Ministry for Economic Affairs and Quality Association. Elcoteq was awarded for the best quality management performance among the nine Estonian companies that took part in the contest.
- As of January 1st 2007, new businesses will be able to register on a newly created central information portal on the Internet. In the new system it will take a maximum of two days to register a company, but the central registry office will try to complete the procedure in two hours. At present, company registration takes up to 15 days.
- The Estonian Parliament approves repurchase of Estonian Railways. The majority of the Estonian Railway company is repurchased with EUR 150mln by its American-based owner Baltic Rail Services.
- Two Estonia's largest oil terminals may merge. Owners of E.O.S., an oil terminal located in the Port of Muuga, have proposed a merger with Pakterminal, another large oil terminal in Muuga.
- Estonian builder, Oma Ehitaja, will develop a restaurant street in the centre of Ulemiste City in Tallinn with EUR 3.8mln. The street shall be located in a former production building that is 80 metres long.
- The Tallinn, Riga and Vilnius stock exchanges adopted new indexes on 4th December. The new All-share, Bencmark, Tradeable and sector indexes will mark another milestone in the creation of an integrated Nordic and Baltic securities market. The new OMX is calculated in euros and as price (PI) and gross (GI) indexes.

Estonia - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	0.3	7.9	6.5	7.2	6.7	7.8	9.8	11.6	1-9/2006
Industrial production (y-o-y %-growth)	-3.4	14.6	8.9	8.2	11.0	8.0	9.7	7.2	1-9/2006
Inflation (CPI, end of period, y-o-y %-change)	3.9	5.0	4.2	2.7	1.1	5.0	3.6	4.6	11/2006
General government budget balance (% of GDP)	-3.7	-0.6	0.3	1.5	2.6	1.7	1.6		1-12/2005
Gross wage (period average, EUR)	284	314	352	393	430	466	555	579	Q3/2006
Unemployment (% end of period, LFS data)	12.9	13.9	11.9	11.3	9.3	8.5	7.0	5.4	Q3/2006
Exports (EUR million, current prices)	2 239	3 445	3 698	3 642	4 003	4 770	6 212	5 622	1-9/2006
Imports (EUR million, current prices)	3 224	4 615	4 798	5 079	5 715	6 704	8 192	7 539	1-9/2006
Current account (% of GDP)	-4.4	-5.5	-5.6	-10.2	-12.1	-12.7	-10.5	-12.3	1-6/2006

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

Latvia

GDP growth continues at a record-high pace

Latvia reclaimed the position of the fastest growing EU country from Estonia. During the third quarter of this year, Latvia's economy expanded by 11.8% compared to the respective quarter in 2005. During the third quarter of 2006, economic growth was mainly based on growth in trade, which went up by 21%, transport and construction (15%), telecommunications (10%) and processing (7%). The GDP growth in Q3 was higher than expected and the main reason for the difference between the forecast and reality was the growth in the transport, real estate and communication markets. The signs of a slowdown are still weak and the Latvian economy is heating up instead of cooling down.

Latvia's GDP has increased 11.9% in the first nine months of 2006, compared to the respective period in 2005. It has been bolstered by surging consumer demand and construction. Consumers have taken advantage of low interest rates to buy real estate, which has doubled housing prices over the last two years. In Latvia, there are 25 different bank chains, which have poured money into the market and replaced reserves that have been moved to the central bank.

This growth continues to have an impact on the consumer price index, and Latvia still maintains one of the highest rates of inflation in the EU. In November prices were up by 1% from the previous month and annual inflation reached 6.3% y-o-y. Latvia's inflation was the second highest in the EU, whilst Hungary recorded a yet higher inflation, 6.4%.

In 2006 yearly inflation is estimated to reach 6.5%, the Minister for Finance Oskars Spurdzins informs that at the beginning of 2007 a working group will be established to curb inflation. The Ministry of Economy, Ministry of Finance and the Bank of Latvia have prepared the plan to curb inflation, which required about 20 different actions.

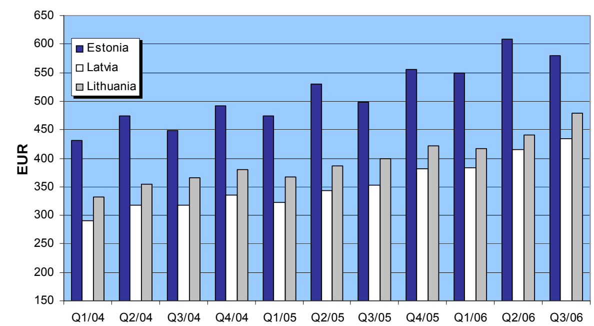
Latvia's trade deficit more than doubles in a year

Latvia falls behind its Baltic neighbours in terms of foreign trade. In January-October of 2006 Latvia's exports were worth EUR 3.8bln, while imports reached EUR 9.3bln. Latvia's trade deficit grew by 60% y-o-y to EUR 410mln. In the first ten months of 2006, exports grew by 15% y-o-y, while imports grew by 29% y-o-y, reflecting very strong domestic demand. The highest increases in exports were 43% for products of the chemical and allied industries, 35% for plastics and plastic products and 32% for base metals and articles of base metals. The decreases in exports, in turn, were 30.9% for mineral products, 13% for wood pulp. The steepest increases in imports were 61% for transport vehicles, 52% for miscellaneous manufactured articles. The unit value of imported goods in Q3 rose by 8.9% y-o-y.

Growth of Latvian labour costs the highest in the EU

The number of job seekers dropped to 6.2% of the economically active population in Q3 of 2006. Latvia's unemployment is falling to record-low levels, driving continued high pay increases. Rapid growth of wages continued in the third quarter of 2006 and the average monthly gross wage reached EUR 436, which is by 22.8% more than in the preceding quarter of 2005. Taking into account the steep rise in prices, real wages went up by 15.4% y-o-y. The most rapid wage increase was observed in the mining and quarrying industries, where wages went up by 37%. In the construction sector, the average wage grew by 35% in a year. In comparison, labour costs went up 20% in Lithuania and 17% in Estonia. In the EU25 the annual rise was 2.6% in Q3 of 2006, down from 2.8% in the previous quarter. According to construction group Merko Ehitus' report, the wages of construction workers in Latvia have skyrocketed 59% in a year. According to figures provided by the national statistic offices of the Baltic states, the construction market grew by 41% in the first half of 2006 in Estonia, 36% in Latvia and 32% in Lithuania. A continued increase in construction costs accounted for the majority of the growth.

Growth of wages in Baltic countries



Source: Statistics Lithuania

Baltic countries' natural gas prices up considerably

Due to Russia's Gazprom price rise, the price of natural gas for European countries will rise by an average 15% in 2007; though the Baltic states are likely to see their average gas rates jump 30–54%. According to preliminary reports, Estonia will pay approximately $260 per 1,000 cubic metres (up 36%), Latvia some $220 (up 54%), and Lithuania up to $210 (up 30%). Electricity rates in Latvia will jump 6% for households and 18% for corporate users beginning on January 1st 2007.

Some business highlights

- Latvijas Gaze has announced a general plan to spend EUR 44.5mln to expand and modernise the gas network over the next four years. An additional EUR 105mln will be invested in system safety improvement, and a total of EUR 66mln will be spent on renovations at the Incukalns facility, near Riga.
- Income tax for small companies and individual private proprietors will be cut from the current 25% down to 15% in 2008.
- Latvian airline airBaltic has launched scheduled flights from Riga to Dubai in the United Arab Emirates.
- Riga Free port Authority has decided to rent out land in Kundzinsala and build a second container freight terminal to Riga Port.
- Number of internet users in Latvia has grown twofold. At the end of Q3, the total number of internet subscribers was 45.2 per 100 people.
- GE Money, a Latvian consumer lending unit of US corporation General Electric, is planning to launch operations in Lithuania and Estonia in the near future. Planned operations could be started in three ways, by acquiring an existing company, finding a cooperation partner or establishing an entirely new company.
- The Ministry of Transport is working on two road building projects costing millions of euros. The Kekava bypass and the Riga bypass are expected to ease the traffic jams along these routes.
- Latvian private airline VIP Avia is planning to invest EUR 3mln to build a new hanger and terminal at Riga airport.
- According to the Global Competitiveness Index, calculated by the World Economic Forum, Latvia ranks 36th in 2006. In 2005 Latvia was ranked to39th
- Microsoft, together with the Bill & Melinda Gates Foundation, have donated EUR 18.2mln towards updating Latvia's nationwide library system. The donation will be spent on installing 3,833 new computers in 874 libraries across Latvia. Part of the money will be spent on IT education to over 9000 Latvians.

Latvia - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	3.3	6.9	8.0	6.5	7.2	8.5	10.2	11.9	1-9/2006
Industrial production (y-o-y %-growth)	-8.8	3.2	6.9	5.8	6.5	6.0	5.6	3.9	1-10/2006
Inflation (CPI, end of period, y-o-y %-change)	3.2	1.8	3.2	1.4	3.6	7.3	7.0	6.4	11/2006
General government budget balance (% of GDP)	-4.9	-2.8	-2.1	-2.3	-1.2	-0.9	0.2		1-12/2005
Gross wage (period average, EUR)	225	268	282	297	298	314	350	436	Q3/2006
Unemployment (% end of period, LFS data)	13.2	13.3	12.9	11.6	10.3	10.3	7.8	5.6	Q2/2006
Exports (EUR million, current prices)	1 613	2 020	2 232	2 416	2 559	3 204	4 086	3 832	1-10/2006
Imports (EUR million, current prices)	2 758	3 453	3 910	4 284	4 634	5 671	6 879	9 281	1-10/2006
Current account (% of GDP)	-9.0	-4.8	-7.6	-6.6	-8.1	-12.9	-12.3	17.9	1-6/2006

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

Lithuania

GDP up 7.7% in nine months year on year in 2006

Lithuania's robust economic growth continues, although the current growth pace is around 4 percentage points below the Estonian and Latvian ones. In the third quarter of 2006, the Lithuanian economy expanded by 6.4% compared to the corresponding quarter of 2005. In the third quarter, Lithuania's economic growth was based on a strong increase in all the main industries, excluding agriculture and fisheries. The strongest growth was noticed in the construction sector, which expanded by 18.9% y-o-y. Robust, above-average growth was also recorded in financial intermediation and real estate and other business (9.4%), trade, hotels and restaurants, transport and communications (8.4%) and non-market services (7.6%). Industrial production in Lithuania increased almost 9% y-o-y during the first eleven months of 2006. Mining, quarrying and manufacturing industry production (excluding refined oil products) increased 14.4%.

The Ministry of Finance predicts that Lithuania retains its fast economic development in the near future; however growth will slow down over the next three years. The rise of GDP may reach 7.8% in 2006, while in 2007 growth will slow down to 6.3%, in 2008 to 5.3%, and in 2009 to 4.5%.

According to Statistics Lithuania, In November 2006, the (harmonised) consumer price index stood at 4.4% y-o-y. The most rapid price increase was observed in housing, water, electricity, gas and other fuels, which went up by 10.7% y-o-y, food products and non-alcoholic beverages went up 8% y-o-y. The average annual inflation, measured by EU methods, was 0.1% higher than estimated using Lithuanian standards.

Inflation is expected to rise in the next two years, but to decline and stabilise in 2009 when Lithuania's compliance with the Maastricht criteria will be measured again.

European Commission's forecasts for 2007

	EU-25	Estonia	Latvia	Lithuania	Poland
GDP (in real terms)	2.4	9.5	8.9	7.0	4.7
Private consumption	1.9	12.3	11.4	9.5	3.9
Public consumption	1.5	2.9	3.7	6.1	3.3
Investment	3.6	12.9	11.7	9.7	10.8
Inflation (HCPI)	2.3	4.2	5.8	4.6	2.5
Government balance*	-1.2	1.6	-1.2	-1.2	-2.0
Government debt*	61.4	2.7	10.6	-19.6	43.1
Current account*	-0.4	-10.5	-17.4	-9.4	-2.7

Source: European Commission Autumn Forecasts 2006 *(% of GDP)

Lithuanian imports and exports on the up

Growth in Lithuanian foreign trade continued over 2006. During the first ten months, exports grew by 23% y-o-y, while imports grew by 26% respectively. The most notable increase was observed in the exports of oil products (22%) surface vehicles (63%) and plastics and plastic ware (71%). Imports grew due to increasing imports of crude petroleum and gas, surface vehicles (48%), electrical machinery and equipment, TV video and audio recorders and players and their parts (30%). The foreign trade deficit in Lithuania grew by 35% y-o-y, reaching EUR 3227bln.

From January to October 2006, EU countries were the major market for Lithuanian commodity exports (62%) and imports (61%). Exports to and imports from CIS countries stood at 21% and 30% respectively. According to Eurostat, Lithuania was fourth in the EU by growth of nine-month exports, while Estonia was third and Latvia tenth. In import growth, Latvia was first, Estonia fourth and Lithuania fifth.

Average monthly wage grew 20% y-o-y

The rapid growth of wages continued in the third quarter of 2006. Lithuania's average gross monthly wage stood at EUR 479, increasing by 19.9% compared to the corresponding quarter in 2005. The growth of wages during the third quarter relied on several different factors such as the higher number of working days, new rates of the monthly minimum wage and the minimum hourly fee raised on July 1st. Taking into account the rise in prices, real wages in Lithuania grew by almost 17%. In comparison, the average gross wage increased by 19% in Estonia and by 15.4% in Latvia during this period. According to SEB Vilniaus Bankas analysts, salaries will rise 15% in 2007 and 13% in 2008 and thus outpace inflation growth.

Lithuania is also facing a labour shortage and the deficit of skilled and unskilled workers is becoming more pressing, especially in Lithuanian provincial towns, as more people emigrate and move to Vilnius and Kaunas. According to a population employment survey, the unemployment rate was 5.7% in Q3 of 2006. In September, seasonally adjusted average unemployment in EU member states was 8%. The percentage of employed people has risen to 84.8% of the total workforce.

Majority of Mazeikiu Nafta refinery to Poland

Polish PKN Orlen closed a negotiated deal on a controlling interest in Mazeikiu Nafta (MN), acquiring 53.7% from Yukos International UK with EUR 1.1bln. One share was worth EUR 2.96. Furthermore, Poles purchased 30.66% of MN's stake from the state of Lithuania for EUR 650mln. PKN Orlen now controls an 84.36% stake in the refinery. The government of Lithuania will keep a 10% stake in MN, the country's largest taxpayer, with a five-year option to sell it to OKN Orlen.

Some business highlights

- Swedish ICA takes over the Baltic Rimi retail chain in the Baltic states.
- After years of discussions and delays, Lithuania and Poland have finally signed a bilateral deal to build a high-voltage network that will help integrate the Baltic's in the EU's energy-sharing system. The Polish-Lithuanian energy link will cost some EUR 304mln, of which the next EU budget (2007–2013) will finance some EUR 142mln, according to reports, including funds earmarked for the closure of the Ignalina Nuclear Power Plant. The electricity line is expected to be built by 2012.
- The real estate developer Ogmios Centras states having noted high interest among foreign companies during the international real estate exhibition Mapic. More than 40 global retail chains intend to open several or more stores in Lithuania in the coming years.
- Fortum, the Finnish energy group has acquired a 4.9% share of Klaipedos Energija in Lithuania from VNG-Erdgascommerz GmbH.
- The Lithuanian Criminal Police Office and Leasing Association are starting cooperation against leasing frauds by organising specialised training for the staff of leasing companies and for police officials investigating these crimes.
- Lithuania's ZIA Valda, the direct owner of flyLAL Lithuanian Airlines, plans to earmark up to EUR 120 mln for the purchase of Hungarian airline Malev, which is seven to eight times larger than Lithuania's flagship carrier. flyLal plans to build its own terminal as well, but Vilnius airport is firmly resisting the plans.
- Next spring, the airline airBaltic will offer new direct flights from Vilnius to Brussels, Milan, Rome and Zurich.
- Lithuania's poverty level dropped in 2005. Statistic Lithuania reported that some 615,000 residents, 18% of the population lived below the poverty line.
- Swiss-registered AP Anlage & Privatebank, a member of Latvia's Parex, the third largest Baltic finance group, aims to set up a representative office in Lithuania.
- Clothing retailer Apranga is opening 13 new stores in the first quarter of 2007. Currently, the Apranga group, owned by MG Baltic, operates 64 stores in the Baltic States: 46 in Lithuania, 15 in Latvia and 3 in Estonia.
- Icelandic investment bank Behrens Corporate Finance opened its office in Vilnius.

Lithuania - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	-1.7	3.0	6.4	6.8	10.5	7.0	7.5	7.7	1-9/2006
Industrial production in sales (y-o-y %-growth)	-9.9	2.2	16.0	3.1	16.1	10.8	7.3	10.6	1-9/2006
Inflation (CPI, end of period, y-o-y %-change)	0.3	1.4	2.0	-1.0	-1.3	2.9	3.0	4.4	11/2006
General government budget balance (% of GDP)	-5.6	-2.5	-2.0	-1.4	-1.2	-1.4	-1.5		1-12/2005
Gross wage (period average, EUR)	231	263	274	293	311	335	421	479	Q3/2006
Unemployment (% end of period, LFS data)	15.3	16.9	17.9	13.0	11.6	10.6	7.1	5.6	Q2/2006
Exports (EUR million, current prices)	2 583	3 841	4 778	5 526	6 158	7 478	9 502	9 411	1-10/2006
Imports (EUR million, current prices)	4 340	5 650	6 767	7 943	8 526	9 959	12 446	12 637	1-10/2006
Current account (% of GDP)	-11.2	-5.9	-4.7	-5.1	-6.8	-7.7	-7.0	-15.9	1-6/2006

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

Poland

GDP growth of 5.8% in the third quarter

Poland's robust economic growth continues and in the third quarter of 2006 the economy grew by 5.8% compared to the corresponding period a year earlier, being approximately 0.4% above expectations. The economic growth was supported by an acceleration in investments and domestic consumption. During the third quarter gross fixed capital formation increased by 19.8% y-o-y and private consumption by 5.5% y-o-y. As a result, in the first nine months of 2006 GDP growth equalled 5.5% y-o-y.

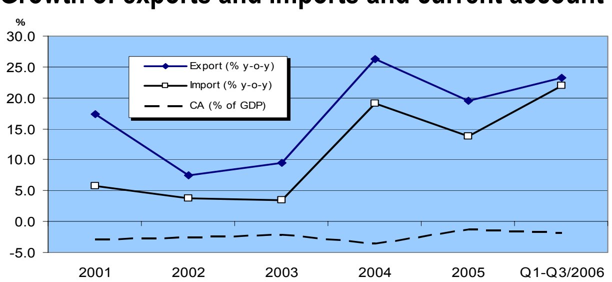
The consumer price index in November amounted to 1.4% y-o-y. However the CPI is expected to rise over the coming months, due to a gradual increase in inflationary pressure. As a result the CPI in Q1 of 2007 may exceed even 2.5% y-o-y. Over 2006 the highest price growth was observed in the case of goods and services related to housing, especially energy prices. Prices of food and services as well as prices in hotels and restaurants were clearly up.

During the first ten months of 2006, industrial output was 12.6% higher than in the corresponding period of the previous year. Output growth was even higher in construction, where the economic climate is already the best in years. In October, construction-assembly output noted a 28.6% y-o-y increment.

Imports exceeding exports

The present condition of the Polish economy and rapidly growing demand are reflecting on foreign trade results, since exports continued to outpace imports. In the first ten months of 2006, imports reached EUR 81bln, being 22.4% higher than in the corresponding period of 2005, while exports grew by 23.2% reaching EUR 72bln. Poland's trade deficit, as measured by customs declarations, hit EUR 8.9bln at the end of October. The exchange of goods was focused on trade with EU, which accounted for 83% of total exports and 70% of imports.

Growth of exports and imports and current account



Source: Central Statistical Office of Poland

Poland's economy optimistic in several instances

The European Commission is not the only institution, which has evaluated Poland's future prospects to be propitious in the economic field. The International Monetary Fund assessed Poland's prospects for 2007 as very favourable on its annual report. According to the IMF, the country's economic growth accelerates, while equilibrium among consumption, investment and exports stays steady. Furthermore, Moody's rating agency gave good grades in its November report. According to it, rapidly growing exports and other factors behind GDP growth in Poland are investments and domestic demands, which offers good prospects, therefore economic growth in Poland is likely to continue at its fast pace in 2007.

Real estate markets booming

The Polish real estate market is booming; average square metre of apartment in Warsaw in September 2006 cost EUR 1,617, which is approximately 26% more than in January 2006. Since 2004 the construction market in Poland has been growing steadily. Demand for new apartments is especially high and new apartments are bought even before the developer obtains a construction permit, thus developers are unable catch up with the demand. In the first nine months, 57,800 construction permits were issued. The construction price index in January-October 2006 totalled 2.7%.

Foreign companies are also showing growing interest in Polish real estate markets. According to different estimates, over the next five years foreign investors will build at least 100,000 apartments to Poland.

Currently construction companies face a problem not seen on the Polish construction market. More and more workers from the sector are emigrating abroad, where wages are much higher. As a result, construction companies are having difficulties finding new employees. Labour shortage is seen as one of the most severe obstacle to doing business on the Polish construction market. Poland's unemployment rate declined to 14.8% in November from 14.9% in October and is likely to drop to 14.7% in December. A year ago the unemployment rate was 17.5%.

Some business highlights

- In the first 11 months of 2006, gross revenues from privatisation amounted to approximately EUR 150mln, according to data from the Treasury ministry. It represents only 10.7% of the sum planned for the entire year.
- Estonia, Latvia and Lithuania have invited Poland to invest in the project of building a new nuclear reactor in Lithuania. Poland wants to own a quarter of the new plant. In addition, Poland is also mulling a plan to build its own nuclear plant.
- A new airport will open near Warsaw in 2008 to serve budget carriers. The project is established by four joint-venture companies and is estimated to cost EUR 64mln. Some of the funding will come from an EU structural fund.
- Dell will construct a new factory to Lódz. In 2007, 800 employees in two shifts will be working on the production of computers. The Dell factory will have 500 office personnel and aims to eventually employ a total of 3,000 staff.
- Klenk Holz, a German timber and sawmill company, is planning to build a production complex in the Kostryn-Slubice Special Economic Zone. The new plant will turn out timber products for the furniture industry. Investment is worth EUR 50mln.
- General Motors confirmed that it will start production of a Chevrolet compact four-door sedan, late 2006 at the FSO plant in Warsaw. The companies plan to manufacture about 60,000 cars during the first full year of production and increase production to over 150,000 in the next full business year.
- NMC Polska, who specialises in the production of rubber and plastic materials, is planning to build a second factory to the Katowice SEZ. The investment is estimated to be worth EUR 13mln and will create more than 110 jobs.
- ISD Polska, owned by Ukrainina Donbas, has announced its plans to spend a total of EUR 100mln to revamping the Huta Czestochowa steelwork plant. Currently it has 4,300 people on the payroll.
- The government increased the size of Special Economic Zones. Wałbrzych zone is enlarged to 1422 hectares, now being the largest SEZ in Poland, while Pomeranian SEZ was enlarged to 677 hectares and the Kostrzyn-Slubice SEZ to 899 hectares.
- Internet giant Google plans to open a research and development centre in Krakow
- JVC, builds an LCD television and monitor factory in Boleslawiec. Investment is incorporated to SEZ. Investment is estimated to be worth EUR 24mln and it will provide work for 500–1000 people.
- Toshiba has launched the construction of a new LCD television factory in Kobierzyce. Production is due to begin in summer 2007. More than 1,000 people will be hired by 2010.
- Indesit has been granted permission to build a factory at Lodz SEZ. The new plant is estimated to be worth EUR 80mln and will create 1,000 jobs.

Poland - main economic indicators	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP (y-o-y %-growth, constant prices)	4.5	4.2	1.1	1.4	3.8	5.3	3.5	5.5	Q3/2006
Industrial production (y-o-y %-growth)	3.6	6.7	0.6	1.1	8.3	12.6	4.1	12.5	1-9/2006
Inflation (CPI, end of period, y-o-y %-change)	9.8	8.5	3.6	0.8	1.7	4.4	0.7	1.4	11/2006
General government budget balance (% of GDP)	-1.4	-0.7	-3.7	-3.3	-4.8	-3.9	-2.5		1-12/2005
Gross wage (period average, EUR)	401	472	557	544	497	505	591	643	Q3/2006
Unemployment (%, last survey in the year, LFS data)	15.3	16.0	18.5	19.7	19.3	18.0	16.7	14.1	Q2/2006
Exports (EUR billion, current prices)	25.7	34.4	40.4	43.4	47.5	59.7	71.4	71.9	1-10/2006
Imports (EUR billion, current prices)	43.2	53.1	56.2	58.3	60.4	71.4	80.6	80.9	1-10/2006
Current account (% of GDP)	-7.6	-6.0	-2.9	-2.6	-2.1	-3.5	-1.2	-1.8	1-10/2006

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

Education and research — Key factors in development in the Baltic Sea Region

by Antti Kalliomäki

The Baltic Sea Region is an important section of Europe: one third in population terms with its 150 million inhabitants. The Region has changed with European integration. Finland, Sweden and Denmark are old EU members; Estonia, Latvia, Lithuania and Poland joined in 2004; and Germany, one of the major EU countries, is connected to the Baltic Sea and has vested interests in the Region. The non-EU country, the Russian Federation, participates in the activities through St Petersburg and the Kalingrad Oblast.

The underpinning of cooperation around the Baltic Sea has traditionally been trade and business. Today, quite rightly, we again talk of a Baltic Sea economic area, and great expectations are directed at the area as a generator of economic growth. With their brisk economic growth, the Baltic states have outdone all the other members in the new EU, and Poland is on a promising track towards growth. There are, however, large differences in the standard of living and development stage. Redressing the balance and improving the competitiveness of the Region require sustainable social and economic development. The social, cultural and economic welfare of the population is a challenge shared by the Baltic Sea countries.

Favourable development of the economy, employment and welfare is seen to be closely associated with high-standard education and the production and application of new knowledge. Production and trade based on innovations and high technology are crucial productivity factors. Interdependence between countries and regions is growing with advancing globalisation. This is another impetus for improving competitiveness, and the Baltic Sea countries should be able to step up their regional cooperation and interaction in the education and research sector. Owing to its growth potential, the Baltic Sea Region plays a major role in the overall effort to improve competitiveness in Europe. According to the Lisbon Strategy, research and education are an important component of this effort.

For the extensive university network in the Baltic Sea Region, the most natural framework for cooperation is the EU and the opportunities it offers for cooperating with Russia. A key development trend in education is internationalisation, in which all the countries currently invest. The pan-European Bologna Process offers a wide range of opportunities for cooperation. Russia, too, has adopted the Bologna goals and the European Higher Education Area 2010 as guiding principles in its higher education reform. During its EU Presidency, Finland has wanted to stress the role of mobility as a priority in internationalisation and as a major competitiveness factor.

Promoting world-class research is an important aim for Europe as a whole, and it is believed to be in the best interests of all the EU Member States. European countries are getting ready to apply the Seventh Framework Programme for R&D, which will take effect in the beginning of 2007. Other important measures in the development of the European Research Area are the competitiveness and innovation programme and wider application of the ERA-NET Scheme.

The Baltic Sea universities should be active and choose priorities of crucial importance for the Region. A good example of this is research on the ecological state of the Baltic Sea and environmental research more widely. Another critical theme is research into economic development in the Region. As an example of viable structures I would like to mention the Nordic-style graduate schools and centres of excellence, which could be developed more widely within the Baltic Sea Region. A special priority in the Region is the wide-ranging Baltic 21 programme for sustainable development, which comprises both research and education.

The Ministry of Education has allocated funding to Baltic Sea cooperation and to education and research relating to the Region during three performance management periods. The University of Turku has received funds for coordination and development and the Åbo Akademi University for participation in the University Program network. Further, both the University of Turku and the Turku School of Economics and Business Administration have received project funding for developing studies with a Baltic Sea dimension.

Another boost for research and education cooperation will be the new political framework document on the Northern Dimension in the EU, which will take effect in 2007. This was one of the objectives set for the Finnish Presidency. The Northern Dimension will change from an EU-centred policy into a common policy of the EU and the current Northern Dimension partners, Russia, Norway and Iceland, with jointly set objectives. The Northern Dimension comprises several sectors. Research and education is a very important sector in it and also one of the four Common Spaces in EU-Russia cooperation. The aim of the reform, in which the internal and external sources of funding were combined, is to create a simple and efficient funding instrument for the Northern Dimension.

As regards the future of the Baltic Sea Region, the expectation and hope is to create an increasingly integrated economic, political and administrative area. There is every reason to expect that this Region will constitute a significant zone, with an identity of its own, in the future Europe. The Baltic Sea Region will need special experts for different sectors and organisations. Promoting this aim is in line with Finland's internationalisation strategy.

Antti Kalliomäki

Minister of Education and Science, Finland

Sweden's role in the Baltic Sea region

by Carl Bildt

Our European continent has seen major and overwhelming political and economic changes since the 1990's. The changes have forced us to rethink co-operation. We have been faced with questions such as how to best promote democracy and economic growth in the Baltic Sea region and how to work together to improve our environment. In this connection I think the co-operation in the Baltic Sea Region – in the framework of the Council of the Baltic Sea States (CBSS) - has helped pave the way for increased regional integration and been instrumental in making the Baltic Sea region one of the most competitive areas in the world when it comes to economic growth.

There is a growing recognition that we need a strong, broad co-operation to deal with issues that have high relevance to all our citizens such as the horrific trafficking of women and children, the troubling environmental problems and the tragedies of refugee children who turn up in our countries unaccompanied. Energy, transport and nuclear safety are other issues where co-operation is truly beneficial.

The regional dimension cannot be underestimated for tackling many of the common problems we face. Take the terrible example of trafficking of young women. The same features that unite the Baltic Sea region - the short distances between our countries, our common historical background, our linguistic similarities, our cultural resemblance – are also the features used by the traffickers. Only they are still one step ahead of us. The same characteristic goes for many of our shared problems. How can we change this? To me, the obvious answer would be to develop and improve the regional dimension.

One effect of the changes during the last years is that the co-operation within the CBSS has changed character and reached a more concrete and diversified level. It has reached a stage which has many similarities with the long-time work within the Nordic Council. The governments are no longer in the driving seat. It is instead much more business, local authorities, universities and independent organization that co-operate on many levels and in different capacities. This I find very encouraging.

The opportunities of the Baltic Sea region derive to a large extent from the economic potential of the region where we have seen a strong economic performance for quite some time. The Baltic Sea region has been able to utilize and produce attractive opportunities for business and investment and can boast diversity and a strong track record of political and economic reform, which make it one of the world's most competitive regions.

However, it is important not to lose ground in terms of competitiveness and inward investments and the Baltic Sea region need to look on how it can position itself for the future to keep up the growth figures. One important thing is how to achieve a truly integrated market in the Baltic Sea region, including Russia.

Russia presents probably the largest potential for trade and investment but it also has very cumbersome barriers to trade. Regional efforts such as those undertaken by the CBSS to remove barriers to trade and investment and encourage customs co-operation need to continue and to be intensified.

In general, during the Swedish Presidency of the CBSS (1 July 2006 - 30 June 2007) the Swedish Government has focused on developing the co-operation in trade and investment, the environment and sustainable development as well as on civil security issues.

There is still much to do to improve the practical co-operation in these areas and Sweden has taken the initiative to a number of projects such as seminars on corruption, joint work on environment and to strengthen the capacity to manage assistance in the event of a large-scale emergency - to take a only a few concrete examples.

What is then my vision with the CBSS for the future? I think we will see an even closer practical cooperation between participating states.

An important aspect of CBSS today is that around the Baltic Sea all countries except Russia are members of the EU. The CBSS format today therefore presents an opportunity to have a dialogue with Russia about concrete everyday issues that concerns our citizens. I think we will also see a closer practical cooperation with CBSS observers Ukraine and Belarus as well as other states in the wider Baltic Sea area.

We need to work towards achieving an even closer integration in the Baltic Sea region and promote economically and socially prosperous societies, based on a market economy, freedom and democracy. Societies that share the same objectives, whether they concern protecting our environment or fighting organized crime and trafficking in human beings, are the best guarantee for stability, security, peace and prosperity. It also gives our economies new dynamism and serves the objective of maintaining the Baltic Sea region as one of Europe's strongest growth areas.

Carl Bildt

Minister for Foreign Affairs, Sweden

Kaliningrad region – a new development strategy

by Georgy Boos

The Kaliningrad region is a relatively small unit of the Russian Federation and a unique region according its geographical location. On the one hand the Kaliningrad region is a part of the Baltic region and it belongs to "the Baltic development belt" – one of the most dynamic zones of modern Europe, and this defines its strategic potential for Russia. On the other hand the region is a part of one of the most rapidly growing Russian regions for the last 5 – 7 years – the North-West federal district.

A specific location of the region defines its problems. Remaining a part of Russia after the Soviet Union disintegration, the Kaliningrad region found itself under the influence of the external factors, which included the additional barriers for the transit of people and goods.

The external factors affected the structural changes in economy and the break of the traditional economic relations. So the economic recession in the region was more significant than in Russia and in the adjoining Lithuania and Poland.

At present the economy development of the Kaliningrad region have higher rates of growth, then all Russia and other regions of the North-West Federal district.

The gross region product of the Kaliningrad region increased nearly by 156%, whereas the gross region product of the North-West district increased by 150%, but gross domestic product of Russia – just by 142.2%. Average annual rates of growth of the gross region product of the Kaliningrad region counted 12.4 pcts. And the potential of the growth has not been yet exhausted.

The region takes the 16th place among 89 regions of the country according to the solvency rate for the year of 2005. For comparison in 2004 it took 24th place. **The general situation is evidence of gradual reduction of the general characteristics gap between the Kaliningrad region and the Russian Federation, and also between Kaliningrad region and other Europe countries.**

A number of factories were created in the furniture industry, food industry and in the electronic engineering.

The Kaliningrad region specialization in the All-Russian division of labour has formed at present. The main goods, produced in the Kaliningrad region are the foodstuffs, electronics, vehicles, cellulose and paper, furniture. According some criterions the industry of the region takes leading positions in the Russian economy. So every third tin of canned-fish produces in our region. Two thirds of the general television sets output of Russia produced in Kaliningrad. About 9 % Russian furniture production concentrated in our region.

The development strategy of the Kaliningrad region for the average- and long-term outlook defines such priority lines of the Kaliningrad region development as:

- **Development of the transport sector and its fusion in the Europe transport patterns due to new quality**

The prerequisites for this are the presence of branched infrastructure. There is a non-freezing port on the Baltic Sea, which is the only one in Russia. The road density is ten times more then the average density in the main part of Russia. At the same time we modernize step by step the present infrastructure. So since 2006 the modern roads building program meeting the European requirements will be launched in the region. We plan extend consecutively the port and develop the air transportation.

Among the economic priorities of the regional government there is an organization of logistics, providing the development of the all modes of transport. This means a forming of HABs, which allow organizing of multimodal transportation system and a forming of integrated load processing. There are the railways of Russian and Europe standard in the region. Kaliningrad can be considered as the most western station of the Trans-Siberian Railway. Today there are all conditions for development of the transport relations between the Europe and Russian industrial centers through Kaliningrad.

- **Development of the agroindustrial complex and fish industry**

Due to the conditions of the Special Economic Zone the food industry in the Kaliningrad region is developing focused on the Russian markets. This industry uses basically import raw products. The task of the regional government will be to stimulate the development of own raw products base. At the same time we rely on the historical prevalent specialization of the region.

The climatic conditions in the Kaliningrad region are quite favorable for development of agriculture; moreover, at present there is a rise of investments in this field. Some pig-breeding and dairy animal projects are developed and begin to work. The legislative preferences for agricultural companies and the opportunities which are offered by the national priority project "Development of agrarian and industrial sector" being implemented in the Russian Federation are strongly supported this process.

- **Development of the tourist-recreational complex**

According to the World tourist organization, the potential of Russia allows to receive up to 40 million foreign tourists a year at a corresponding level of the infrastructure development, and the number of the international travellers will grow since 664 million up to more than 1 billion a year by 2020, and by 2020 it will reach 1,6 billion.

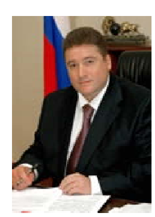
The historical objects, closed for visiting for a long time, beaches of the Baltic seaside and the development of new technologies all together allow predicting the increase of demand for trips to our region.

- **Residential development**

The important task is maintenance of modern quality living conditions. For 10 months of the current year it has been constructed about 370,6 thousand sq.m of habitation – it is 1,4 times more, than last year. The competition in sphere of housing construction is supported through the mechanism of sale of the land lots by the open auctions.

Plans in this branch are so grand that the Kaliningrad region need a lot of investments, modern technologies and building materials to implement them.

Setting and implementation of new strategic tasks open a new horizon for the development of the Kaliningrad region. The most important of them are the achievement of competitiveness of the Kaliningrad region at the macro-regional level and the assurance of the effective integration of the region into the general social and economic processes took place on the Baltic Sea region.



Georgy Boos

The Governor of the Kaliningrad region,

The Russian Federation

European Investment Bank's financing in the Baltic Rim Region

by Sauli Niinistö

The Bank in General

The European Investment Bank was established in 1958 as the European Union's long-term lending institution to finance projects furthering the economic and social integration of the EU Member States.

The Bank's Corporate Priority Objectives include:

- Economic and social cohesion in an enlarged EU
- Implementing of the Innovation 2010 Initiative (i2i)
- Development of Trans-European and Access networks (TENs)
- Support for Small & Medium Sized Enterprises (SMEs)
- Environmental Sustainability
- Support of EU Development and Cooperation Policies in Partner Countries

In 2005, the EIB lent a total of EUR 42 billion, some 90% of total lending, for projects furthering the EU's political objectives in the EU-25, of which EUR 6 billion went to the new EU Member States. The EIB also made available some EUR 5 billion, approximately 10% of its total lending, in non-EU countries in support of EU development and co-operation policies. Finally, the EIF, the EIB specialised venture capital arm and guarantee provider, invested EUR 368 million in venture capital funds and provided around EUR 1.7 billion in guarantees for SME portfolios.

Deepening the European Integration of Poland and the Baltic States

The EIB's lending in the Baltic States and in Poland is focused on four core areas: economic and social cohesion, the development of TENs, environmental protection and support for SMEs. EIB lending in these countries has reached some EUR 14 billion since 1990.

Economic and Social Cohesion: Economic and Social Cohesion is the main corporate priority objective for the EIB with the aim of supporting developments in the less favoured regions (Objective 1 regions) and, in particular, meeting the challenges of enlargement. The whole territory of Poland and the Baltic States consists of Objective 1 regions (where GDP per capita is lower than 75% of the EU average). As such, these are designated as areas qualifying for allocations from the EU Cohesion and Structural Funds.

Development of TENs: The TENs are large infrastructure networks of transport and energy underpinning EU's developmental and integration goals. TENs, notably transport corridors, are crucial for the development of the region's new EU Member States and for removing bottlenecks and barriers to the efficient movement of people and goods in the EU, for safety and for the environment. Since 1990, the EIB has granted loans of approximately EUR 4.5 billion (35% of the total lending in the mentioned four countries) in support of projects in the transport sector. Major projects in this area cover construction of motorways along TEN corridors (e.g. A1, A2 motorways in Poland, railways rehabilitation), modernisation of airports in the individual capitals and upgrading of ports.

Support for SMEs: Support for SMEs has become one of the EIB's corporate priority objectives. SMEs are financed by the EIB indirectly through credit lines in favour of EIB's partner banks. These financial intermediaries then on-lend EIB funds to their customers who meet the EIB's eligibility criteria. In this framework some EUR 2.4 billion, or 17% of total lending, has been provided in order to improve access to long-term loans for SMEs and municipalities in the Baltic States and Poland since 1990. List of EIB's partner banks can be found on the EIB's website (www.eib.org).

Environmental Protection: The EIB finances projects that protect and improve the environment and promote social well-being in the interests of sustainable development. EIB support to projects in the water, municipal environmental infrastructure and flood damage protection sectors has exceeded EUR 2 billion or 14% of the total lending in the mentioned four countries since 1990. An example of a major project financed in this area is the investment for environment improvement in the city of Poznan and the neighbouring municipalities, thus decreasing the contamination of the Odra River and subsequently the Baltic Sea. Other projects include the Warsaw sewage treatment plant and the Riga water and environmental loan.

Recently, the EIB has developed a new technical assistance facility in conjunction with the European Commission and the EBRD. This initiative is designed to improve the preparation of projects in order to help the new Member States use the grant finance provided by the Union in a more rapid and effective manner.

Fostering cooperation with Russia

The EIB operates in Russia on the basis of mandates provided by the European Council and the Bank's Board of Governors. The first mandate for Russia covered the financing of environmental investments in a total amount of EUR 100 million in the Baltic Sea basin of Russia. Subsequently, in December 2004, the European Council confirmed a further EIB mandate for Russia, Ukraine, Moldova and Belarus for an amount of EUR 500 million. This second mandate is for projects in the areas of environment, as well as transport, telecommunications and energy infrastructure on priority Trans-European Network (TEN) connections having cross-border implications for EU Member States. The Bank has financed environmental projects under the first mandate thus contributing to a higher quality of life, not only in Russia but in all countries surrounding the Baltic Sea. The Bank is currently identifying eligible projects that would be financed under the second mandate.

The EIB is also actively involved in and is the current chair of the Northern Dimension Environmental Partnership (NDEP), which co-ordinates and accelerates the implementation of important environmental and nuclear safety projects in the Northern Dimension region, especially in North West Russia and Kaliningrad. The environmental projects financed by the EIB in Russia have also benefited from NDEP resources.

Sauli Niinistö

Vice-President

European Investment Bank

The role of scientific research and higher academic education in the Baltic Sea region

by Tapio Reponen

In this globalising world the particular role of regions is obviously strengthening. The Baltic Sea area has a great deal of potential to be a competitive player in the world economy. Some of the countries are very high in the world competitiveness rankings, and many are spending a high proportion of their GNP on research and development activities. Success needs, however, strong efforts in developing successful innovation systems to continuously generate new products and services.

Universities are regarded as key actors in promoting innovativeness. The expectations are very high and at the same time there are a lot of critics with regard to their operations. One of the main expectations is to reach and maintain top quality research and education in all the Baltic countries. In the present discussion there are, however, many doubts about the present performance of higher education units. Many diverse viewpoints give one reason to consider the situation and think of the actions needed to strengthen this sector. In the following there is a grass-root opinion put forth on how researchers and educators see the present strengths and weaknesses of the academic world.

According to the different University rankings, peer reviews and evaluation reports we have every reason to believe that in the Baltic countries we have academic fields which are, without a doubt, leading ones or near the top in the world. At the same time the overall development of the University sector has many problems, such as recruiting good students, recruiting the most talented faculty possible, the financing of research projects, increasing bureaucracy etc.

In our societies the demand for “efficiency” has increased, also in the research and education sectors. Market orientation has led in speaking of the “production” of academic degrees and research projects and increasing their productivity. The relationship between results (output) and resources (input) is consequently deteriorating. In academic research and education there is, however, a reverse connection between quality and productivity.

In business literature we can find research results that in the service sector we can increase productivity by redesigning processes, but only marginally. We can gain short term benefits, but by continuing this process re-engineering, the quality of services will, in the long run, suffer. In the University sector we are now living at this stage of development. We have improved productivity considerably by increasing the number of degrees produced, by starting numerous new, large research projects and by adding new forms of operating. The number of personnel has been growing less than the output, thus effectiveness has increased.

The critics of the University sector are correct in the way that we inside Universities have noticed signs of decreasing quality. Increased productivity means more mass education, less tuition, more routine work, longer working hours, less enthusiasm, poor motivation among personnel, more stress and thus exhausted people.

These problems should be tackled immediately. The main objective in University policy should be to increase the quality of research and education. Real quality improvement is a human process, where motivation and encouragement are the key factors. This can be supported, but not replaced, by quality assurance systems. The role of quality assurance may be important in taking care of an even quality. Controlling does not, however, help if the incentives are missing.

The Baltic Sea University sector has long traditions, high quality in many operations, diversity of actions and much hidden potential, but its global competitiveness needs to be improved. We need competitive research environments, which offer circumstances that are tempting to the young, talented scientist. At the moment we are losing our best candidates to industry, to better research environments and to other sectors. E.g. US Universities are able to offer much better environments for research and education. Consequently we are slowly losing our position, which in the longer run is a critical factor.

We need a career development programmes to recruit and keep the best researchers. The present situation, with many short engagements, does not meet this goal. We in the Universities understand that resources are scarce and there are limits to investing into higher education and research. Therefore it is important to guarantee that everything we do is of the highest possible quality. The resources we have should be deployed in an efficient way, but in all focal areas of research the balance between resources and objectives should be realistic. Every University cannot be good or best in all fields. We need prioritising, focusing, specialisation and networking to reach the best possible results.

We have already examples of well-functioning networks between Baltic Sea area Universities. This development should be strengthened to guarantee equal possibilities for our researchers, which those in other countries have. National policies on higher education and research definitely have an influence on our success. We in the Universities hope that these national policies follow the same direction so as to build a unified Baltic research area.

Tapio Reponen

Rector

Turku School of Economics

The Euro-rule for inflation is too strict for the Baltic economies

by Niels Mygind

It was an unnecessary rigid decision that Lithuania was not allowed into the Euro just because inflation was 0.1% higher than the Euro criterion. There would be no problem for the Euro or for the three Baltic economies if their inflation was considerably higher. We must expect a higher inflation in these countries during their catching up process.

After the fall of the command economies they needed deep restructuring from a system based on bureaucratic directives to the new market system where customers' demand and market based costs completely changed what and how firms should produce. Quite fast companies cut away unprofitable production, but it took several years to build up the new production structure with new technology, products and markets. Therefore, GDP fell in the first years of transition reaching the bottom around 1994 in the Baltic countries.

EU-accession accelerated the development of new market institutions meaning more efficient use of the highly educated labour, the quite advanced and improving infrastructure, and the good location close to some of the richest countries in the world. Therefore, the Baltic countries are in a fast catching up process with real growth since 2000 around 8%. Labour productivity is increasing at the same speed. This is the background for steeply growing wages and for increasing prices in the non-tradeable domestic sector. In Balassa-Samuelson terms we see a real appreciation mainly as an increase in the Baltic price-level in relation to EU15, but also nominal appreciations played a role for Latvia and Lithuania. Now, all three currencies are fixed to the Euro leaving only increasing prices as the adjustment mechanism for real appreciation.

In 1995 the price levels in three countries were only 25-36% of the level in EU15 (see table). There was room for steep increases. With the increase in productivity wages started to grow and this was reflected in an increasing domestic price level. By 2000 it was around 50% of the EU15 price level. In the first years of this millennium inflation was quite low probably as part of the policy to be ready for the Euro, but from 2004 inflation increased and it is now the main barrier for fulfilling the Euro-criteria. In 2006 the forecast is around 10% volume growth and Baltic inflation is about 3% higher than in EU15.

	Price levels			GDP/capita, EU15=100			GDP/capita PPS			GDP growth
	1995	2000	2005	1995	2000	2005	1995	2000	2005	2000-05
EU15	100	100	100	100	100	100	100	100	100	2.0
Estonia	36	50	56	11	19	31	30	38	56	8.7
Latvia	31	48	48	8	16	21	27	32	44	7.9
Lithuania	25	44	47	8	15	23	31	35	48	7.1
	2010	2015	2025	2010	2015	2025	2010	2015	2025	2006-25
EU15	100	100	100	100	100	100	100	100	100	2.0
Estonia	65	75	101	41	56	99	64	74	99	5.0
Latvia	56	65	87	28	38	68	50	58	77	5.0
Lithuania	55	64	86	31	41	73	56	64	85	5.0

1995-2005 based on Eurostat.

2006-25 volume growth difference 3%, inflation difference 3%

With the institutions in place, integration into EU, continuing high FDI, and strong restructuring the fast catching up is expected to continue. A difference in real growth rates between EU15 and the Baltics of 6% may not be unrealistic in the coming years. Later, when the economies converge technological spill-over effects will be smaller and growth will also converge to the lower EU15 level. Still, a 3% higher growth in Baltics is probably not too optimistic. Also the price level will catch up and converge to the level in EU15.

The table shows a simple calculation for a possible development for 2006-2025. Catching up is assumed to be 3% in volumes and on top of this is added a 3% price catching up. With fixed exchange rates this means 6% catching up per year measured in Euro. The result is that the Estonian GDP will reach the level of EU15 in about 20 years and Latvia and Lithuania a few years later. The prices will also catch up within this period and the Baltic inflation will thus be 3% higher than the EU15 inflation every year.

However, a 3% higher inflation is not within the Euro criterion. This shows that the inflation-measure is much too rigid for catching up countries with fixed exchange rates. Catching up with steeply growing productivity means higher inflation. Tough economic policy could keep inflation down at the Euro-level for a certain period when fulfilling the Euro-criterion, but the cost would be lower growth. Then, after Euro-entry the price levels should catch up at an even faster speed. The catching up process can be expected to be fastest in the first part of the period and it will be easier to fulfil the inflation criterion when the gap to EU15 has been narrowed considerably – the case for Slovenia with the highest GDP per capita of the new member states. However, it may take several years before it again will be relevant for the Baltic countries to fulfil the tough inflation criterion unless they run into a period of slower growth.

The advantage of joining the Euro may be exaggerated. Nobody claims that the Baltic part of the extended Euro area fulfil the conditions for an optimal currency area. However, with the currency boards in Estonia and Lithuania and the fixed exchange rate in Latvia the three Baltic countries have de facto had a sort of membership of the Euro for a long time. The Russian crisis hit the Baltics as an asymmetric chock compared to EU15 and still this chock was solved within the policy of strictly fixed exchange rates.

The costs of staying outside the Euro for a longer period are probably not high because the exchange rate uncertainty is already very low. It can be argued that interest rates at the Euro level combined with higher inflation mean very low, maybe, even negative real interest rates and this can cause overheating of the Baltic economies. However, already now a high proportion of Baltic loans are Euro-based with a very low real interest rate and very low exchange rate risk.

Niels Mygind

Professor, Director of Center for East European Studies, INT, Copenhagen Business School

Baltic Sea energy roulette: is a survival kit on civil protection needed?

by Timo Hellenberg

Throughout its turbulent history the Baltic Sea has played a trivial role being that of a bridge and a barrier between Eastern and Western Hemispheres. The Sea has carried hopes and spread destruction, whilst always harboring some hidden dimensions unpredictable for the governing regimes. After recent waves of eastern enlargement the European Union has finally generated the borderless socio-economic maritime region, gearing its growth from mounting energy transportations and logistical highways. But as in all historical success stories, there is always the less glorious side of a coin to be tackled.

The greatest potential risks within the Baltic Sea Region are derived from growing energy transportations, namely natural gas and oil. The EU's external dependence and, at the same time, vulnerability for energy is rapidly increasing. Though the Union has very limited scope to influence energy supply conditions, it can effectively manage the risks related to the energy transports, particularly at sea corridors. Regardless of the usage of high-end technology and a stable business environment, the European Union energy transits at the Baltic Sea is facing physical risks (transfer of demand, geopolitical crisis, natural disaster), economic risks (price fluctuations), social risks (social disruptions), environmental risks (global warming) and terrorism. The terrorism risk related to sea transport is clearly evident within the Baltic Sea Region but it has yet to be studied properly.

This is particularly true of some sub-regions of the Baltic Sea, e.g. the Baltic Proper and the Sound, where the narrow and shallow straits cause additional risks. In upcoming years the maritime traffic, for instance the amount of transported oil, is forecast to increase substantially. The oil transit by shipping within the Gulf of Finland is 7 times greater than 10 years earlier. In 2000, the oil cargo through the Gulf of Finland was 40M tons, in 2006, 140M tons and by the end of the decade it is estimated to reach the level of 190-200M tons. Sea transportation essentially uses larger vessels and, although this means less traffic, the risk potential for a large scale accident will grow.

The narrow ship lanes and shallow waters increase the probability for collisions and groundings. Particular risk areas at the Baltic Sea are the Gulf of Finland, the Archipelago Sea and the Quark; the threshold between the Bothnian Sea and the Bothnian Bay, both of which have specific ecological value, but also serve as crossing paths for heavy maritime traffic, particularly between Helsinki and Tallinn. These characteristics together with other kinds of risks, for instance, terrorist attacks on vessels carrying Russian black gold, would have severe consequences for people, property and environment in the region for decades to come.

According to a recent Council of the Baltic Sea States Eurobaltic Report on Cross-Border Risks at the Baltic Sea Region (Hellenberg & Hedin, 2006), there are several advantages within the area currently. On the plus side, the fleet sailing in the Baltic Sea is generally modern. Additionally, transportation by way of single hull vessels will be a thing of the past by 2010 and, importantly, the legislation around transportation is strict. Finally, there is better information flow and possibilities of identification of ships and oil spills. Satellite pictures and the monitoring by aircraft and vessels have, for instance, improved the control of the Baltic Sea traffic. However, apart from the risk of oil spills, the Baltic Sea will face new intergovernmental challenges – with far reaching economic, political and military dimensions – as a result of the North European Gas Pipeline. The risk of disrupted gas outflow would have not only environmental, but also disastrous economic and political dimensions.

Acknowledging that national measures alone are not sufficient to prevent environmental disasters at the Baltic Sea, the Baltic Sea States signed the Helsinki Convention in 1974 which came into force in 1980. Finally, regional cooperation for environmental protection (HELCOM) was initiated. There are also numerous bilateral agreements between BSR countries to tackle oil spills. In 1971, the Copenhagen agreement was established between the Nordic countries to develop multinational cooperation, obligate the countries to arrange annual exercises and man the oil spill capacity. However, where there are arguably too many agreements in place to tackle the oil spill on seawaters, no such agreements exist today for multilateral assistance to tackle oil spills on land or inland waters.

Another obstacle comes from the fact there are too many authorities to deal with oil spill prevention at the national level. For instance in Finland, the Finnish Environment Institute under the Ministry of Interior is responsible for oil spill prevention on seawaters. However, when the oil reaches the shorelines the responsibility shifts to the regional rescue services under the Ministry of Interior. Somewhere between these two agencies lays the capacity and knowledge of the Defence Staff and Ministry of Defence, which may be mobilized if needed. The decision making is at least as complex in neighbouring Sweden where the private sector has an essential role in oil collection from the shorelines.

So what is to be done at the Baltic Sea Region in order to manage these emerging risks around energy transportations? A new model for the regional approach could be derived from the Mediterranean Sea where the United Nations and the EU are co-financing a Regional Marine Pollution Emergency Response Centre for the Mediterranean Sea (REMPEC) to tackle cross border risks, mainly oil spill prevention. Rather than lose time and scarce resources on overlapping national monitoring, training and decision support systems, the Baltic Sea Countries should promote the region as a piloting area within the European Union and worldwide in the field of cross-border risks prevention. This would provide citizens of the region comprehensive safety across their borders and enhance the mutual trust towards our common survival kit targeted to respond to the greatest megatrend of the 21st century; the balancing of domestic safety risks and external security threats. Something which the Baltic Sea has witnessed over centuries but which could prove lethal if not recognized and faced with proper survival strategy and power.

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Will tourism become "pole of growth" of the Kaliningrad economy?

by Elena Kropinova

During the last 15 years the Kaliningrad oblast has been regarded a perspective region for tourism development. Global changes both in the world and in the immediate surroundings of the territory have taken place within this period of time. How has it affected tourism business? Can we consider this sphere "pole of growth" of the Kaliningrad economy?

In 1991 the Kaliningrad oblast counted 90 sanatorium-and-spa and resort institutions (capacity 9921 beds) which had served 250 thousand people. The average accommodation price for foreign tourists amounted to 25-30 US dollars. The main kind of international tourism was nostalgic tourism, which could be proved by increasing flow of German tourists and their dominance in the share of foreign tourists.

According to the 1990s territory development forecast done by SPb experts capacity of accommodation facilities should have grown up to 60 thousand beds in wintertime and 170 thousand beds in summertime[1]. However tourism business growth and restructuring have flown slower than expected and these results were not achieved. In 2005 over 125 accommodation objects (capacity about 15-20 thousand beds), 147 museums, 47 leisure entertainment centres and around 300 restaurants, cafes and bars were at tourists' service. The number of Russian and foreign tourists visited the Kaliningrad oblast in 2005 was 256,6 thousand and 76,4 thousand respectively[2].

Among the problems of tourism development since 1990-s remain visa regime (with expected complication of the situation resulting form inclusion of Lithuania and Poland in Schengen Agreement in the nearest future), poor transport connection (direct regular international flights only to Warsaw-once a day, Copenhagen –four times, to Berlin – three times a week), railroad connection with Gdansk-Berlin (trailing car; 600 km distance is covered in 15 hours), Vilnius (Moscow and St. Petersburg trains), underdeveloped infrastructure, poor condition of landmarks and historic monuments (some improvements, connected to celebrating of the 750th anniversary of the city, should be noted).

The most evident improvements have been achieved in accommodation sector. Among the measures taken are thorough repair of existing and construction of new hotels meeting European requirements. At the same time the price-rate has increased to average 50-100 US dollars per day. The quality of professional training has improved (at present five educational institutions provide the region with specialists in services and tourism). The ecological situation has as well improved due to more strict environmental requirements and utilization of modern technologies.

Besides permanently existing problems which are taken for granted, two comparatively new have risen. One of them results from the new conditions of the Russian Federation tourism enterprises operation in view of the planned introduction of amendments to the Federal Law "On the Essential Principles of Tourism Activity in the RF". If they will be approved financial guarantees will be introduced accordingly. These guarantees will account for 10 million rubles for the tour operators, specialized in external tourism (according to experts' opinion this amount is sufficient to cover, for example, the costs of the costumers flight from abroad in case of bankruptcy) and 1 million rubles for the tour operators specializing on incoming tourism.

[1] The Kaliningrad Oblast Recreational Complex Development Programme, 1993 г.

[2] Kaliningrad Oblast v zyphrakh. State Commettee for statistics in Kaliningrad Oblast, 2006

[3] Russia. Federal Internet Channel. 6.12.06 , http://www.rfn.ru/cnews.html?id=116274

However this amount is too large for the regional tour operators who see these innovations supportive of larger Moscow companies (there are about 30) interested in displacement of smaller companies. Hence, we will have the following situation on the Kaliningrad tourism market – around 10 regional operators, Moscow branches (the most active at the time is "Neva" (airplanes), "BonVoyage" (busses), "Infinity", "Rus.Adventure" etc.) and, possibly, foreign tour operators (Turkish, Greek, Spanish, Egyptian) (apparently international partners' guarantee can become rescue for the smaller firms). Other firms will have to extend or merge with the survived ones (including Moscow and foreign companies).

Another problem is faced by the regional government, the administration of municipal formation "Zelenogradskij district" and the administration of the "Curonian spit" national park. It is a consequence of the decision by the Ministry for Trade and Economic Development of the RF Government on creation of tourist-recreational area "Curonian spit" on the territory of the Kaliningrad region taken in November 2006. This territory together with six more regions has won the tender for investment. The planned amount of state financing is 1,8 billion rubles[3]. 1,5 rubles of this amount will be allowed by federal centre within the framework of recreational areas development programme. The advantage is that the funds will cover modernization and infrastructure development. Obviously, the territory with sufficient infrastructure will become attractive for construction of tourism and recreation objects (according to the regional government forecast it will draw at least 9-10 billion rubles private funds). However, the project raises doubts from both economic and ecological perspectives, as the territory is occupied by the "Curonian spit" national park and economical activity, therefore, is significantly restricted. The amount of the requested investment is groundlessly low – 1.5 billion rubles (43 million Euro) (construction of bicycle lanes, promenades etc. is planned) while the time constraints of assignation are wide - till 2026.

To compare, 6,9 billion rubles are allowed for tourism-recreational area development in Altayskiy krai, 4,8 billion rubles for the republic of Altai, 2,56 billion rubles for the Irkutskaya oblast, 10 billion rubles for Buryatiya, 12,9 billion rubles for Krasnodarskiy krai, 2,5 billion rubles for Stavropolskiy krai. One has also take into account that infrastructure development will be carried out in the area with complex geology, which involves complex coast-protecting measures. More than that, the project has to undergo ecological examination which sets specific, more strict requirements for the area within the National park. Not less interesting is the international community opinion, considering that the territory is included into UNESCO World Heritage List. Therefore, those elaborating the project bear greater responsibility, both ecological and financial.

The Kaliningrad oblast authorities face a complicated task – to transform the oblast into a tourist centre, capable of competing with neighboring areas and at the same time attractive and accessible (in respect of visa and transportation) to be included into international tourist routs in the Baltic Sea region. Mere adequate solution of the indicated problems will make tourism profitable business and "pole of growth" of the Kaliningrad economy.

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Finnish – Baltic Trade Associations
Case: Finnish-Latvian Trade Association

by Tapio Aho

As soon as the Soviet occupation was over in the Baltic States, Finnish companies started to investigate business opportunities especially in Estonia, but also in Latvia and Lithuania. Estonia issued as the first former Soviet republic its own currency in June 1992. This successful operation supported Estonian economy by cutting it away from Rouble economy. It also caused a new wave of Finnish companies entering to Estonia. At that time most of the official contacts between Finland and Estonia were missing. One of the reasons was the lack of institutions in Estonia. Sufficient information about development was not available in Finland. To cover these needs Finnish – Estonian Trade Association www.seky.fi was established 1992. Finnish-Lithuanian Trade Association www.suli.fi saw day light 1994. Finnish-Latvian Trade Association www.laky.fi was registered in Finland 1997. The main task of associations is to develop trade between the countries and also to support the Baltic institutions and organisations with information and training.

Total number of Finnish investors in Latvia is 290. The number of members in Finnish-Latvian Trade Association is growing every year and has now reached the highest level so far and is almost 90. The first members were retail chains or companies offering Finnish products to consumers, farmers, etc. This group was followed by service sector; like banks, law offices and advertisement companies, who were forced to follow their customers to new market areas, in order for not to loose the customer relations also in Finland. Today we see more and more manufacturers looking for possibilities to produce components in cheaper labour area like in Latvia. Real estate developers have started to move to the Baltic countries already some years ago. It has been most important for association to keep close contacts and strong co-operation with Latvian embassy in Finland and also Finland's embassy in Latvia. Among partners of Finnish-Latvian Trade Association there are also high schools, central banks and ministries. Through the members association owns a huge amount of know-how from all fields of business. Association has organised annual seminars, meetings and trips to Latvia. Today the need of information is not as important as it was some 10 years ago. Information is available from many sources like law offices, banks and research units. In spite of that it is possible to cover special areas, which may have impact on most of the members. At the moment Association follows infrastructure investments in Latvia and transparency of projects. Naturally Association also keeps individual contact with as many members as possible.

We still believe in strong integration between the economies of Baltic countries and Finland. Estonia is leading this process. The number of Finnish direct investors in Estonia is 570, in Latvia 290 and in Lithuania 180. More and more medium sized companies are also looking for trade possibilities. Many of them seek producers of components. Especially Finnish metal companies contact rather often Association for information of potential counterparties.

A new phenomenon is Baltic investment activity in Finland. Estonians' are leading also this process with names like Tallink, Teho and Alta Capital. Latvian investors are still missing, but finally new Latvian products have entered Finnish markets.

Because most of the members have activities in each Baltic country, Baltic Trade Associations also co operate and arrange joint meetings. However we still feel that separate associations are needed. There is much in common, but the Baltic States are different. Their history, economy, language and culture differ from each others.

Tapio Aho

Chairman

Finnish-Latvian Trade Association

Threats and opportunities regarding Latvia's economy

by Raita Karnite

On the surface, Latvia and other Baltic States, have demonstrated surprising progress in developing their economies. Growth rates have been high for several consecutive years in all the Baltic States with varying degrees of success for each country. Estonia attains better positions in all international comparisons and evaluations, whereas Latvia and Lithuania occupy lower positions, yet in the middle of the list, usually next to each other.

Economists know that a high growth rate does not necessarily provide good economic development, or, that quantitative achievement not always transforms itself into adequate qualitative achievement. The adequacy of qualitative and quantitative improvements depends on the growth engines.

Taking Latvia as an example, high economic growth is supported by strong domestic demand; besides a low starting level helps to see high growth rate figures. The average annual GDP growth rate has been more than 9% for five consecutive years, and the steep rise (more than 10%) continues since 2005[1]. The domestic demand is fueled by higher real income, resulting from the dynamic expansion of lending, FDI, financing from EU structural funds and other factors.

It is expected that the present pace of Latvia's economic development will remain unchanged for some years. The Bank of Latvia reports[2] that the annual lending growth rate was 59.5% in QII 2006. However, the positive effect of loans availability is deteriorative as lending activities are focusing on consumption financing. More than half of all the credit issued goes to households, primarily for house purchase. Two-thirds of the corporate loan portfolio is allocated towards real estate, renting and business companies. The third larger borrower is the banking sector itself. Through this disproportional financial provision, banks have encouraged structural changes in the Latvian economy within a short time period. In 2004, the increase in the gross value added was equal in the goods-producing and services sector, while in 2005 growth in the service sector (by 11.2% on y/y basis) surpassed that of the goods-producing sector (7,9%)[3].

The high increase in money supply continues (about 40% in QII 2006), and also domestic deposits grew by more than 40%[4]. The lending activities of foreign-owned banks surpass borrowing; essentially meaning that banks no longer primarily transport money within the Latvian economy, giving earnings to lenders in Latvia, but they allocate deposits accumulated in their parents into Latvian economy thus increasing external debt. The banks focus on the high profit and liquidity sectors – currently the real estate sector, on the basis of mortgage crediting. This business is attractive, and several other foreign-owned banks have entered the Latvian financial market in 2006.

Due to the substantial structural changes, the picture seems less sunny from the supply side of Latvian economy. The Bank of Latvia states[5], that the upward trend in GDP is strongly supported by a steady rise in retail trade turnover, while the progress in manufacturing is considerably less, associated with internal demand. The demand for exports has slowed in the main exporting sectors in QII 2006. The growth was also moderate in the transport, storages and communication sectors due to problems of oil and mineral fertiliser transit.

On other hand, imports grew at the high average pace. The deterioration of the goods balance persisted and the current account deficit jumped to 17.9% of GDP in QII 2006. The deficit was covered by long term capital, of which FDI comprised almost half[6].

The economy faces some other structural problems – tight labour market conditions, emigration, and fast-growing labour costs and salaries, as well as high inflation on the basis of price rises for energy, increasing material and labour costs. The bubble of the real estate market has reached considerable amounts, yet prices continue their growth. It is clear that the current situation can not remain forever and there should be changes. What changes would we like to see?

They must turn the economy from the dangerous "only consumption" oriented path to a more sustainable one, by forwarding a part of the lending to the producing sectors – no matter to the material production or service sectors. It is likely that foreign-owned banks are not going to cut their lending activities and prefer consumption credits unless other sectors show better productivity. The first comers' preferences in using unbelievably cheap labour are almost exhausted. Investors have not yet understood profit from that of investing in productive sectors, and clearly demonstrate their short-term interests in Latvia. In this moment, the winner will be the one who finds new paradigms of competitiveness in Latvia. The external situation also supports investment in NMS in general and Latvia in particular. Economic development in the "core" EU countries remains uncertain – good in projections but moderate in real figures whilst growth rates in NMS remain high.

What are the new paradigms of competitiveness in Latvia? From the current point of development, it is the implementation of the Lisbon pattern in an easy way. The share of industry in Latvia's GDP is only slightly more than 12%, and it is segmented into a large number of small production units. The development of knowledge-intensive service sectors is also moderate, so the market is free and competition stays away. On the other hand, the availability of the highly-skilled workforce is still substantial. At the time being labour resources are used and paid inadequately with regard to their qualifications, labour productivity may be raised several times. Besides, the government has declared support for the knowledge-intensive model of Latvian economy in the National Development Plan that governs investment priorities in forthcoming years.

We may conclude that the development reserves of the Latvian economy remain high. Despite the dual situation at the current moment, and probably because of it, the country is at the beginning of a new development wave.

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[6] The same.

■ **Baltic Rim Economies**, Bimonthly Review 6▪2006, 29.12.2006
ISSN 1459-9759
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