STATE OF THE REGION REPORT™

[2007]

The Baltic Sea Region as a Place to Do Business

Baltic Development Forum

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Key messages

- Regional cooperation is a key opportunity and necessity for the Baltic Sea Region to improve its competitiveness position within the European Union and globally.
- The Baltic Sea Region registers solid levels of economic performance and competitiveness. The Region needs to prepare for further increasing global competition and worsening demographics that threaten to erode its current competitive advantages over time.
- Companies are only starting to experience the Baltic Sea Region as an integrated geography. The separation in small national markets has so far limited the ability of companies to fully exploit the existing qualities of the Region.
- The current discussions in the Baltic Sea Region provide an opportunity for a step-change towards an institutional architecture for effective regional collaboration in the 21st century.

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Prepared for the Baltic Development Forum in collaboration with
the Nordic Investment Bank (NIB) and the Nordic Council of Ministers (NCM)

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Foreword

We are proud to present the fourth annual State of the Region Report, providing in-depth knowledge and analysis of what makes the Baltic Sea Region and its 11 countries tick. From our point of view, there are three messages from the Report to be highlighted.

Talents matter! A primary strength of the Baltic Sea Region is its capacity to innovate. The future competitive success of the Region will therefore depend on its ability to develop, attract and retain the skills necessary to upgrade its high-tech and knowledge-intensive industries. In a situation where the mobility of students and high-skilled labour is rising, it will be essential that the Baltic Sea Region provides strong and clear incentives to match the growing demand for excellence in skills.

Businesses matter! Prosperity and competitiveness are closely linked to the growth and profits generated by successful businesses and investments. Fundamental understanding of what drives business and investments is therefore essential for providing the right framework conditions for future growth. To position the Baltic Sea Region – on Top of Europe – for the future, it will be essential that the voice of its business leaders is more prominently present in the competitiveness upgrading debate.

Neighbours matter! In the future, European cooperation and integration will be crucial but needs to be completed by further efforts among neighbours to achieve a higher degree of economic well-being. In parallel to the efforts undertaken in relation to Lisbon Agenda of the EU, stronger integration can be achieved within a smaller regional framework that is more narrowly geographically and culturally defined. In this context, it is essential that the countries in the Baltic Sea Region build on their ability to cooperate to optimise their common competitive potential.

The analysis and conclusions in the State of the Region Report are those of the author and do not necessarily reflect the views and commitments of our organisations. However, we are positive that the Report will be of use as a source of knowledge and information for competitiveness, innovation and business upgrading, that can spur concrete action for the development of the Baltic Sea Region.

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November 2007

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Executive Summary

The 2007 State of the Region Report is the fourth edition in this series of annual evaluations of competitiveness and cooperation across the Baltic Sea Region. The Report is organized into three parts: Part A of the Report describes the motivation for regional cooperation and the macroeconomic context in which it currently occurs. Part B covers different aspects of the Region's competitiveness, from an assessment of its economic performance to an evaluation of its microeconomic fundamentals to its position regarding the European Union's Lisbon Agenda. Part C looks at the Region from the perspective of businesses and discusses its attractiveness as a market, its potential as a source of competitive advantages, and its effectiveness as a policy platform for competitiveness upgrading.

Part A sets the stage for regional cooperation in the Baltic Sea Region, home to 53.5 million people and an annual GDP of about €1400 billion. The academic literature has increasingly pointed out that cooperation among neighboring countries has significant benefits for competitiveness and economic performance. It has also started to provide a better sense of what role different levels of geography ought to play. In the Baltic Sea Region, the opportunities for the neighborhood to generate benefits are high but require an active political strategy to overcome remaining barriers. And the Region can become an important complement to the European Union, pursuing deeper levels of integration and creating a platform to influence policy making at the EU level.

Regional cooperation is affected by the macroeconomic climate in which it occurs. At the global level, the environment has been very benevolent in recent years. The most likely outcome now is a moderate slowdown of the global economy. A much more serious contraction driven by financial market problems is unlikely, but possible. At the Baltic Sea Region level, the macroeconomic climate is strong. Real GDP growth remains significantly above the level in the EU-15 and has started to outperform both the NAFTA region and the world economy overall. The economies in the Region are entering the later stages of the current business cycle. While there is some risk of overheating, the most likely outcome is for an orderly slowdown of growth rates over the coming months and years.

Part B, a continuation of the tracking of the Baltic Sea Region's competitiveness started four years ago, discusses economic outcomes in the Region. Prosperity growth has accelerated and is overall on a solid path, even if the high speed of the last year will be hard to sustain. The Region continues to benefit from a solid combination of high labor mobilization and solid productivity levels. Intermediate indicators of competitiveness, often a bellwether for things to come, send more mixed signals but are generally also at solid levels. The underlying theme of the changes in 2006 has been that the Region is entering the later stages of a classic business cycle upswing.

In terms of underlying competitiveness, the Baltic Sea Region continues to be among the most competitive economies in the world. Where changes occurred since last year, they tended to be positive, reflecting the benign economic climate that the Region is experiencing. The Region's strengths continue to be its sophisticated companies, its asset base, its innovative capacity, and its equal rules for all in competition. Weaknesses exist in the burden that rules and regulations impose on the vitality of competition and in some aspects of the education system. The skill base remains strong for now but there are concerns whether it will remain competitive in a changing future environment. The cluster portfolio of the Region is solid, but a Region-wide strategy to develop it is required, in the face of increasing competition among clusters within Europe and globally.

From the perspective of the European Union's Lisbon agenda, the Baltic Sea Region remains in a leading position, a 'beacon for the rest of Europe' as EU Commission President Barroso commented two years ago. The countries from the Region also get generally good reviews for the direction and implementation of their National Reform Programs, a new policy tool introduced with the relaunch of the Lisbon Agenda in 2005. Regional cooperation could, however, become a more visible part of these programs.

Part C, a special section for this year, takes the company perspective and is based partly on a set of CEO interviews conducted for this Report. As a market, the Baltic Sea Region is not perceived as integrated, largely because the need for locally serving customer needs and the differences in regulatory regimes and legacy market structures require companies to run businesses nationally. The Region is, however, becoming increasingly important as a higher management level to increase the efficiency of business models. The lack of market integration raises cost levels for companies. Further integration will reduce these costs and can attract more foreign companies and open the door for consolidation across the Region. This process has only begun; in the past, regional integration has supported the growth of existing business models but has not led to their recalibration.

The Baltic Sea Region provides a number of qualities that make it an attractive source of competitive advantages. Its small market size has, however, leads foreign companies to stay outside instead of leveraging these opportunities. Those companies that have come, like GE Health Care, are able to draw especially on the skill base of the Region. Companies from the Region have seen the particular nature of local markets and business environments shape their strategies on global markets. Competing on innovation, design, and a willingness to adjust business models flexibly to the particular needs of foreign markets, companies from the Region have been successful in a significant range of businesses across the world. The market opportunities in the Baltic countries, to some degree also in Poland and NW Russia, have invigorated the Region and given companies new opportunities to develop strategic advantages.

Efforts to upgrade competitiveness in the Baltic Sea Region work generally well; better than in many other parts of the world. But the current review of public sector institutions for Baltic Sea Region cooperation needs to be ambitious in its approach to register with the business community. Company leaders themselves will need to discuss whether they should create a new Baltic Sea Region voice of businesses as a counterpart to the existing public sector structures.

Without a doubt, 2006 has been a good year for the economies of the Region, a trend that is likely to carry through for 2007. The challenges are further away in the future, related to the Region's position in the world economy and its demographic profile. The most immediate step to address these challenges is the creation of an effective institutional architecture that can devise and execute an action agenda for long-term competitiveness in the Baltic Sea Region.

Introduction

Why a State of the Region Report?

The 2007 State of the Region Report is the fourth edition in this series of annual evaluations of competitiveness and cooperation across the Baltic Sea Region. The series was created to inform decisions about regional economic cooperation in the Region, to track the impact of these decisions on competitiveness, and to communicate the Region and its willingness to upgrade both within and outside. The Report made the Baltic Sea Region visible in a very direct way.

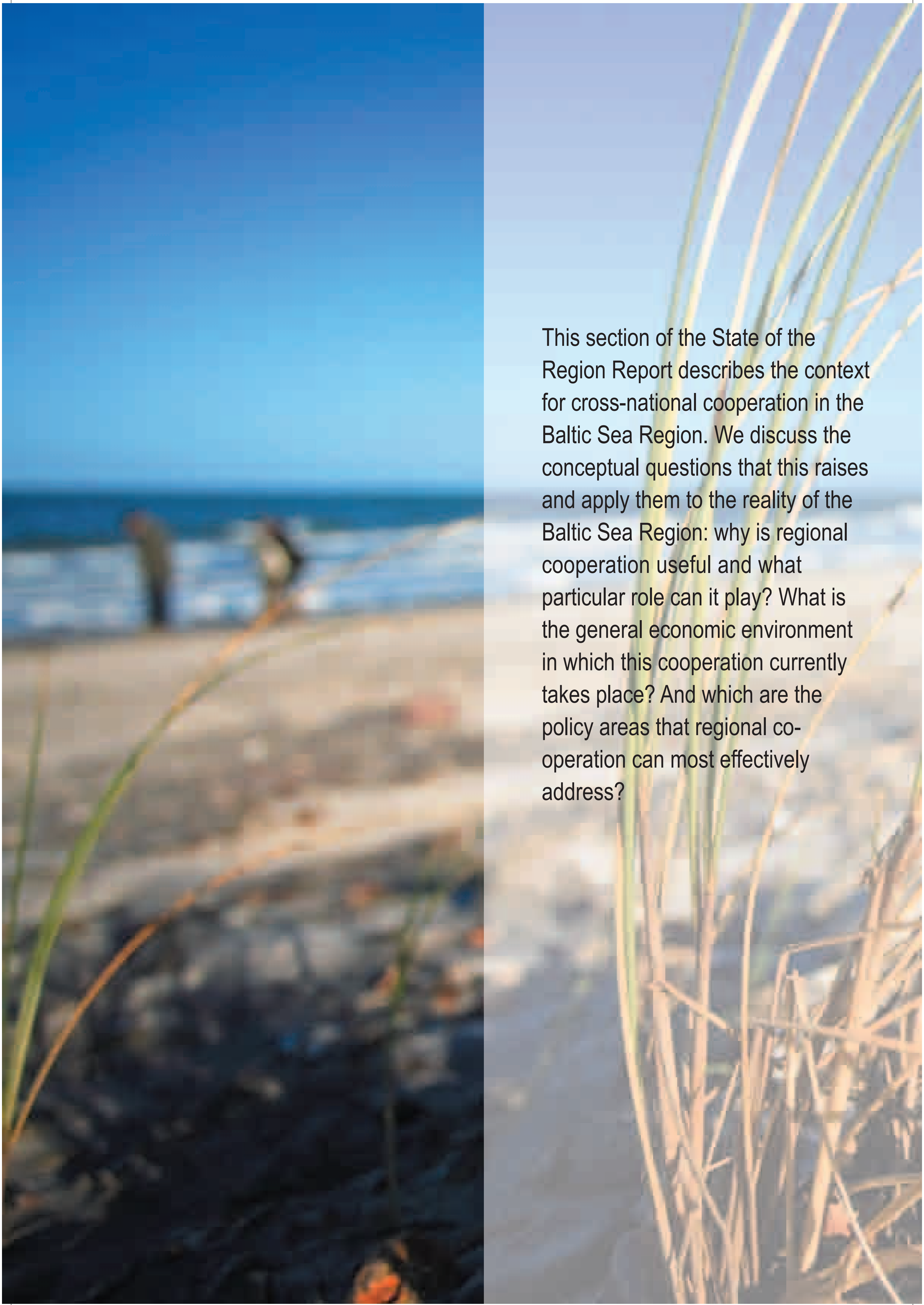
This year's Report follows the broad structure that we have developed since 2004. Section A provides a discussion of the broader context in which regional cooperation and competitiveness occurs. We discuss the findings of the academic literature on the impact of neighboring countries on prosperity and competitiveness. And we provide an overview of the current macroeconomic situation across the Region. Section B presents the latest results on the competitiveness of the Baltic Sea Region. We look at economic performance, underlying microeconomic competitiveness, and the position of the Region's countries in terms of the European Union's Lisbon Agenda. Section C takes the perspective of businesses and asks how they perceive the Region. We look at the attractiveness of the Baltic Sea Region as a place to do business, as a source of competitive advantages, and as a Region that aims to upgrade its competitiveness.

What is the Baltic Sea Region?

For our analysis, we define the Baltic Sea Region – as in previous years – to include the Baltic countries (Estonia, Latvia, and Lithuania), the Nordic countries (Denmark, Finland, Iceland, Norway, and Sweden), northern Germany (Hansestadt Hamburg, Mecklenburg-Vorpommern, and Schleswig-Holstein), northern Poland (Pomorskie, Warminsko-Mazurskie, and Zachodnio-Pomorskie), and most parts of Russia's Northwestern Federal District (excluding the four regions least connected to the Baltic Sea Region: the Republic of Komi, Arkhangelskaya oblast, Nenetsky AO, and Vologodskaya oblast).

This Region, as measured in this Report, is home to 53.5 million people, a number that has been decreasing by about 50,000 annually over the last few years. The Nordic countries and northern Germany—together now representing about 58% of the Region's inhabitants—have gained in population but the decrease in population in the Baltic countries, northern Poland, and north-western Russia was even higher. The Region's labor force of 25.6 million employees has been growing since 2003. Most recently, this growth has come more from the Nordic countries than from the Baltics, Poland, and Russia. The Region creates an annual GDP of about €1400 billion. The Nordic countries account for a stable 75% of the total while the relative importance of the other parts of the Baltic Sea economy are slowly changing. Northern Germany still comes second with a share of 14%, which, however, is falling. Northwestern Russia, now at 5%, is growing, as are the Baltic countries now at 4%. Northern Poland, finally, accounts for 3% of regional GDP.

There is no scientific way to exactly determine the boundaries of the Baltic Sea Region. We proceed pragmatically, including those regions that appear closely integrated with other regions around the Baltic Sea. Iceland and Norway are included because they have close relations to many countries around the Baltic Sea and are eager to participate in regional cooperation. Most of Germany, Poland, and Russia is not included, because only for the regions closest to the Baltic Sea does the interaction with other parts of the Region constitute an important part of their economic reality. Whether or not this geographic Region becomes a real platform for business and policy is not only a question of proximity. It depends on what decision-makers in business and politics make out of the potential that this neighborhood provides.



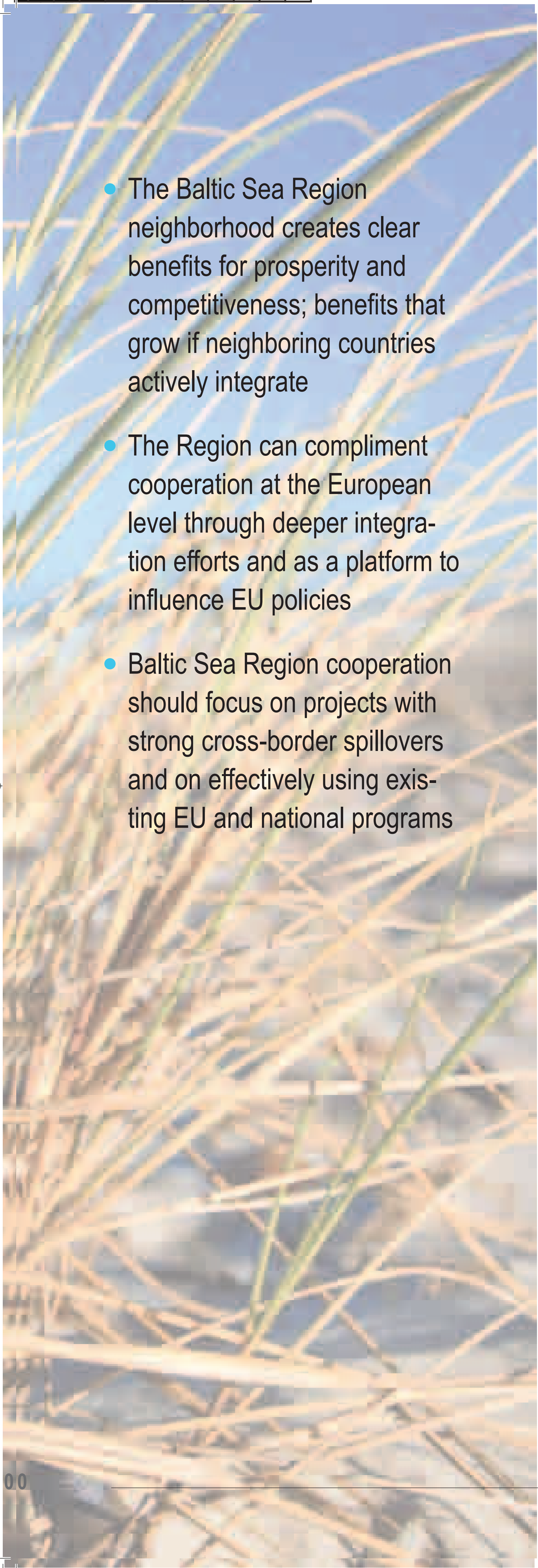
This section of the State of the Region Report describes the context for cross-national cooperation in the Baltic Sea Region. We discuss the conceptual questions that this raises and apply them to the reality of the Baltic Sea Region: why is regional cooperation useful and what particular role can it play? What is the general economic environment in which this cooperation currently takes place? And which are the policy areas that regional co-operation can most effectively address?

SECTION A: The context for cross-national cooperation in the Baltic Sea Region

Cross-national cooperation is often celebrated in public speeches but tends to be pushed down the political priority lists once domestic challenges arise. In this respect, the Baltic Sea Region has to deal with the same challenges as many other neighborhoods that aim to increase their level of cooperation.

First, we review the academic literature on the economic importance of neighborhood and on the role of different geographic levels, including cross-national regions, in economic policy making. These general concepts are then applied to the reality of the Baltic Sea Region. While this discussion might seem theoretical, it turns out to have highly practical implications. Without a sound understanding of the Region's role, it can easily become an irrelevant side-arena when policy making responsibilities are divided between Brussels and national capitals.

Second, we look at the current macroeconomic climate in the Region. This climate has an important impact on the willingness to engage in regional cooperation and on the issues that regional cooperation has to deal with. Competitiveness deals with the underlying capacity of the economy, while the macroeconomic climate affects the short-term fluctuations in the way this capacity is used. The macroeconomic climate has important repercussions on competitiveness, because it shapes companies and politicians view of priorities and opportunities for collaborating across borders.



- The Baltic Sea Region neighborhood creates clear benefits for prosperity and competitiveness; benefits that grow if neighboring countries actively integrate
- The Region can compliment cooperation at the European level through deeper integration efforts and as a platform to influence EU policies
- Baltic Sea Region cooperation should focus on projects with strong cross-border spillovers and on effectively using existing EU and national programs

1. Cross-national cooperation as a tool for competitiveness

Cross-national cooperation is not a goal in itself – it is a tool to achieve other, more ultimate goals like economic prosperity or security. Whether or not cross-national cooperation is useful depends on its ability to make a significant contribution to reaching these ultimate goals. Cross-national cooperation is appropriate as long as the energy and resources it requires are not more efficiently used at home or at other geographic levels.

In t the Baltic Sea Region, for most of the 1990s the goals for cross-national cooperation have been primarily political, with areas like economics playing an important but ultimately only supporting role. When the Baltic countries and Poland became members of the European Union in 2004, the balance between these goals, and the role of the Baltic Sea Region as a tool in achieving them, has shifted. Economic development and other practical matters like environmental protection have become dominant goals. And the institutions of the European Union have become the focal point for many cross-national discussions and policies.

What are the consequences that these fundamental changes have had for Baltic Sea cooperation? First, we need to re-evaluate the role that cooperation at this level can play in the context of economic policy. Second, we need to define the relationship between cooperation in the Baltic Sea Region and cooperation in Europe. And third, we need to re-evaluate the policy areas that regional cooperation in the Baltic Sea Region should focus on.

Cross-national regions and competitiveness

Neighbors and the nature of economic relationships between them matter for economic prosperity. While local conditions are the most important drivers of a country's prosperity and competitiveness, the neighborhood can make a significant contribution towards higher economic well-being. How strong the neighbor is economically makes a difference. How strong the ties with the neighbor are makes a difference. And how big the overlap in economic specialization is makes a difference.

- The competitiveness and prosperity of neighboring countries have a clear positive impact on a country's own competitiveness and prosperity. A rich neighbor provides an attractive market and source of investment. A competitive neighbor creates opportunities to provide complementary activities in integrated value chains. And a competitive neighbor with strong institutions creates an example and is an effective benchmark for strengthening the country's own competitiveness.

- The neighborhood effects are strengthened if countries have strong economic ties through trade, investment, and personal interchange. Countries empirically trade more with their neighbors than with others and the closer these trading relationships are, the higher the benefits for prosperity. Countries that trade less with their neighbors because of large distances, inefficient infrastructure connections, bad political relations, or exports which mainly consist of commodities like oil that are sold on global markets, miss out on these advantages.

But most neighborhood effects have to be earned, they do not come automatically.

- The neighborhood effects are also stronger, if countries specialize in similar clusters. Competition between neighboring clusters is more intense and spurs higher performance. Cooperation between neighboring clusters can be more intense if effective linkages between clusters emerge. Cooperation can increase the specialization of individual clusters, broaden the array of assets and activities available, and thus increase the role that such a network of neighboring clusters can play in global value chains.

Some neighborhood effects work through sheer proximity. The mere presence of a successful neighbor can make a difference, even if there is little direct contact. But most neighborhood effects have to be earned, they do not come automatically. Countries need to set rules and regulations and invest in infrastructure so that linkages can develop. Clusters need to establish communication, develop linkages, and create a clearly differentiated profile of complementary strengths for collaboration to become a reality. And ultimately, companies need to make linkages a reality through their sales, procurement, and investments.

What does this mean for the Baltic Sea Region?

- First, the Region's geographic position increases the need for leveraging the benefits of regional integration. The countries across the Baltic Sea Region are small and the entire Region is located at the periphery of a larger economic area, with low dynamic growth in the past. Regional integration provides the opportunity to reduce the limitations of small domestic market size and increases the inherent attractiveness of this region for economic activity. Iceland's focus on developing its relations with the Baltic Sea Region is an example of how such active policies can overcome even a challenging geographical location.

- Second, the Region's heterogeneity in terms of economic development and legacy can complicate the integration between the Baltic countries, Russia, and Poland on the one hand, and the Nordic countries and Germany on the other hand. The remaining labor market barriers kept in place by Germany for employees from the former Communist countries is an example of the political problems this can create. A pro-active approach is needed to overcome these differences in terms of company maturity, administrative procedures, and pure market transparency.

- Third, the Region's closeness in terms of cultural values, the strong legacy of cooperation among the Nordic countries, the increasing linkages through trade, investment, and personal travel, and the many common initiatives and institutions that have developed in the Baltic Sea Region create a solid basis for embarking on an ambitious agenda for regional cooperation. But regional cooperation can easily become the victim of political rivalries, even when the economic benefits are clear. Too often, the economic relations between Russia and the other parts of the Baltic Sea Region, particularly the Baltic countries and Poland, suffer from this political baggage.

Overall, there is a strong general argument for regional cooperation as part of an overall competitiveness strategy. And this argument applies in the Baltic Sea Region even more than in many other parts of Europe and the world.

Regional cooperation within the European Union

The region of neighboring countries is only one of many policy arenas in which decisions with an important impact on competitiveness and prosperity are made. In the past, the competitiveness debate focused much on competition between countries and national level policies. If other geographic levels were considered as relevant policy arenas, the discussion usually assumed a zero-sum competition about relative influence.

This view has changed. First, there is a much larger appreciation that competition occurs between subnational regions within and across national borders. The differences in prosperity between subnational regions within countries are a sign that some regions succeed much better than others, even if they are subject to the same national policies. Second, there is a much clearer understanding that conditions within a particular subnational region are shaped by decisions on different geographic levels. Local choices matter, national policies matter, the cooperation with neighboring countries matters, and the context set by supranational institutions like the European Union matter as well. This deeper understanding of the role of different geographic levels in competitiveness poses new tasks for policy makers:

The Baltic Sea Region can be a 'natural coalition' with significant influence, if its member countries are able to identify common priorities and coordinate positions

- The competitiveness of a location depends on the appropriate allocation of economic policy responsibilities across the different levels of geography. Whether a policy should be managed at the local, national, cross-national, or European level depends on a trade-off between the advantages and costs of location-specific versus general policies.

- The competitiveness of a location depends on its ability to influence decision making at higher geographic levels in order to lead to policy choices that take account of the location's specific needs and interests. While part of the task is bargaining with the interests of other locations, much of it also involves the provision of information about local experiences and needs so that they can be taken into account in the decision-making process.

In Europe, the emergence of the European Union as the focal point for economic policy making has affected the allocation of policy responsibilities across all levels of European geography. National governments have seen a significant amount of their responsibilities move to Brussels. They remain engaged in the decision process through their representation in the European Council, but have to compromise with other governments rather than (only) winning parliamentary support domestically. Subnational regions have been removed further from the decisions that used to be taken in national governments but also find a more open environment in which to cooperate with subnational regions in other countries. Cross-national regions face probably the most significant challenge to their traditional role. They need to define their role relative to what nations can do and what European institutions can do.

The growth of the European Union to 27 members, and the EU's past success in economic integration, have changed the demands that the European policy system is facing. First, the rising number of EU members has complicated the pure mechanics of making decisions. The increasing heterogeneity among EU-member countries adds further complexity. Second, the success of the European Union in removing the most obvious barriers to economic integration that existed at national borders has changed the policies under discussion. Policies now on the agenda are as (or more) important domestically as they are for cross-border economic integration. Reaching a consensus on issues that have a strong domestic policy aspect is getting increasingly difficult. European integration is necessary but not sufficient for improving competitiveness across European regions like the Baltic Sea.

What does this mean for the Baltic Sea Region?

Within the European Union, individual countries become part of a complex political structure where decisions depend on the support of a sufficient number of other EU members. The ability to organize coalitions that provide such support becomes a crucial element of successful economic policy. The Baltic Sea Region can be a 'natural coalition' with significant influence, if its member countries are able to identify common priorities and coordinate positions. The countries in the Baltic Sea Region will not always share opinions and the coalition will not always include the same combination of countries. Especially Germany and Poland might have national interests that do not always coincide with the interests of their northern regions. But the Baltic Sea Region can provide a useful starting point for discussions and increase the likelihood for opinions from this Region to be heard. This is particularly evident in policy initiatives at the European level that directly target this Region, like the Baltic Sea Region strategy developed by the European Parliament and the activities of the EU, Iceland, Norway, and Russia under the umbrella of the Northern Dimension.

Many decisions that need to be taken on competitiveness-related issues at the cross-national level involve a myriad of technical rules and regulations. Achieving agreement on these issues in a European Union of 27 members with a high degree of heterogeneity is complicated and sometimes impossible. Achieving agreement within the Baltic Sea Region, however, might still be possible. The gains from common regulations are higher among neighbors with close economic ties. And the potential to negotiate a compromise is larger with fewer countries with a higher degree of cultural proximity. The Baltic Sea Region could become a role model for how cross-national cooperation within parts of Europe can benefit European integration. It could push the Lisbon Agenda aggressively forward, not just through policy action on the national level but by creating a new policy process among neighboring countries to be copied in other parts of Europe as well.

European integration and the EU accession of Estonia, Latvia, Lithuania, and Poland have created new roles for Baltic Sea Region cooperation. The European Union and the Baltic Sea Region are different, not competing policy arenas. EU accession has not made Baltic Sea Region cooperation superfluous. In fact, with more power migrating to Brussels, a strong Baltic Sea Region will be increasingly important to retain real influence in this region of largely small countries.

Key policy areas for regional cooperation

Regional cooperation can cover many different policy areas and take many different forms. The specific choices that are being made along these two dimensions can change over time, depending on the countries' needs and the roles played by institutions at other geographic levels:

- In terms of policy areas, regional cooperation can cover everything from initiatives towards upgrading the microeconomic competitiveness (i.e. investment attraction, infrastructure projects, joint research projects, etc) to macroeconomic coordination (i.e. monetary policy, exchange rate policy, etc.) to other policies (i.e. legal and administrative reforms, social policies, environmental protection).

- In terms of the intensity of cooperation, the activities can reach different levels of integration from pure consultation, i.e. focusing on policy learning, to targeted collaboration on specific issues with cross-border spill-overs, i.e. joint transportation infrastructure or border procedures, to fully integrated policies, i.e. common FDI attraction or integrated R&D funding programs.

The European Union and the Baltic Sea Region are different, not competing policy arenas.

The European Union has policies which cover the full range of microeconomic, macroeconomic, and institutional/non-economic policy areas. It widely supports policy learning across European countries and regions, since the re-launch of the Lisbon Agenda under the heading of the "Open model of coordination". It provides funding for cross-border cooperation, for example through the Interreg program. And it organizes common EU policies in many areas from environmental regulation and structural funds to the 7th Framework Program on R&D and the Competitiveness and Innovation Framework Program on microeconomic upgrading.

The policies of the European Union and the regional cooperation within the Baltic Sea Region have enabled significant progress in administrative and legal reforms as well as regional security. Environmental cooperation has delivered many benefits as well, but huge challenges remain.

What does this mean for the Baltic Sea Region?

Cooperation should focus on areas with clear cross-border spill-overs that occur largely within the Region instead of broader geographies. Both microeconomic upgrading, i.e. efforts to increase market integration as well as generally strengthening the business environment, and many aspects of environmental protection fall into this category. Such efforts will provide direct mutual benefits for the participants. Within business environment upgrading, examples which have been discussed in previous Sate of the Region Reports are: integrated transportation and electricity networks, joint investment attraction and branding, a common Baltic Sea Region space for innovation and skills, and the collaboration of regional clusters in a specific field, like in ScanBalt for life sciences.

Cooperation should focus on strategic planning, i.e. on identifying how the available national and EU level programs and policy tools can be applied most effectively. In some areas additional programs and tools might be needed but in most cases existing national resources can be pooled. The Baltic Sea Region does not need a higher quality of initiatives and institutions; it needs to get better organized in creating an integrated and mutually reinforcing action agenda. This agenda would provide clear guidance on the role that individual institutions and efforts play, overall. The reorganization and consolidation of existing institutional structures in the Baltic Sea Region can make an important contribution to regional competitiveness, if they create the basis for more coordinated action.

2. The macroeconomic climate for cross-national cooperation

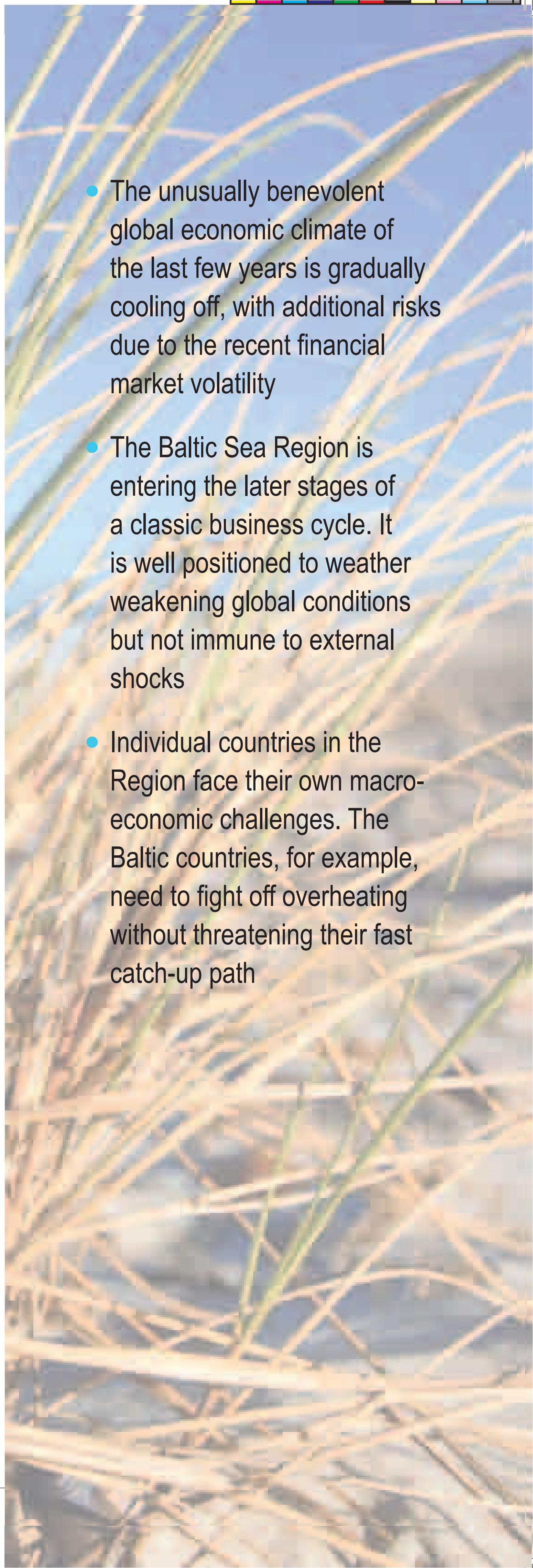
The State of the Region Report analyzes the medium-term drivers of microeconomic competitiveness and prosperity. It is not an assessment of the short-term macroeconomic climate in the economies of the Region; such assessments are provided regularly by many banks, government agencies, and multilateral financial institutions. The macroeconomic environment can, however, have an influence on the ability of a Region to mount cross-national efforts. On the one hand, strong economic growth can make it easier to focus on and invest in cooperation and competitiveness upgrading. On the other hand, strong economic growth can reduce the political pressure that motivates progress on competitiveness upgrading. In either case, the macroeconomic climate is an important contextual factor to recognize when discussing regional cooperation.

The global context

The global economy currently provides a generally benevolent environment for economic growth. There are signs of an economic slowdown but as far as this slowdown continues to proceed at a moderate pace it is a welcome indication of a normal business cycle, and not a real problem. More worrying are the risk factors that have emerged recently and which now threaten to push the global economy off course.

The concerns about global imbalances, especially the external deficits of the United States, have been dampened over the last few months. Some adjustments are under way through the devaluation of the US dollar. These adjustments have so far had limited overly negative effects on others. Exports outside of the United States have so far been able to manage the adverse pressure on prices. The European market has taken some of the slack, having entered a more positive phase in its business cycle. The Asian economies, too, continue to grow strongly. Overall, the real economy is doing well and global imbalances seem manageable.

The concerns about risks in the global financial system, however, have recently increased. While the sub-prime loans in the weakening US housing market were the trigger, the effects are now threatening to spread to other markets as well. The real concern



- The unusually benevolent global economic climate of the last few years is gradually cooling off, with additional risks due to the recent financial market volatility
- The Baltic Sea Region is entering the later stages of a classic business cycle. It is well positioned to weather weakening global conditions but not immune to external shocks
- Individual countries in the Region face their own macro-economic challenges. The Baltic countries, for example, need to fight off overheating without threatening their fast catch-up path

is the impact of new financial instruments on risks. These instruments have created enormous new possibilities for wealth creation through better availability of capital and more effective allocation of risks. But the lack of experience with the use and regulation of these new instruments has also created significant risks. Who ultimately bears what risks, is less obvious than before for many market participants. And it is equally uncertain who will be affected if a particular institution or market gets into trouble. In addition, the emergence of these new instruments concurrently with the solid growth in the world economy has fueled a sense of exuberance that might have resulted in a general mis-pricing of risks.

The most likely outcome remains a further moderate slowdown of the global economy. Inevitably there will be some effects of the volatility on the financial market, such as pressure on countries and companies with high external deficits/high leverage, but these need not affect others too much. But a much more serious contraction, with a significant number of financial markets shutting down, is possible as well. It may be unlikely, but too little is known to rule out such a scenario altogether.

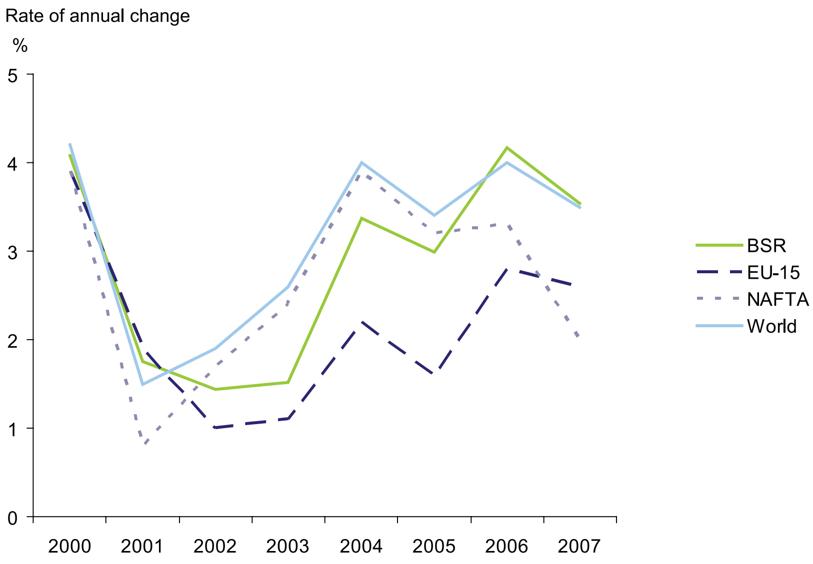
The Baltic Sea Region

The macroeconomic climate in the Baltic Sea Region is strong. Real GDP growth remains significantly above the level in the EU-15 and has started to outperform both the NAFTA region and the world economy overall. The economies in the Region are entering the later stages of the current business cycle. While there is some risk of overheating, the most likely outcome is for an orderly slowdown of growth rates over the coming months and years.

GDP growth in the Baltic Sea Region is being driven by increasing domestic consumption and investment, while the contribution of trade has receded. Import growth is outpacing export growth; the still significant current account surplus is falling. The strengthening of currencies in the Baltic Sea Region against the US dollar will slow down exports to the US and increase competition with US rivals on other markets. Wage pressure is building up and inflation is slowly accelerating. Unit labor cost growth is set to increase significantly, roughly in parallel to changes in the EU-15. The increase in the Region's terms of trade since 2004, entirely driven by higher prices for Norwegian, Russian, and Danish oil exports, has meanwhile come to a halt. It has always been negative for the other countries in the Region.

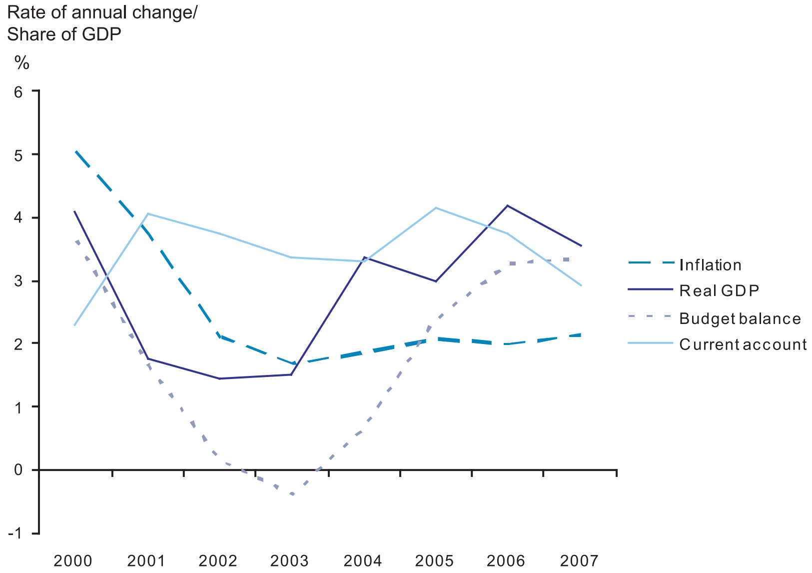
Monetary policy is tightening and will most likely continue to do so unless the financial market risks should escalate. Nominal exchange rates have generally strengthened. Fiscal policy has been relatively restrictive, even though political pressure has been building up to increase spending. The debt level of govern-

Figure 1: GDP growth in main world regions



Source: EIU (2007)	State of the Region-Report 2007

Figure 2: Main macroeconomic trends in the Baltic Sea Region



Source: EIU (2007) State of the Region-Report 2007

ments in the Region has been dropping fast in recent years; between 2004 and 2007, the debt level dropped by 10% of GDP. It is now approaching the level of the NAFTA region, roughly 20%-points ahead of the EU-15.

The turbulences on global financial markets should on average affect the Baltic Sea Region less than other parts of Europe.

The turbulences on global financial markets should on average affect the Baltic Sea Region less than other parts of Europe. Real estate prices have risen significantly in many parts of the Region and the mortgage markets in some countries are large relative to the size of the economy. But there is no sign of a collapse of the real estate market, even though price increases are slowing down. Nordic banks have had less direct exposure to the US market than their German and UK peers. And the strong external position and the solid position of government finances provide a cushion even if risk premiums should dramatically rise. The main challenge for the Baltic Sea Region is to manage the orderly slowdown of growth rates without a sequence of overheating and subsequent crisis.

Countries in the Baltic Sea Region

Within the Baltic Sea Region, individual countries face different challenges, often related to how far they have already come in the business cycle and how well they are prepared for a slowdown.

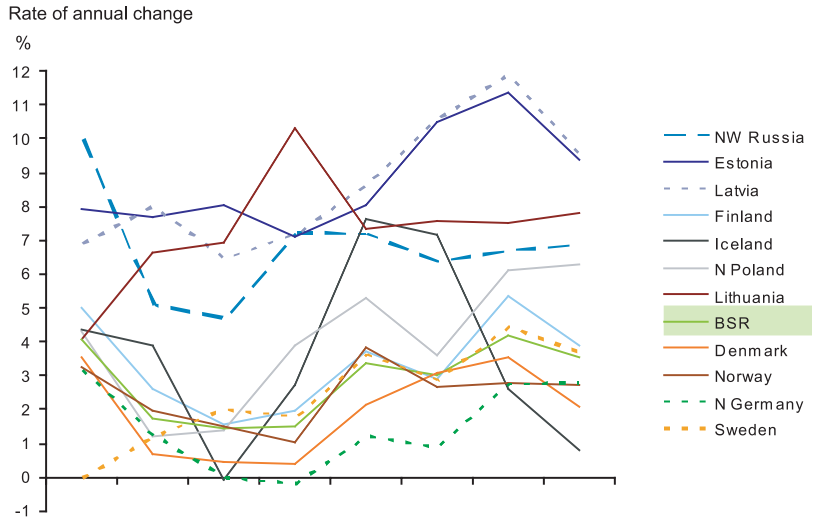
The Nordic countries generally enjoy the most favorable macroeconomic position of the countries in the Region. As the Region overall, their main challenge right now is to achieve a gradual moderation of growth while avoiding an overheating of the economy.

Sweden, the largest economy of the Region, has recently experienced a strong growth surge, broadly based on consumption, investments, and exports. Unemployment is falling and the government has initiated labor market and tax reforms that are intended to increase labor supply. Wage growth has increased but remains below productivity growth. Interest rates are edging up and inflationary pressure is slowly increasing. Fiscal policy is getting more restrictive and the government's debt ratio is starting to drop more quickly. The growth rate is expected to slow down gradually, pointing towards a soft landing of the economy.

Norway's growth rate has been slightly lower but more stable over recent years. The fiscal and monetary policy regimes, reaffirmed by the new government after it took office in 2005, have enabled the prudent management of buoyant export revenues from the country's oil and gas sector. Unemployment is low; Norway records the second lowest unemployment rate in the Baltic Sea Region. Real wages are rising fast despite the increasing inflows of workers from the EU, especially the new EU member countries. Public spending remains relatively restrictive and inflation has been moderate despite the growth. There are concerns, however, whether the government will keep its restrictive fiscal policy.

Denmark's economy has been steadily accelerating since 2003 but growth is now moderating. Strong growth and fiscal consolidation have led to a marked improvement of public sector finances. Inflation remains at an acceptable level but is edging upwards. Wage growth has come down but remains ahead of productivity growth. Unemployment continues to fall and is significantly below its long-term average level. Changes in the tax structure aim to reduce the tax burden on low-income earners. The current account balance remains strongly positive but imports are growing faster than exports. If policies stay on course, the economy will face no major macroeconomic risk factors. The slowdown of growth should signal a soft landing of the economy without overheating.

Figure 3: GDP growth across the Baltic Sea Region



Source: EIU (2007)

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Table 1: Monetary indicators across the Baltic Sea Region

	2000	2001	2002	2003	2004	2005	2006	2007E
Consumer Price Index (annual change in %)								
Denmark	3.1%	2.3%	2.4%	2.1%	1.1%	1.8%	1.9%	1.7%
Estonia	4.0%	5.8%	3.6%	1.3%	3.0%	4.1%	4.4%	5.5%
Finland	3.4%	2.6%	1.6%	0.9%	0.2%	0.8%	1.6%	1.4%
Iceland	5.1%	6.4%	5.2%	2.1%	3.2%	4.0%	6.7%	4.6%
Latvia	2.7%	2.5%	1.8%	2.9%	6.2%	6.7%	6.5%	8.3%
Lithuania	1.0%	1.3%	0.3%	-1.2%	1.2%	2.7%	3.8%	4.6%
N Germany	1.5%	2.0%	1.3%	1.1%	1.7%	2.0%	1.7%	2.0%
N Poland	10.1%	5.5%	1.9%	0.8%	3.5%	2.1%	1.0%	2.3%
Norway	3.1%	3.0%	1.3%	2.5%	0.4%	1.6%	2.3%	0.8%
NW Russia	20.8%	21.5%	15.8%	13.7%	10.9%	12.7%	9.7%	8.2%
Sweden	0.9%	2.4%	2.2%	1.9%	0.4%	0.5%	1.4%	2.0%
Baltic Sea Region	2.8%	3.1%	2.2%	2.0%	1.2%	1.9%	2.2%	2.1%
ASEAN	2.4%	6.1%	6.3%	4.5%	4.7%	7.2%	8.1%	4.6%
EU-15	2.0%	2.3%	2.1%	1.9%	1.9%	2.1%	2.1%	1.9%
NAFTA	3.8%	3.1%	1.9%	2.5%	2.8%	3.3%	3.2%	2.6%
World	4.1%	4.0%	3.5%	3.7%	3.6%	3.7%	3.8%	3.7%
Unit Labor Cost Index (in US dollar. 1996 = 100)								
Denmark	71.1	71.4	78.0	95.0	101.6	101.2	103.6	114.3
Estonia	116.1	126.4	151.4	199.2	233.8	259.7	305.2	387.3
Finland	62.9	61.5	63.2	73.2	78.1	77.2	74.1	80.2
Iceland	106.3	91.2	105.3	129.6	141.4	169.7	172.2	208.9
Latvia	100.0	95.8	101.3	113.6	122.8	125.2	139.7	157.1
Lithuania	116.1	106.1	113.6	134.3	147.8	155.8	170.9	208.3
N Germany	72.2	70.5	74.9	89.8	98.6	97.4	96.9	104.4
N Poland	n a	n a	n a	n a	n a	n a	n a	n a
Norway	87.1	87.7	100.7	110.0	111.1	115.3	116.1	127.5
NW Russia	44.0	59.9	71.5	86.6	106.6	129.5	161.8	196.8
Sweden	77.7	72.8	78.3	95.3	104.3	103.2	103.6	115.1
Baltic Sea Region	75.8	74.3	81.4	95.7	103.0	105.3	108.4	121.8
ASEAN	n a	n a	n a	n a	n a	n a	n a	n a
EU-15	80.2	79.4	85.4	102.7	114.7	116.2	118.1	129.6
NAFTA	n a	n a	n a	n a	n a	n a	n a	n a
World	n a	n a	n a	n a	n a	n a	n a	n a

Source: EIU

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Finland is experiencing a similar moderation of high growth. With higher unemployment, wage pressure has been somewhat lower than in other Nordic countries. Inflation remains low despite some recent acceleration. The combination of fiscal consolidation and strong growth is driving a faster drop of the government's debt ratio. Macroeconomic risks for the medium term appear low.

In *Iceland* the risks are more pronounced than in the other Nordic countries. GDP growth will drop as the significant investment in a new aluminum smelter comes to a close. Inflation is set to slow down but remains significantly higher than in the other Nordic countries. Unit labor costs are growing quickly. Government debt levels are moderate and should fall on the back of a strong government budget surplus. The attempts to rein in overheating consumption have been only partly successful and the possibility of the global financial market volatility affecting the economy seems real.

Northern Germany is experiencing a solid cyclical upswing, with higher growth rates, improving public budgets, and falling unemployment. A combination of fiscal policy tightening, labor market reforms, and company restructuring has supported the recovery. Exports remain strong and the current account surplus is solid. Whether enough has happened to push the German economy on a higher medium-term growth path remains to be seen. While the improvements are real, the performance on unemployment and public finances significantly lags behind the Baltic Sea Region average. Wage pressure is picking up and inflation is edging upwards from low levels. The involvement of two German financial

Table 2: Fiscal indicators across the Baltic Sea Region

	2000	2001	2002	2003	2004	2005	2006	2007E
Public Debt (in % of GDP)								
Denmark	51.7%	47.4%	46.8%	45.8%	44.0%	36.3%	30.1%	26.0%
Estonia	5.2%	4.8%	5.6%	5.7%	5.2%	4.4%	4.1%	3.6%
Finland	43.4%	42.0%	41.2%	42.9%	43.5%	41.9%	38.9%	34.6%
Iceland	41.1%	46.0%	42.3%	40.9%	34.5%	25.5%	31.5%	30.4%
Latvia	12.2%	13.7%	13.1%	13.2%	13.1%	11.6%	9.9%	9.0%
Lithuania	27.9%	26.6%	25.3%	21.1%	19.4%	18.6%	18.2%	16.3%
N Germany	59.2%	58.7%	60.2%	63.8%	66.0%	68.0%	67.8%	64.4%
N Poland	36.4%	37.4%	41.8%	46.5%	44.7%	45.4%	45.5%	45.7%
Norway	34.0%	32.9%	40.2%	49.0%	52.7%	49.0%	47.4%	46.7%
NW Russia	54.5%	43.2%	36.2%	28.2%	21.8%	14.1%	7.7%	5.5%
Sweden	54.8%	52.7%	52.0%	52.2%	52.0%	51.5%	47.8%	43.0%
Baltic Sea Region	48.1%	45.9%	46.9%	49.1%	49.3%	46.4%	43.1%	39.6%
ASEAN	68.1%	66.5%	64.3%	64.1%	61.9%	57.3%	51.7%	49.4%
EU-15	63.0%	61.6%	61.0%	62.0%	62.8%	63.7%	63.0%	61.0%
NAFTA	37.6%	35.6%	36.5%	38.5%	39.2%	39.3%	38.9%	38.4%
World	59.6%	58.4%	59.2%	60.6%	60.8%	59.5%	56.9%	55.0%
Government Balance (in % of GDP)								
Denmark	2.3%	1.2%	0.2%	-0.1%	1.9%	4.6%	4.2%	3.8%
Estonia	-0.2%	-0.2%	0.4%	2.0%	2.3%	2.3%	3.8%	1.7%
Finland	6.9%	5.0%	4.1%	2.4%	2.1%	2.5%	3.8%	4.2%
Iceland	1.7%	-0.7%	-2.6%	-2.8%	0.2%	5.2%	5.3%	3.7%
Latvia	-2.5%	-1.9%	-2.3%	-1.6%	-1.1%	-1.0%	-0.3%	0.0%
Lithuania	-4.0%	-3.6%	-1.8%	-1.3%	-1.5%	-0.5%	-0.2%	-0.5%
N Germany	1.3%	-2.8%	-3.7%	-4.0%	-3.8%	-3.3%	-1.7%	0.5%
N Poland	-2.1%	-4.2%	-4.9%	-4.4%	-4.5%	-2.9%	-2.4%	-2.3%
Norway	15.4%	13.3%	9.2%	7.3%	11.1%	15.2%	18.2%	16.8%
NW Russia	2.4%	3.1%	1.7%	2.4%	4.8%	7.5%	7.4%	3.2%
Sweden	3.8%	1.7%	-1.5%	-1.1%	0.6%	1.8%	2.1%	2.4%
Baltic Sea Region	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%
ASEAN	-2.5%	-2.2%	-2.4%	-2.1%	-1.7%	-1.0%	-0.8%	-1.7%
EU-15	0.9%	-1.2%	-2.3%	-3.0%	-2.8%	-2.3%	-1.7%	-0.9%
NAFTA	2.3%	1.1%	-1.4%	-3.1%	-3.1%	-2.2%	-1.6%	-1.0%

Source: EIU

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institutions in the US sub-prime loan market meltdown has created a new risk factor.

The *Baltic countries* face significant overheating problems. Local wages and prices are growing strongly, above the level of productivity growth. Current account deficits are high. While a significant amount of the inflow finances investments, there is also a huge increase in credit-financed consumption. Without an independent monetary policy – all countries have tied their currencies to an external anchor – the countries have only fiscal policy and financial market regulations as short-term tools to address the emerging imbalances.

The imbalances seem most problematic in *Latvia*, where the current account deficit is the highest and the shift to a more competitive export economy the slowest. As in Iceland, there is some vulnerability to tightening international financial markets. Despite the fast growth, Latvia registers relatively high unemployment, possibly driven by a segmented labor market for ethnic Russians that do not speak Latvian. The Latvian government, the Latvian central bank, and the owners of the main Latvian banks are working to address the overheating; it remains to be seen whether the steps taken are sufficient.

Estonia and Lithuania have similar challenges but at a lower level of intensity. Estonia is closely tracking Latvian growth rates but can rely on strong government finances with low debts and a budget surplus since 2002. Unemployment is dropping fast and could soon be lower than in Sweden. Lithuanian growth rates have been slightly lower and the size of the external imbalances is not as worrying. Unem-

Table 3: External macroeconomic indicators across the Baltic Sea Region

	2000	2001	2002	2003	2004	2005	2006	2007E
Current Account (in % of GDP)								
Denmark	1.4%	3.0%	2.0%	3.3%	2.4%	3.8%	2.4%	1.4%
Estonia	-5.3%	-5.2%	-10.7%	-11.6%	-12.6%	-10.1%	-15.7%	-16.5%
Finland	8.6%	9.6%	10.2%	6.5%	7.8%	5.0%	5.9%	6.2%
Iceland	-9.8%	-4.3%	1.6%	-4.9%	-10.0%	-16.2%	-27.4%	-17.1%
Latvia	-4.7%	-7.5%	-6.7%	-8.2%	-12.9%	-12.5%	-21.1%	-22.2%
Lithuania	-5.9%	-4.7%	-5.1%	-6.9%	-7.7%	-7.1%	-10.8%	-13.0%
N Germany	-1.7%	0.0%	2.0%	1.9%	4.3%	4.6%	5.1%	4.7%
N Poland	-5.8%	-2.8%	-2.5%	-2.1%	-4.2%	-1.7%	-2.3%	-3.0%
Norway	14.9%	16.1%	12.6%	12.3%	12.8%	15.4%	16.7%	14.9%
NW Russia	18.0%	11.1%	8.4%	8.2%	10.0%	10.9%	9.6%	5.9%
Sweden	2.7%	3.0%	5.2%	7.5%	7.9%	6.6%	7.2%	7.4%
Baltic Sea Region	4.5%	5.6%	5.7%	5.8%	6.3%	6.5%	6.5%	5.7%
ASEAN	7.8%	6.4%	5.6%	6.6%	5.9%	5.7%	8.3%	6.6%
EU-15	-0.8%	-0.1%	0.3%	0.4%	0.8%	0.0%	-0.3%	-0.3%
NAFTA	-3.7%	-3.4%	-3.9%	-4.2%	-4.7%	-5.1%	-5.2%	-4.9%
World	-0.5%	-0.4%	-0.4%	-0.1%	0.0%	0.0%	0.2%	0.3%
Terms of Trade (1990 = 100)								
Denmark	100.0	100.7	100.8	102.1	102.8	103.7	104.3	105.8
Estonia								
Finland	92.0	89.2	84.6	84.6	84.4	82.0	90.2	91.1
Iceland	75.0	74.9	80.5	79.0	78.8	72.6	75.9	77.7
Latvia	125.6	127.4	122.9	121.5	124.0	119.8	124.6	127.0
Lithuania	132.8	132.3	132.9	132.2	133.4	128.0	129.1	129.5
N Germany	100.2	100.6	102.7	104.8	104.2	101.1	98.5	94.7
N Poland	108.2	110.8	113.8	109.9	115.6	115.7	115.2	115.6
Norway	149.4	141.4	141.3	140.3	139.4	179.3	230.1	245.4
NW Russia	129.9	119.8	115.6	122.8	142.6	162.0	174.6	179.1
Sweden	92.7	90.0	88.1	87.9	85.5	83.1	81.7	77.1
Baltic Sea Region	107.3	105.3	104.8	104.8	105.0	113.5	126.0	127.3
ASEAN	96.1	92.5	92.3	93.3	92.6	92.5	94.7	95.1
EU-15	96.0	96.7	98.0	99.0	98.9	97.7	97.5	97.6
NAFTA	98.5	100.3	101.2	101.5	101.7	99.6	99.3	99.6

Source: EIU

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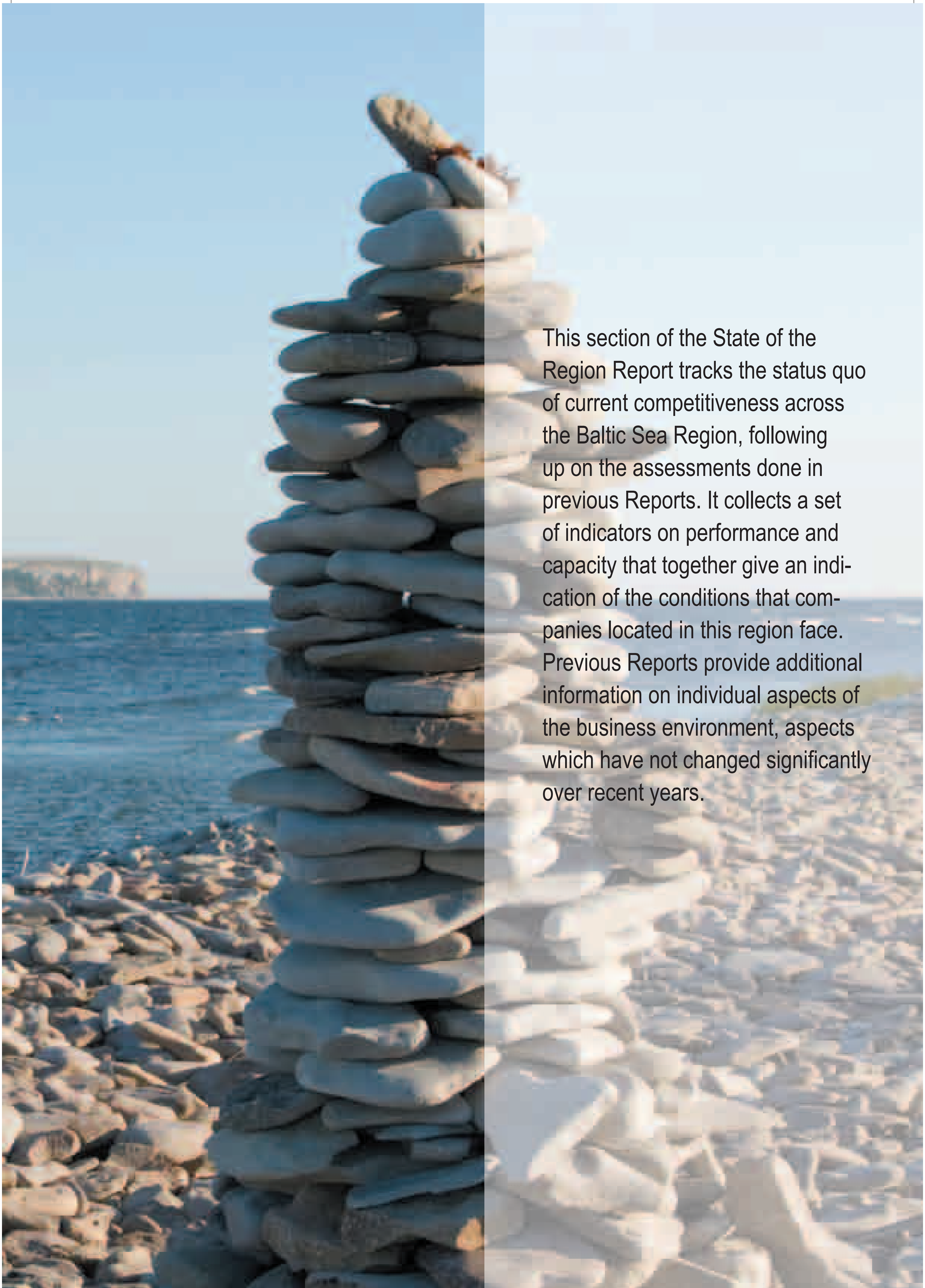
ployment is lower than in the two other Baltic countries, close to Norwegian levels. The financial situation of the public sector, however, is less favorable.

Northern Poland has benefited from the strong growth that the entire country experienced following EU accession. After years of subdued growth, there remains sufficient slack in the economy to keep inflationary tendencies at bay. The government deficit is falling to low negative numbers, benefiting from stronger tax receipts and lower expenditures for unemployment benefits. The current account remains in deficit but for a growing economy the level of deficit seems fully sustainable.

Northwestern Russia continues to grow strongly, driven by growing domestic demand fuelled by strong revenues from oil and gas exports. With oil prices stabilizing on a high level, the growth rate of the Russian economy is expected to fall. The current account surplus is quickly eroding and the real exchange rate is appreciating. Inflation is receding but remains close to 10%. Unit labor cost growth is high. Fiscal policy has been relaxed somewhat but remains solid overall. Russia's government debts have been dropping fast since 2000.



This section of the State of the Region Report tracks the status quo of current competitiveness across the Baltic Sea Region, following up on the assessments done in previous Reports. It collects a set of indicators on performance and capacity that together give an indication of the conditions that companies located in this region face. Previous Reports provide additional information on individual aspects of the business environment, aspects which have not changed significantly over recent years.

SECTION B: Competitiveness of the Baltic Sea Region

Competitiveness remains a concept that is much debated but not well understood. The concept of competitiveness we apply here, building on the work by Professor Michael E. Porter since 1990, defines competitiveness as the level of productivity that companies can achieve in a given location. Productivity is central because it defines the level of prosperity that regions or countries can ultimately sustain.

The competitiveness concept provides a framework to assess the impact of the different determinants of productivity for a specific country or region. It is focused on the medium term, around five years, and aims to support policy makers in identifying which areas they ought to focus on in this period. It provides recommendations that are situation-specific; priorities change as countries develop and there are no magic policy formulas that are effective or fundamental for all locations at all times. Competitiveness is particularly concerned with the microeconomic level, i.e. dimensions of the business environment that have a direct impact on company productivity and innovation capacity.

Competitiveness and traditional growth economics

Competitiveness and traditional academic growth economics are related but different concepts. Both are interested in the same phenomena, i.e. explaining the differences of prosperity across locations. But they take different perspectives in order to understand it.

The academic growth literature tries to find the minimum amount of factors that can explain prosperity differences across a wide group of countries over the long-run. This has led to a focus on deep-seated institutions and geographic location. It has also led to models in which all factors that improve prosperity work additively, i.e. their impact does not depend on how good or bad other things are in a country.

The competitiveness literature tries to identify the specific areas in which a location has to improve in order to increase productivity. While institutions and geographic locations matter, they do not predetermine outcomes. They work their way, slowly and with many stops and turns, through many policy choices that then affect productivity. The competitiveness literature is interested in these choices, and aims to give policy makers the tools to make better choices rather than just follow the trends rooted in institutions and location. While ultimately all factors that are important for productivity have to be upgraded, only a few are 'binding constraints' in any given situation. Improvements in other areas have no effect, because the binding constraints limit the ability of companies to take advantage of them. The competitiveness literature tries to identify these binding constraints and aims to give policy makers the tools to address them rather than apply generic policy formulas based on ideological positions.

The two literatures are complementary and their theoretical underpinnings are, to a surprising degree, consistent.

We assess competitiveness at three levels: First, we look at performance in terms of prosperity and key prosperity drivers, particularly productivity. We also look at intermediate indicators like world export market shares, FDI attraction, or patenting that are both outcomes and drivers of a location's competitiveness. Second, we review the factors that drive the level of productivity companies can reach. We focus on microeconomic foundations of the economy, but also discuss the overall macroeconomic, legal, political, and social context. Third, we discuss performance on the wider range of indicators included in the Lisbon Agenda.

1. The economic performance of the Baltic Sea Region

The ultimate test for the quality of business environment conditions and economic policies is the outcomes achieved in terms of economic performance. We continue to track the performance of the Baltic Sea Region relatively to key peers, as well as of individual countries and sub-national regions across the Baltic Sea. The key indicator of performance is the level of prosperity achieved, here operationalized as GDP per capita. Prosperity is then further decomposed into its key drivers, i.e. labor productivity, labor mobilization, and domestic price levels. Additional indicators capture factors that are both outcomes and drivers of competitiveness.

Prosperity

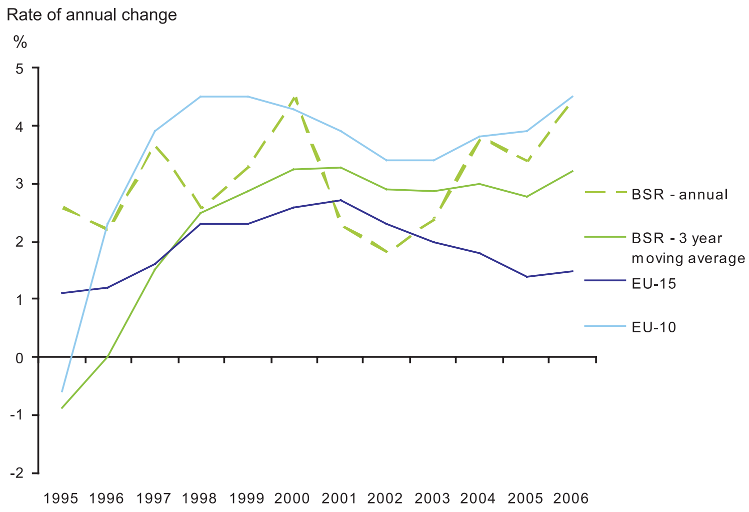
The central measure of prosperity we use is gross domestic product (GDP) per capita in 2006 US dollars, adjusted by purchasing power parity. This measure is comparable across countries and time, and eliminates the strong influence of exchange rate fluctuations. It also captures the impact of local price levels rather than just production values, a key determinant of the actual standard of living citizens enjoy in a country.

The Baltic Sea Region continues to increase in prosperity at a solid rate. After slowing down slightly in 2005, the Region reported in 2006 its strongest GDP per capita growth rate since 2000, reaching an annual rate of 4.5%. The Region has now reached a prosperity level of 92% of the EU-25 average, a marked improvement from 84% ten years ago. If the Baltic Sea Region keeps the growth differential of the last ten years versus the EU-25, it will reach the European average in 2015. If it keeps the growth differential of 2006, the catch-up would be completed already in early 2012.

The acceleration of growth in 2006 was not limited to the Baltic Sea Region. Other parts of Europe markedly improved their performance as well, while regions elsewhere in the global economy continued to stay on their previous growth trajectories. The Central European Region improved its growth performance from a lower level by even more than the Baltic Sea Region, registering 4.1% growth in 2006, 1.5% more than in the previous year. The EU-15 old member countries moved to 2.5% growth, up

- The last year has seen exceptionally strong performance by the economies in the Baltic Sea Region, with labor productivity and mobilization rising
- Investment activity is up and the Region's record on FDI attraction significantly improved, while exports and patenting are stable at high levels
- The Region's business cycle position has driven many of the recent improvements; a reversal to more moderate levels is to be expected

Figure 4: Prosperity growth over time



Source: EIU (2007) State of the Region-Report 2007

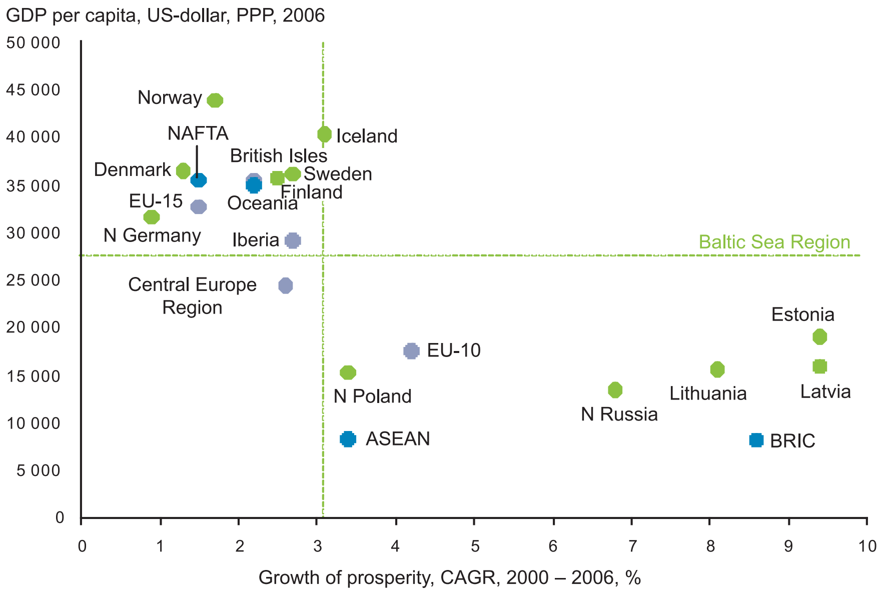
from 1.3% in 2005. Germany, Italy, and the Benelux countries topped the list of countries by growth acceleration, raising their growth rates by between 1.5% and 1.9%.

Within the Baltic Sea Region, the three Baltic countries followed by Russia and Poland registered the highest GDP per capita growth in 2006. Norway, Germany, and Iceland registered the lowest GDP per capita growth. Russia, Finland, Poland, and Germany saw the strongest growth acceleration relative to 2005. Iceland was the only country in which growth actually slowed down relative to the previous year.

Among subnational regions in the Baltic Sea Region, the metropolitan areas of Hamburg, Oslo, Stockholm, and Helsinki lead the regional ranking in terms of prosperity. Copenhagen is presumably also on this list, but Denmark reports only national level data to Eurostat. The leading metropolitan regions account for about 1/3 of all GDP in the Baltic Sea Region.

The level of heterogeneity among subnational regions in the Baltic Sea is large but slowly decreasing. In 2004, the most prosperous region (Hamburg) registered 5.0 times the level of GDP per capita of the least prosperous region (Warminsko-Mazurskie). In 2000, the ratio had been 5.4. Compared to other parts of the European Union, the distribution of regions by prosperity is more balanced with equal numbers of very prosperous and very poor regions. Statisticians call this a 'normal distribution'. The majority of regions is in the middle range of €20,000 to €30,000 GDP per capita. The EU-15 have a similar share of highly prosperous regions but no region with a GDP per capita below €10,000. The EU-12 recent entrants to the EU have no regions in the top group but a large concentration of regions below €10,000 and between €10,000 and €20,000 GDP per capita. The EU-15 and the EU-12 thus have a so-called 'one-sided' distribution, where in the EU-15 most regions have higher GDP per capita, and in the EU-12 most regions have lower GDP per capita, than the average region.

Figure 5: Prosperity level and growth, selected countries



Source: Groningen Growth and Development Centre and The Conference Board (2007) State of the Region-Report 2007

Prosperity and Human Development Index

GDP per capita is one indicator of prosperity but there is a recognition that other factors, like social and environmental conditions, matter as well. The Human Development Index is the most established attempt to provide a broader perspective on the quality of life across countries. It includes health and education measures alongside GDP per capita.

The Baltic Sea Region overall ranks 25th on the latest Human Development Index (HDI). Over time, the Region has consistently increased its absolute HDI value. It has, however, dropped slightly in rank. Hong Kong, Israel, and Greece have moved ahead of the average of the Baltic Sea Region in the last years. The rank of the Baltic Sea Region on the broader HDI measure of prosperity is slightly lower than on GDP per capita alone (25 versus 22). Spain, New Zealand, Israel, and Greece all rank higher than the Baltic Sea Region on the HDI but lower on GDP per capita.

The main reason for the surprisingly weaker position of the Baltic Sea Region on HDI is the situation in Russia. Russia's HDI position dropped until 2000, and is only now improving again based on growing GDP per capita figures. The country ranks high on education but very poor on health due to low life expectancy. The Baltic countries dropped until 1995 as their economies contracted, but have improved since then. All other countries across the Baltic Sea Region, including Poland as the remaining former Communist country, have improved since data is available.

Prosperity accounting

In an accounting sense, prosperity is the result of three factors: labor productivity, i.e. how much GDP is generated in an hour of work, labor mobilization, i.e. how many hours of work are performed per capita of the population during the year, and price levels, i.e. how much consumption goods can be bought for one unit of income.

The Baltic Sea Region continues to perform strongly on labor productivity as well as on labor mobilization, while it remains a region with relatively high local prices. Over the last decade, it has caught up in terms of labor productivity and lost some of its advantage in terms of labor mobilization relative to the EU average.

In labor productivity, measured by GDP per hour worked, the Baltic Sea Region saw a solid acceleration relative to last year, with the 2006 growth rate reaching 2.8% The Region has now reached a productivity level of 83% of the EU-25 average, compared to 75% ten years ago.

The Central European Region remains about 6% behind the Baltic Sea Region and continues to increase labor productivity at a lower rate, despite significant growth acceleration last year. Since last year, the Baltic Sea Region has surpassed the Iberian Peninsula in terms of labor productivity. The EU-10 countries have significantly lower productivity levels but continue to catch up to the Baltic Sea Region and the EU-15, at average rates of 0.8% and 1.1% per year. Outside of Europe, labor productivity growth continued to be strong in the emerging economies, especially in Asia. Australia and New Zealand improved after a labor productivity drop last year. In North America, labor productivity growth dropped to 1.4%, significantly below last year but still higher than in the EU-25.

Figure 6: Prosperity decomposition, selected cross-national regions

GDP per Capita (PPP)	=	Purchasing Power-Factor	x	Employment-Factor	x	Productivity-Factor
B ISLES		BRIC		BRIC		B ISLES
NAFTA		ASEAN		ASEAN		EU-15
OCEANIA		EU-10		OCEANIA		NAFTA
EU-15		CER		NAFTA		OCEANIA
IBERIA		IBERIA		IBERIA		Baltic Sea Region
Baltic Sea Region		NAFTA		Baltic Sea Region		IBERIA
CER		OCEANIA		EU-10		CER
EU-10		Baltic Sea Region		B ISLES		EU-10
ASEAN		EU-15		CER		ASEAN
BRIC		B ISLES		EU-15		BRIC

Source: Groningen Growth and Development Centre
and The Conference Board (2007), authors' calculations

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Figure 7: Prosperity decomposition, selected countries

GDP per Capita (PPP)	=	Purchasing Power-Factor	x	Employment-Factor	x	Productivity-Factor
Norway		Lithuania		Iceland		Norway
Iceland		Latvia		Estonia		Germany
Denmark		Poland		Russia		Sweden
Finland		Russia		Latvia		Finland
Sweden		Estonia		Baltic Sea Region		Denmark
Germany		Baltic Sea Region		Denmark		Iceland
Baltic Sea Region		Germany		Finland		Baltic Sea Region
Estonia		Sweden		Sweden		Poland
Latvia		Finland		Lithuania		Lithuania
Lithuania		Denmark		Poland		Estonia
Poland		Norway		Norway		Latvia
Russia		Iceland		Germany		Russia

Source: Groningen Growth and Development Centre
and The Conference Board (2007), authors' calculations

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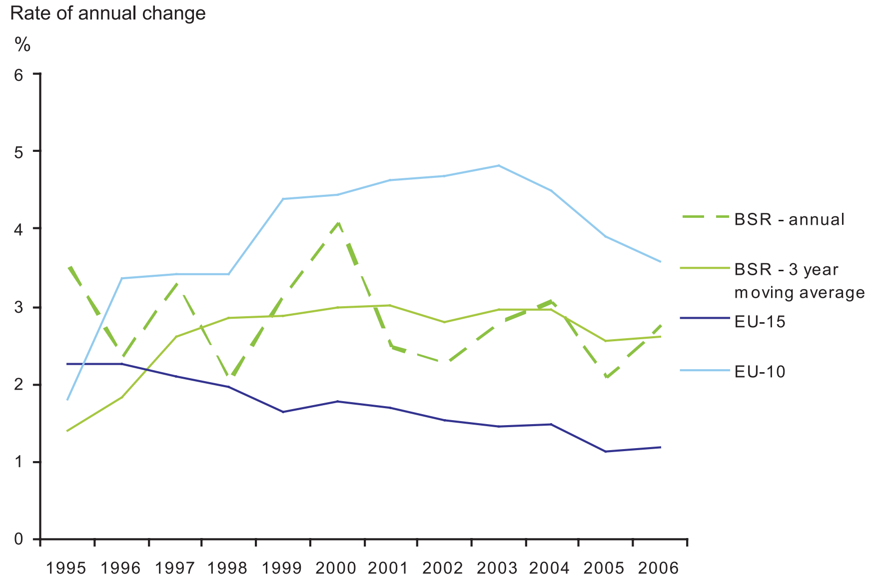
Figure 8: Prosperity growth over time, GDP per hour worked

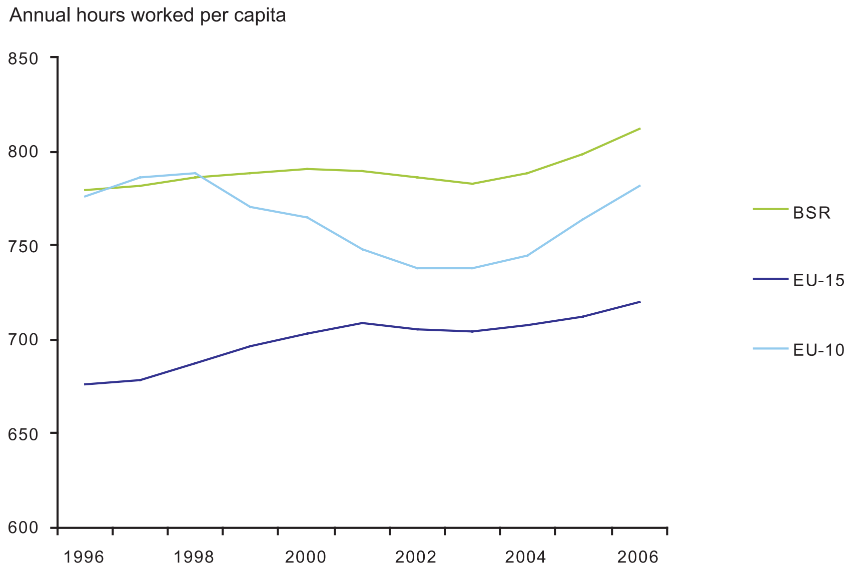


Source: EIU (2007) State of the Region-Report 2007

Within the Baltic Sea Region, Norway continues to register the highest level of GDP per hour worked, partly driven by the role of the oil and gas sector in its economy. Germany, Sweden, Finland, and Denmark follow, with only small differences among them. In 2006, Finland surpassed Denmark, driven by the strongest annual improvement of the Region. Iceland saw a drop in labor productivity in 2006 but has progressed most since 2000. Russia remains at the bottom of the Region's labor productivity ranking. The country has made little progress on productivity growth over the last few years; only Poland and Denmark registered lower absolute improvements since 2000.

Among subnational regions within the Baltic Sea Region, data is only available for the level of GDP per employee until 2004. On this measure, three Norwegian regions in which the oil revenues are registered, primarily Oslo, come out on top. They are followed

Figure 9: Labor utilization over time, annual hours worked per capita



Source: EIU (2007) State of the Region-Report 2007 by Hamburg, Stockholm, Åland, and Helsinki. The Baltic countries and the Polish region of Warmin-sko-Mazurskie registered the strongest productivity increase since 2000. The two Swedish regions of Sydsverige and Småland registered the lowest productivity growth.

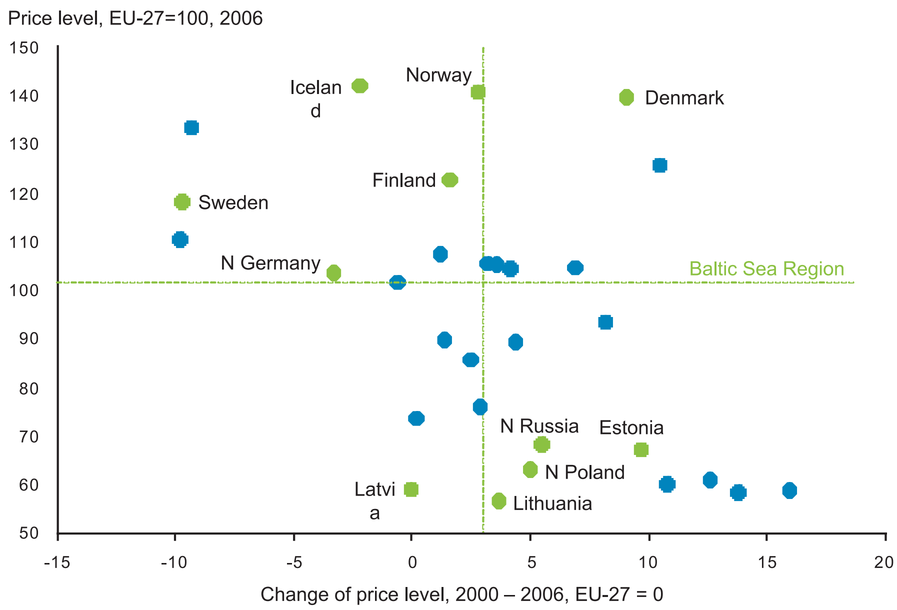
In *labor mobilization*, measured by annual hours worked per capita, the Baltic Sea Region saw a significant improvement in 2006, driven by employment gains across all countries in the Region. The Region now registers 812 hours worked per capita, compared to 730 in the EU-25 average.

The Central European Region has dropped to 93% of the Baltic Sea Region level, compared to 98% ten years ago. The gap has opened up mainly in the years until 2000; more recently the growth of the gap has slowed down significantly. The Iberian Peninsula has increased its labor mobilization dramatically over the last decade and registers now 6% more hours per capita than the Baltic Sea Region. Since last year, the EU-10 countries have reduced the gap to the Baltic Sea Region in terms of labor mobilization somewhat, while it has increased relative to the old EU-15 member countries. Outside of Europe, labor utilization continues to be significantly higher than in the Baltic Sea Region. The gap is between 7% and 9% for advanced regions in North America and Oceania, and between 20% and 30% for emerging economies in Asia and across the BRIC (Brazil, Russia, India, and China) countries.

Within the Baltic Sea Region, Iceland remains on top of the labor mobilization ranking, followed by Estonia, Russia, and Latvia. In 2006, Iceland had the greatest labor mobilization increase; despite this, the country registers the highest drop in working hours per capita in the Region since 2000. Estonia, Latvia, and Poland increased labor mobilization by significant amounts as well last year. In fact, all countries in the Region registered increasing working hours per capita in 2006 as a result of solid economic growth. The increase was the smallest in Germany.

Among subnational regions within the Baltic Sea Region, data is only available for the number of employees relative to the total population. Nord-Norway, Stockholm, Åland, and Denmark are ahead on this measure in 2005. With the exception of the three Polish regions all Baltic Sea Regions are above the average of the European Union. Four of the five regions with the highest increase in the share of employees in the population are from Sweden. Only Latvia enters the top ranks. The largest decrease is registered by two Polish and three Norwegian regions. One factor driving the differences is unemployment. The other is the demographic profile, a

Figure 10: Relative price changes, European countries



Source: Eurostat (2007)

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factor that currently favors the Baltic countries with their low birth rates. But the effect will be strongly negative when the small cohorts enter the workforce.

In *domestic price levels,* measured by price levels relative to the European average, the Baltic Sea Region continues to perform worse than the EU-27 average. Since 2000, price levels have grown faster in the Baltic Sea Region than across the average of the EU. The EU-15 old member countries continue to be slightly more expensive than the Baltic Sea Region but the gap is gradually shrinking.

Within the Baltic Sea Region, Iceland, Norway, and Denmark are the most expensive countries. Sweden continues to be more expensive than the EU average, but has achieved some convergence to the EU price level. The entry of more low-cost retail chains might have had an effect. Denmark and Estonia have seen their relative price levels increase the most.

Data on price levels in subnational regions is not readily available. There is a tendency in many countries, however, that more prosperous regions experience higher prices for local real estate and other local goods. This is likely to be the case as well in the Baltic Sea Region, reducing the measured difference in GDP per capita across regions.

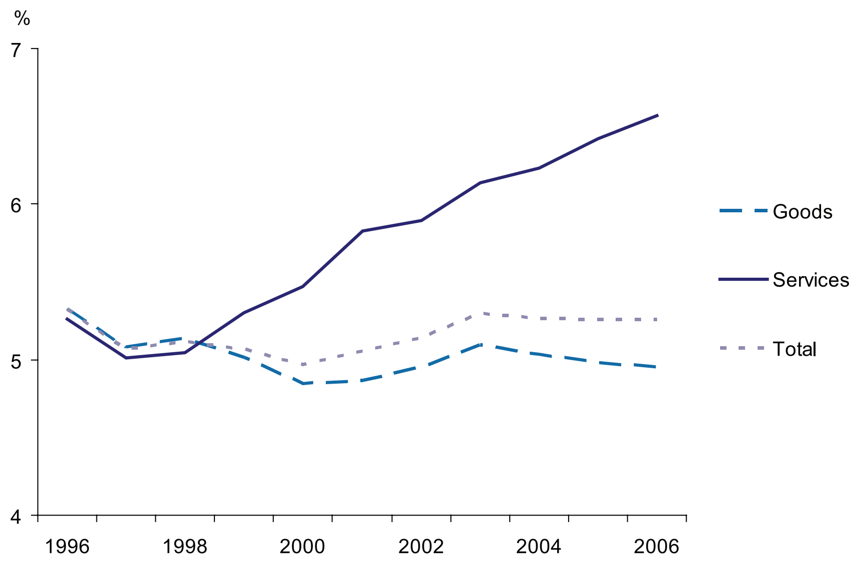
Intermediate indicators and enablers of competitiveness

Exports, investments, and patenting are indicators of underlying competitiveness and signal the potential for future prosperity. Targeting them directly can be problematic, for example when inward FDI is the result of generous financial incentives, but they are important indicators of strengths and weaknesses in a country's business environment. Exports, investments, and patenting are also enablers of competitiveness. They are channels through which the business environment can be improved, for example by exposure to global competition on export markets.

The Baltic Sea Region does perform slightly weaker on intermediate competitiveness indicators than on prosperity. The changes over the last year have been mixed, with foreign direct investment and domestic investment improving while export markets shares and patenting have fallen behind.

World export market shares are an important indicator of the ability of companies located in a specific country to successfully compete on world markets. They are also an indication of companies' exposure to foreign competition on global markets. Such exposure can be an important driver of higher efficiency and can enable learning from operational practices abroad.

Figure 11: World export market shares, Baltic Sea Region



Source: WTO (2007)

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In world market export shares, the modest downward trend for the Baltic Sea Region that started in 2003 continued in 2006. At 5.25% of world exports, the Region's share is, however, still some way above the previous low-point of 4.96% in 2000. Nevertheless, the fall in export market share is noteworthy given the strong export focus of most countries in the Region.

The relative stability of world export market shares overall masks very different positions in goods exports (a stable 80% of world trade) and services (20%). Since 1998, the Baltic Sea Region has lost market share in goods while it has increased its market share in services by a third, to 6.57% in 2006. Almost half of this market share gain has been achieved by Denmark with a further third accounted for by Sweden. All other countries had no or much smaller gains in service export market shares.

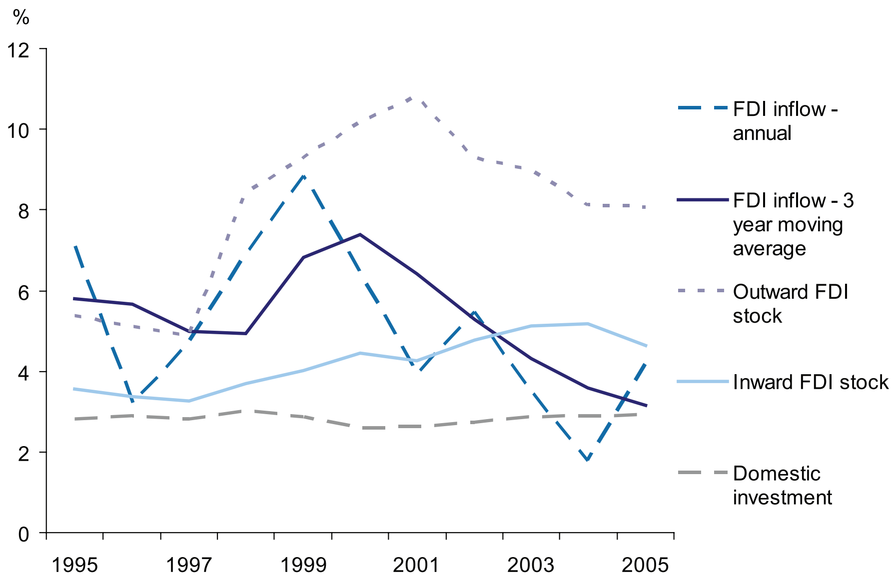
The major shift in world good export market shares continues to be between Asian countries, in particular China, and the OECD, i.e. the European Union and the United States. Since 1999, both the EU-25 and the United States have lost about 3.5% each world market share while China alone gained 4.5%. Compared to the EU-25, the losses of the Baltic Sea Region where small at -0.05%; much smaller than the Region's share of 13% in EU-25 trade would suggest.

Within the Baltic Sea Region, Norway, the Baltic countries, Russia, and Poland have been able to increase their export market shares the most over the last decade. Norway and Russia have gained position as well, largely due to rising prices for their oil and gas exports. In part this is also a factor for Lithuania with significant oil and gas re-exports. Sweden, Denmark, and Iceland have lost between 15% and 10% of their world export market shares since 1996, For Denmark and Sweden, market share losses of between 25% and 20% in goods exports could not be fully compensated by gains in service exports.

Inward foreign direct investment (FDI) is an important indicator of the attractiveness of a location for foreign companies. This attraction can be driven by natural resources, the size and growth of the domestic market, or the opportunities of using the location as a basis for exports. The presence of foreign companies strengthens rivalry on the domestic market, leads to an inflow of knowledge and capital, and creates better linkages to foreign locations.

In 2005, the Baltic Sea Region stopped the downward trend in inward foreign direct investment that had started in 2000. FDI inflows have increased again, first globally and then also in the European Union. 4.2% of all global FDI flows have gone to the Baltic Sea Region. As in the past, the Baltic Sea

Figure 12: Investment activity, Baltic Sea Region



Source: UNCTAD (2006), EIU (2007), author's analysis. State of the Region-Report 2007

Region has reacted even more strongly than other world regions as FDI flows increased. There is no global data available yet for 2006, but the national data from the Baltic Sea Region is clearly positive, indicating that the results will be even stronger than in the year before. Despite the positive trend in inflows, 2005 was the first year in which the share of the Baltic Sea Region in the global inward FDI stock, i.e. the accumulated inflows and retained profits of foreign investors, has dropped.

Globally, NAFTA remains the most important destination of FDI, accounting for 21.5% of the global FDI stock. It is followed by the British Isles with 10.1%; the European Union in total has attracted 44.4% of global FDI stocks. The Iberian Peninsula (4.3%) and Central Europe (3.5%) have so far attracted less FDI than the Baltic Sea Region. The BRIC countries and ASEAN are still less prominent hosts for FDI, with 6.9% and 3.7% of global FDI stocks respectively. Over the last five years, FDI stocks have increased most within the European Union, especially in the old member countries of Continental Europe. NAFTA has lost position relatively to other world regions.

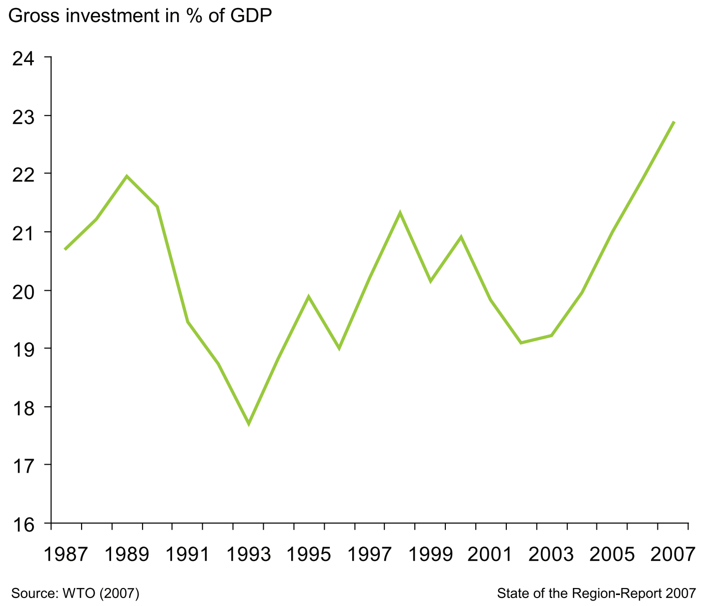
Within the Baltic Sea Region, Iceland (due to a large investment in an aluminum smelter), Estonia, and Russia have been able to increase their inward FDI stock the most since 2000. Finland has been the most successful among the western countries in the Region, but lost position since 2003. Denmark was the only country that lost world market share in inward FDI stock, dropping by 20% since 2000.

Domestic gross fixed capital investment is an important indicator of the attractiveness of a location for all companies, domestic or foreign. It is a signal that companies see business opportunities, today as well as in the future. Capital investment makes a contribution to the capital stock of the economy, one of the drivers of labor productivity. It usually also leads to the use of new technology or new production processes embedded in the new machines, a further driver of productivity.

In the last two years, the Baltic Sea Region has become significantly stronger in domestic gross fixed capital investment. The investment rate has now increased since 2000 and is expected to reach 22.1% of GDP in 2007, 2.6% more than seven years ago. It is now higher than at any time in the last two decades. While positive, part of the explanation is the business cycle: strong growth in recent years has created capacity constraints in many countries and companies needed to strengthen their capital stock.

Among other world regions, the Baltic Sea Region registered one of the strongest improvements in the

Figure 13: Domestic investment, Baltic Sea Region



investment rate, surpassed only by the BRIC countries. Many other regions saw investment increases as well but at lower rates. Only in NAFTA, already entering a later stage of the business cycle, and in ASEAN did investment rates come down. Oceania, the Iberian Peninsula, ASEAN, and, by an increasingly narrow margin, the Central European Region, register higher investment rates than the Baltic Sea Region. The EU-15 and NAFTA, regions with a higher capital stock, are at significantly lower rates.

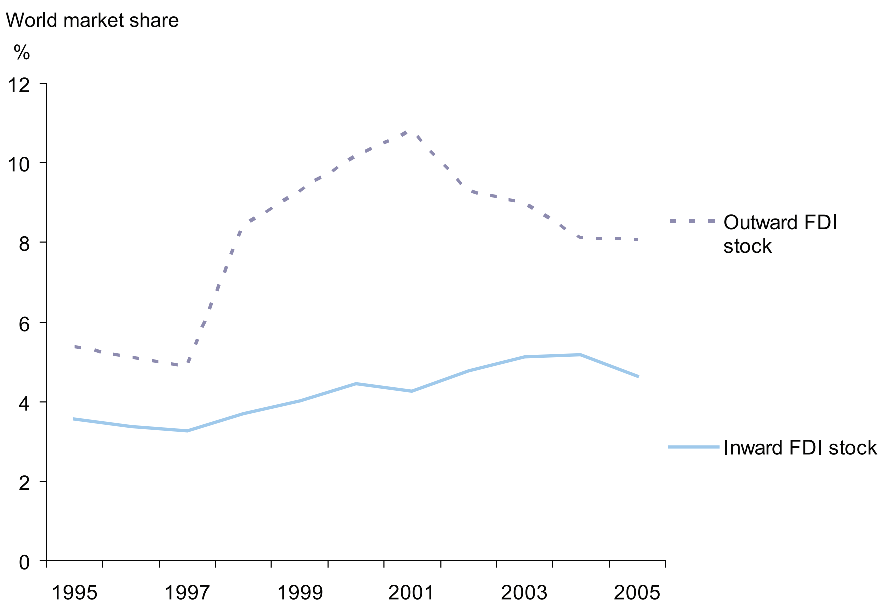
Within the Baltic Sea Region, Latvia and Estonia register the highest investment rates. Poland and Russia are expecting the strongest increase in investments in 2007; both have relatively low investment rates given their stage of development. Russia, in particular, has for years not invested enough to keep up its capital stock and companies need to invest in order to meet growing demand. Sweden has seen a solid increase of investment rates in the last few years but remains at the bottom of Baltic Sea Region countries in terms of investment rates. Iceland expects the largest drop in the investment rate as a large foreign investment in the aluminum sector is coming to an end; despite this drop the country registers a relatively high investment rate given its stage of development.

Outward foreign direct investment (FDI) is an important indicator for the ability of local companies to transfer their competitive advantages to foreign locations. In many cases, it is a substitute for exports that provides companies with control of a larger part of the value chain. Outward FDI exposes local companies to global competition and provides them with access to knowledge and markets abroad.

In outward foreign direct investment, companies from the Baltic Sea Region continue to play an important role, even though companies from other parts of the world, including emerging economies, have become more active recently. The share of global FDI owned by institutions from the Baltic Sea Region reached 8.1% in 2005, down from a high of 10.8% in 2001. The value of the outward FDI held is equal to 48% of the Baltic Sea Region's GDP, about 20%-points lower than in 2001.

Among world regions, the European Union remains the most important source of FDI, controlling about 51% of the global FDI stock. A significant part of these investments are cross-border investments within the European Union. The NAFTA countries follow with about 23% of the global FDI stock, despite gradually losing position over the last few years. Within Europe, the British Isles are ahead of the Baltic Sea Region and remain the most important subregion in terms of outward FDI with 13% of the global stock. The Iberian Peninsula (controlling 4%

Figure 14: FDI position, Baltic Sea Region



Source: UNCTAD (2006), EIU (2007), author's analysis. State of the Region-Report 2007 of the global FDI stock) and Central Europe (2.9%) are still less active investors abroad, despite gaining in importance over the last five years. The same is true for the BRIC countries (2.3%) and ASEAN (1.6%) that both registered significant growth from low initial levels.

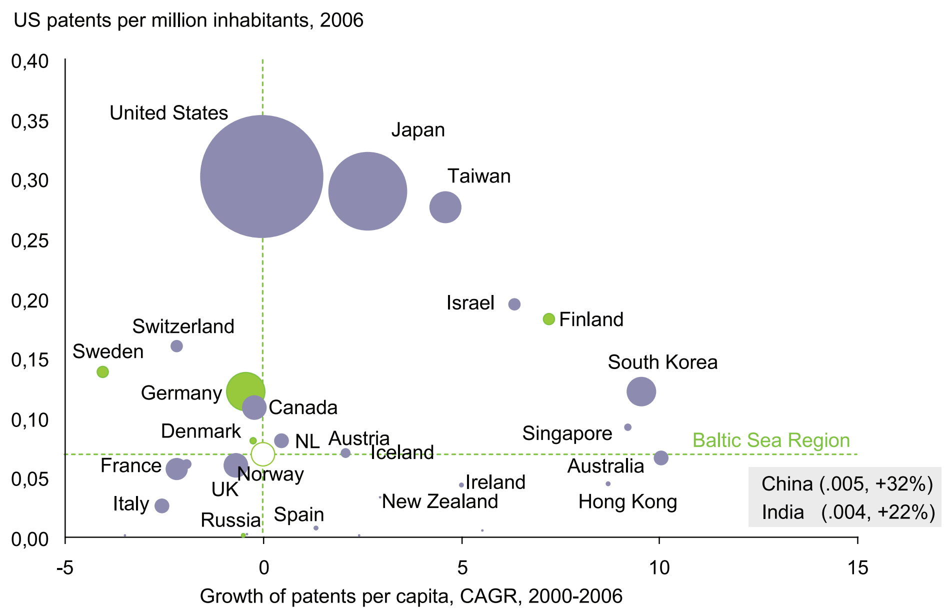
Within the Baltic Sea Region, Norwegian institutions, dominated by the Petroleum Fund, own foreign companies with a value equivalent to 123% of Norwegian GDP. Iceland and Sweden follow at 60% and 57% of their respective GDP. Among the former Communist countries, Russia and Estonia have the most important foreign FDI stock at around 15% of national GDP. These two countries and Iceland have experienced a strong—in the Icelandic case dramatic—increase of outward FDI over the last decade. Norway and Finland were the only countries that saw the value of outward FDI shrink relative to their GDP.

Patenting is an important indicator of a country's innovative capacity, both from companies and research institutions. We use patents in the United States, because virtually all economically significant inventions are patented there for use in the US market. While innovation occurs in many forms that do not involve patents, most researchers consider patents a useful indicator for innovation more generally. Patenting also contributes to a location's knowledge stock and thus increases the opportunities for local companies to further improve their productivity.

In patenting the Baltic Sea Region remains to be one of the most important innovation hubs in the global economy. In 2006, the Baltic Sea Region accounted for 4.4% of patents filed in the US from non-US institutions. This puts it 5th in the country ranking, behind Japan, Germany, Taiwan, and South Korea. Over the last few years, the Baltic Sea Region has, however, dropped from a 2000 level of 5.1%. Patenting intensity, i.e. patents per capita, had dropped slightly from 2001 to 2005 but has now regained its 2001 level.

Among world regions, NAFTA registers the highest share and intensity of US patenting, although the US home bias clearly contributes to this position. Patenting intensity of the NAFTA region has been flat over the last few years. The top ten countries account for 88% of all patents filed in the US by non-US institutions. The Asian countries, South Korea, Taiwan, but also Japan from an already high level, have increased their share and patenting intensity. Singapore, Australia, Hong Kong, and New Zealand are other non-European countries that have improved their position but are still at a more modest absolute level. Outside of the Baltic Sea Region, most European countries

Figure 15: Knowledge creation, leading countries



Source: USPTO (2006), author's analysis

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with a few exceptions like Austria and Ireland have lost position. This is also true for Switzerland, still the 5th most patenting intensive country outside of the US.

Within the Baltic Sea Region, Sweden accounts for 43% of all patents registered in the US last year, followed by Northern Germany (25%), Finland (14%), and Denmark (11%). Finland registers the highest 2006 patenting intensity, followed by Sweden and Germany. Demark, Iceland, and Norway are close to the Baltic Sea Region average, while the other countries have very low levels of patenting intensity. In 2006, all countries in the Region except Estonia increased their US patent count and intensity. Finland, followed by Denmark, Sweden, and Germany, registered the strongest improvements.

Overall assessment

Without a doubt, 2006 has been a good year for the economies of the Baltic Sea Region, a trend that is likely to carry through for 2007. Prosperity growth has accelerated and is overall on a solid path, even if the high speed of the last year will be hard to sustain.

The Baltic Sea Region continues to benefit from a solid combination of solid productivity levels and high labor mobilization. The Nordic countries continue to grow their productivity at high levels while keeping labor mobilization up. The Baltic countries have created the conditions for fast catch-up growth, expanding productivity through economic restructuring while also keeping labor mobilization up as well. Germany and Poland continue to struggle with low labor utilization but have seen some cyclical improvements recently. Russia has benefited from strong overall demand growth largely driven by oil revenues.

Intermediate indicators of competitiveness, often a bellwether for things to come, send more mixed signals but are generally also at solid levels. Export positions are overall stable with a quickly growing role of service exports. Investment activity is up in the short term but still on an long-term downward trend. The Region is an important source of FDI, but has over time lost position as an FDI destination. FDI inflows are starting to approach the relatively low level of domestic investment activity. Knowledge creation remains solid. But while it looks better than in many other parts of Europe, it is significantly less dynamic than in other parts of the world, especially Asia.

The underlying theme of the changes in 2006 has been that the Region is entering the later stages of a classic business cycle upswing. Labor mobilization is up more than labor productivity. Cyclical indicators of competitiveness like investment and FDI are up, while the performance in areas less affected by domestic demand conditions, like patenting and exports, is less strong. As the business cycle will inevitably slow down, the Baltic Sea Region will need to show its ability to adjust.

For the Nordic countries, the challenge will be sustaining sound fiscal policies and microeconomic reforms when the pressure for defensive social and labor market policies will increase. Germany is in a similar position but faces a significantly less benevolent starting position. For the Baltic countries, keeping on the right side of the divide between fast long-term catch-up growth and short-term economic imbalances during an overall slowdown will be high on the agenda for economic policy. Poland first needs to relaunch an active economic reform agenda before these concerns about the growth path will come to the forefront. Russia faces much more fundamental questions about the economic growth model – driven by natural resources or increasingly diversified and driven by knowledge - it wants to pursue as a country.

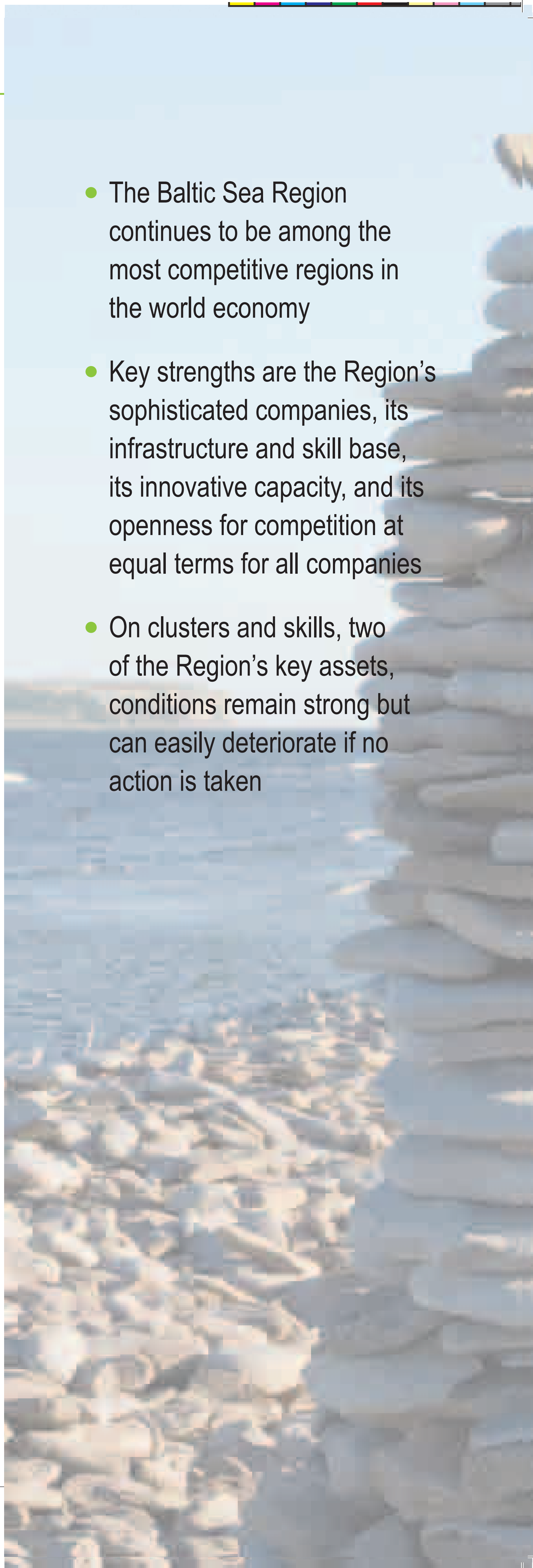
2. The foundations of competitiveness in the Baltic Sea Region

Prosperity and innovation are ultimately driven by the microeconomic capacity prevalent in the locations across the Baltic Sea Region. This section tracks the microeconomic capacity of the Baltic Sea Region relatively to key peers, as well as of individual countries across the Baltic Sea. It also looks at the broader context of economic geography, natural resource wealth, and governance that shape the environment in which microeconomic foundations affect the performance of companies.

Competitiveness is driven by factors at two broad levels: legacy and governance on the one hand, and microeconomic competitiveness on the other.

Countries face a legacy and governance structure that creates the opportunities for engaging in economic activity. Legacy refers to factors that are essentially given and cannot be changed through policy. One important element of legacy is location; the access to oceans as a conduit for integrating into the global economy, the neighborhood of other countries—a point already discussed in Section A—and the general geographic profile of the country. The other element is the presence of natural resources. The governance structure refers to the basic political, legal, and social structures that countries have created, often over long periods of time. These structures are the result of political choices in the best, but they are also heavily influenced by more basic characteristics of societies, like their composition in terms of ethnic or religious groups or the general level of trust in society.

Countries then create microeconomic competitiveness based on the quality of their business environments, the sophistication of their companies, and the development of their clusters. The business environment captures all aspects at a location that have a direct impact on the productivity and innovative capacity of companies. The different dimensions of the business environment work in a highly interrelated way; for example the benefits from a skilled workforce are not fixed, but depend on the context for competition that companies face. Economic policy needs to identify and address those factors that are the most important bottlenecks at a given point



- The Baltic Sea Region continues to be among the most competitive regions in the world economy
- Key strengths are the Region's sophisticated companies, its infrastructure and skill base, its innovative capacity, and its openness for competition at equal terms for all companies
- On clusters and skills, two of the Region's key assets, conditions remain strong but can easily deteriorate if no action is taken

The Global Competitiveness Report
In this analysis, we draw on the Global Competitiveness Report (GCR), an annual assessment of competitiveness across more than 120 countries. It is based on statistical data collected from international organizations and on a survey of more than 10,000 business executives around the world.

The GCR captures microeconomic competitiveness along 58 dimensions, 15 on company sophistication and 43 on business environment quality. The scores countries get on each of these dimensions are then aggregated to the level of subindexes for company sophistication and business environment quality and then to overall microeconomic competitiveness, with the weights reflecting the measured impact of individual indicators and subindexes on GDP per capita.

The GCR also controls for the impact of legacy and governance, using a number of indicators capturing natural resource wealth, location (neighborhood and access), and political stability.

in time. The need to set a consistent set of priorities across many interrelated microeconomic policy areas that all provide potential benefits creates a very different political challenge compared to setting macroeconomic or governance policies, where the choice is between basic policies that are largely good or bad, independent of the specific circumstances.

This Report focuses on the microeconomic foundations of competitiveness, an area where current choices – by government but also many other actors – have the most immediate impact. But the Report also wants to give a broad sense of where the Region starts from, in terms of legacy and governance structures.

The remainder of this chapter is organized in three parts. First, we discuss the legacy and governance structure across the Baltic Sea Region that provides the context for economic activity. Second, we analyze the microeconomic competitiveness of the Region and individual countries. Third, we take a closer look at skills and clusters, two areas of microeconomic competitiveness that are of particular interest to the Region.

Legacy and governance

Geographic location has an important influence on economic performance. An important segment of the academic literature on growth argues that in the long-run geography determines to a large degree the level of prosperity that a location can reach. While this view is challenged by others, reflecting on the opportunities and challenges of a specific economic location is an important element of an action-oriented competitiveness analysis.

The Baltic Sea Region faces a geographic position that in many ways poses significant challenges. As was discussed in more detail in last year's Report, the Region is located at the periphery of the European economy, a large geographic area that has been less economically dynamic than other parts of the world economy in recent decades. This is a challenge, as despite globalization, trade and investment flows continue to be much higher with economies that are more proximate. And the Region has a relatively low population density, with few metropolitan centers that have European or even global reach. This is also a challenge as especially in the creation of new ideas, there seem to be advantages for large metropolitan regions that can combine critical mass in specific areas and very different activities all in one location.

The Baltic Sea Region has other geographic features that work in a positive direction. A large share of the population lives close to the coast and thus has the potential to use maritime trade to connect with the global economy. This has been an important factor historically and contributed to many economic linkages that this Region has to other parts of the world, and to the significant position it has in maritime logistical services. And the Baltic Sea Region is a neighborhood of mostly very prosperous countries that create the potential for a positive dynamic of mutually beneficial trade and investment. This has

Table 4: Legacy and Governance: Selected countries

	BCI Rank	Context and Endowment Rank	Political system	Accesibility	Neighborhood	Natural resources
United States	1	8				
Germany	2	4				
Finland	3	6	+++			
Sweden	4	7	++			
Denmark	5	2	+	++		+
Switzerland	6	9	+++		++	
Netherlands	7	3	+	++	+	++
Austria	8	10	+			
Singapore	9	17		++		
Japan	10	14				
United Kingdom	11	13		++		
Hong Kong SAR	12	15		++	++	-
Norway	13	1	++			+++
Canada	14	5	+		+++	++
Belgium	15	11			+	+
France	16	18			+	
Australia	17	12				++
Korea	18	19			+++	
Israel	19	22				
Malaysia	20	21				
Estonia	24	23				
Lithuania	34	29				
Latvia	43	38				
Poland	44	40				
Russia	55	68	-	-		

Source: Global Competitiveness Report 2007-08

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been a crucial factor for those parts of the Region that become accessible again after the fall of the Communist regimes around 1990.

Overall, for the Baltic Sea Region the geographic location has not been the drag on economic performance as could have been expected. But for this positive balance to remain in place, the Region needs to work harder and be more proactive in overcoming barriers within the Region. This will reduce the costs of low population density and mobilize the benefits of a prosperous neighborhood.

Natural resources can provide direct economic benefits through the wealth they embody. But they can easily have even higher indirect costs by distorting economic and political structures. The academic literature has tended to see natural resources overall as less critical than other factors to explain long-term prosperity, and it has for many countries found the dynamic negative effects of natural resources to be stronger than the static positive effects. An effective competitiveness analysis needs to capture the incidence of both forces.

The Baltic Sea Region is home to a number of valuable natural resources. Norway and Russia control some of the most important oil and gas reserves in the world. Russia's reserves are mostly located outside the northwest but there are important opportunities in the Arctic Ocean. Estonia has, on a much smaller scale, oil tars that are becoming more economically attractive as oil prices increase. Sweden has significant deposits of metals, an asset that has been very important for the historical development of its industry and has risen in visibility more recently as commodity prices have increased. Other resources, like large forests in Finland, Sweden, and Latvia, the access to rich fishing grounds for Iceland, Norway, and Denmark, and the availability of hydropower in Iceland, Norway, and Sweden, have been beneficial as well and shaped the economic specialization of these countries.

The Baltic Sea Region has been able to take advantage of its natural resources, largely avoiding the pitfalls of negative dynamic effects. This is particularly the case for the resources other than oil and gas. These resources have been important enough to have a meaningful impact on economic development. But they have been exploited in a competitive environment, where the government provided a context in which no individual company had control over the resources. A good example is Icelandic fishing, where the regulatory framework allowed more efficient companies to gain market share but also kept rivalry at a high level.

Oil and gas resources are more complex and generally considered to be more prone to have negative dynamic repercussions on competitiveness.

- Norway has arguably been one of the most successful countries in the world in exploiting its natural resources, building a significant cluster around oil and gas related services, and keeping the negative impact on economic structures and public institutions at a low level. This has been possible due to strong existing institutions, an already well developed business environment, and a public consensus to separate the oil sector from the rest of the economy. Should this consensus weaken, which is more than a theoretical possibility, it could dramatically increase the negative impact on Norwegian competitiveness.

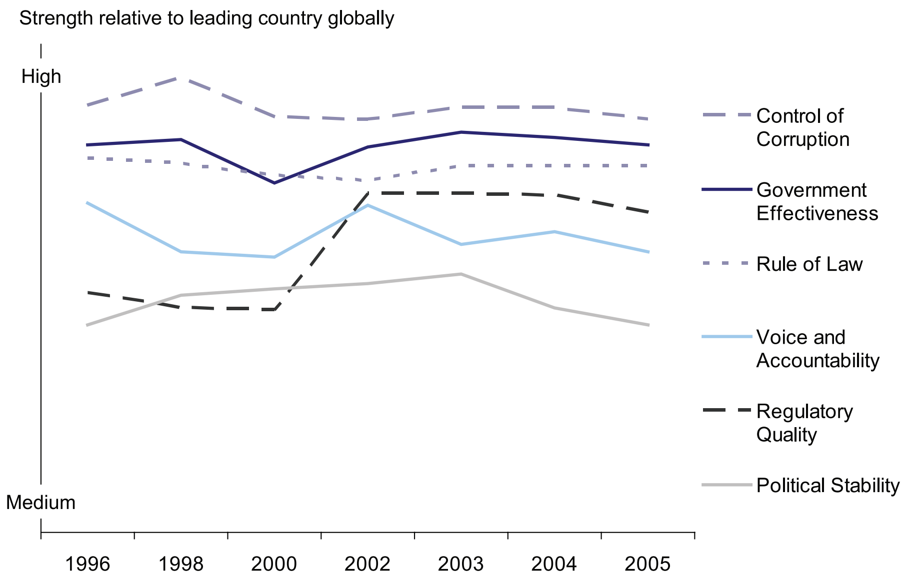
- Russia has not had the benefit of any of the three factors that enabled Norway to succeed. Oil revenues have fuelled the strong resurgence of the Russian economy since the 1998 crisis. Sound macroeconomic policies have kept inflationary pressure and Dutch Disease effects (upward pressure on the real exchange rate due to capital inflows from oil revenues that crowd out non-oil exports) at bay. But the natural resources revenues have made the public sector the dominant actor in the economy, a tendency that recent policy choices have further exacerbated. And the wealth created has increased the incentives to engage in corruption and other illegal activities, and created an atmosphere of deal-making and asset trading, rather than asset creation.

Overall, the Baltic Sea Region has benefited from its natural resources. For Russia, making sure that the natural resource wealth becomes a motor rather than a barrier towards higher competitiveness is one of the central challenges for its economic policy.

Governance in terms of the stability and effectiveness of the political and legal system has become an increasing focus of research. The majority of academic research now argues that governance, and the so-called 'deep factors' that influence it, like colonial heritage, are the most important factors to explain long-term difference in prosperity across countries. Governance and 'deep factors' do matter and their impact has to be understood, even if they do not predetermine economic outcomes in individual countries.

The Baltic Sea Region has a tradition of receiving very high marks for good governance. The Nordic countries regularly rank on the top of international assessments of the quality of public institutions and the nature of the political process. Part of the explanation is the homogeneity of their societies along

Figure 16: Governance, Baltic Sea Region



Source: World Bank (2007), author's analysis. State of the Region-Report 2007 ethnic and religious lines. This has created high levels of trust, which in turn made it possible to create highly stable institutions.

That most of the former Communist countries in the Baltic Sea Region were able to make quick progress on governance despite much weaker initial conditions is one the Region's remarkable success stories of the last 15 years. Trust levels were much lower and institutions either without any track-record, or discredited. The process of EU membership and arguably also the rapid integration across the Region have enabled fast progress and allowed especially the Baltic countries to rank ahead of most other Eastern European countries on governance. Because these stabilizing factors are absent or much weaker for Russia, the country is facing a much more significant challenge in this area. As a result, Russia is facing the real danger of a negative cycle where natural resource wealth weakens institutions and where weak institutions reduce the opportunities to diversify away from oil dependency.

In the World Bank's governance assessment, the Baltic Sea Region ranks among the top 20 countries in the world on the control of corruption, government effectiveness, and the rule of law. On regulatory quality and voice and accountability it ranks around rank 25. It only ranks lower on political stability, largely because Germany and, to a much smaller extent, Denmark and Sweden, dropped on that indicator in the last few years.

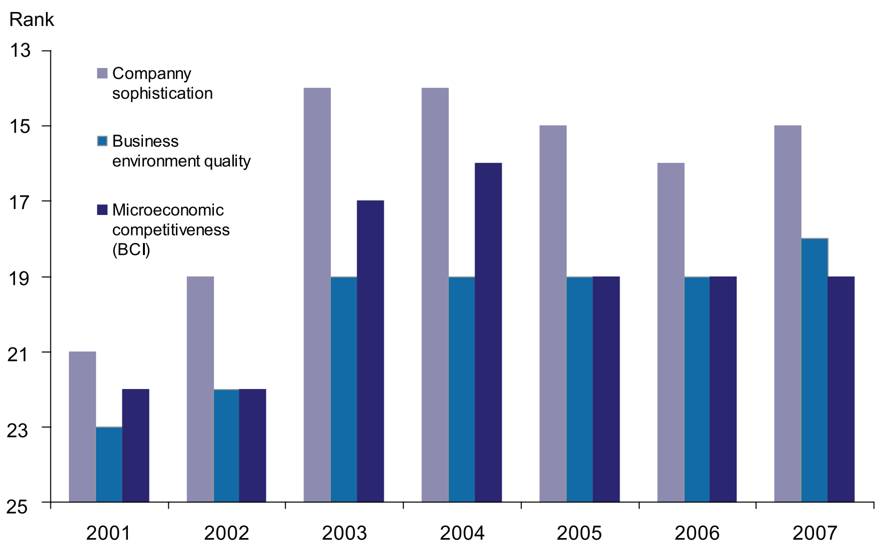
Within the Baltic Sea Region, Iceland and Finland get the best ranks across all aspects of governance. They are closely followed by Norway, with some weaker spots in regulatory quality, Denmark and Sweden, both with a weaker spot on political stability. Germany ranks a bit lower on all categories, and much lower on political stability. Estonia follows at some distance as the first former Communist country, with a particular strength in regulatory quality and weakness in political stability. Lithuania, Latvia, and Poland follow with a similar pattern but lower overall levels of performance. Russia is far behind, ranking around 150 on the average of all categories.

Overall, strong governance has become a key advantage for the Baltic Sea Region, not just the Nordic countries. For Russia, however, it is the root cause for many of its competitiveness problems. Copying western governance models directly is of little help to Russia, because the current conditions in the country are very different from those in Sweden or Germany. Finding the right path for Russia to stabilize its institutions and to make them less reliant on the power of individuals is a crucial task.

Microeconomic competitiveness

The Baltic Sea Region remains to be among the most competitive regions in the world. The Region is doing better on overall competitiveness, especially the sophistication of companies, than on rules and regulations attractive for business. The Region's posi-

Figure 17: BCI rankings over time, Baltic Sea Region



Source: Global Competitiveness Report (2007), author's analysis.

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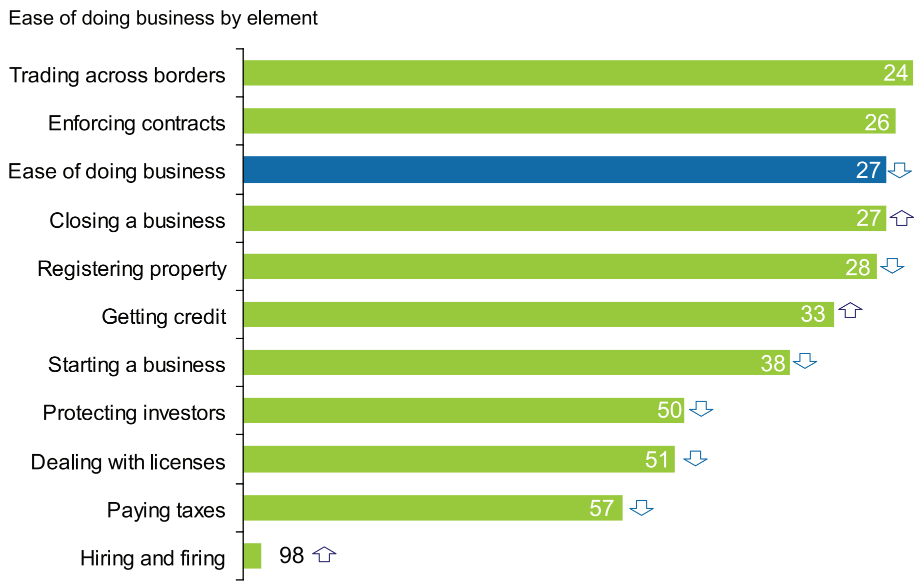
tion has improved slightly this year, benefiting from a benign business cycle environment, but its overall dynamism in improving competitiveness since 2002 remains below the global average. Wages continue to be broadly in line with competitiveness but pressure is building up for this advantage to weaken.

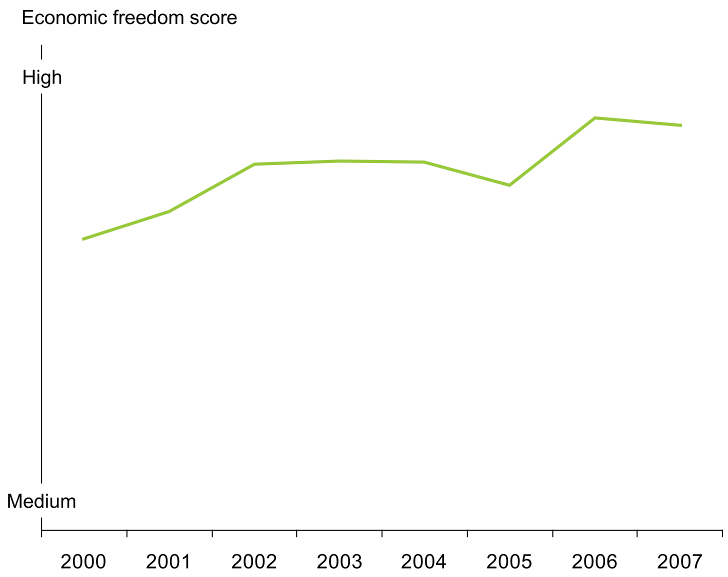
On overall microeconomic competitiveness as measured in the Global Competitiveness Report's Business Competitiveness Index (BCI), the Baltic Sea Region ranks 14th in the world, unchanged from last year. On the World Bank's Doing Business index, a measure specifically focused on the rules, regulations, and institutional conditions for business, the Baltic Sea Region ranks somewhat lower but still among the top 25 countries in the world. On Economic Freedom, a measure focused on the absence of government interventions into markets, the Region ranks similarly

Figure 18: Doing business ranking, Baltic Sea Region



Source: World Bank – Doing Business (2007), author's analysis. State of the Region-Report 2007

Figure 19: Economic Freedom over time, Baltic Sea Region



Source: Heritage Foundation (2007) State of the Region-Report 2007 as 21st this year. On measures of innovative capacity the Region, subnational regions from around the Baltic Sea lead the European ranking.

On the absolute Business Competitiveness score, the Baltic Region has improved since 2005, but so have other countries at a similar competitiveness level. Since 2002, the first year for which comparable data is available, the Region has overall been less dynamic in upgrading competitiveness than the global average of countries. On the Doing Business index, comparable data exists only since 2006. The Region's slight loss of position on this index since last year was largely due to other countries making more progress on improving business regulations, rather than due to any absolute deterioration in the Baltic Sea Region. On Economic Freedom, the Region gained one rank despite dropping slightly in absolute score. On innovative capacity, regions from around the Baltic Sea Region have mostly strengthened their position over time.

The Baltic Sea Region ranks better on company sophistication than on business environment quality. This pattern has been present in the entire period for which we have comparable data, i.e. since 2001. The gap became particularly visible in 2003 and has fallen only marginally since then. In company sophistication, the Region is particularly strong in terms of modern management techniques and areas related to innovative capacity. The weakest ranking is on the extent of marketing, but even there the Region achieves a rank just within the global 25. In business environment quality, the Region ranks strongest on measures of related and supporting industries, technological capacity, demand conditions, and the level playing field for competition. Weaknesses are seen in the intensity of competition and the educational system. In terms of business rules and regulations, the Region has its relative strengths in the regulations associated to trade across borders, the enforcement of contracts, the closing of businesses, and the registration of businesses. The most striking relative weakness is the regulation of the labor market. Other weaknesses include the rules and regulations on paying taxes, dealing with licenses, and the protection of investors' rights.

Table 5: BSR BCI RANKINGS: Competitiveness profile, Baltic Sea Region

COMPANY OPERATIONS AND STRATEGY	BSR
Willingness to delegate authority	11
Capacity for innovation	13
Company spending on research and development	14
Production process sophistication	14
Reliance on professional management	14
Extent of staff training	16
Breadth of international markets	17
Extent of regional sales	17
Nature of competitive advantage	19
Value chain breadth	19
Degree of customer orientation	20
Control of international distribution	21
Extent of performance-based compensation	22
Extent of marketing	24
Prevalence of foreign technology licensing	34

BUSINESS ENIVRONMENT QUALITY	BSR
A. Factor (input) conditions	
1. Physical Infrastructure	
Quality of port infrastructure	16
Internet users per 10,000 inhabitants	16
Railroad infrastructure	18
Overall infrastructure quality	20
Cellular Telephones per 100 inhabitants	20
Quality of electricity supply	21
Quality of telephone/fax infrastructure	22
Air transport infrastructure quality	24
2. Administrative Infrastructure	
Business costs of corruption	16
Freedom from corruption	16
Efficiency of legal framework	19
Laws relating to ICT	20
Judicial independence	21
Centralization of economic policymaking	22
Reliability of police services	23
3. Human Resources	
Cooperation in labor-employer relations	19
Quality of primary education	22
Quality of management schools	27
Quality of math and science education	30
4. Technology Infrastructure	
Patents per capita	12
University/industry research collaboration	18
Quality of scientific research institutions	19
Availability of scientists and engineers	20
5. Capital Markets	
Ease of access to loans	16
Venture capital availability	16
Financial market sophistication	24
Local equity market access	28
B. Demand conditions	
Stringency of environmental regulations	12
Government procurement of advanced technology products	18
Presence of demanding regulatory standards	18
Buyer sophistication	23
C. Related and supporting industries	
Local availability of process machinery	12
Local availability of specialized research and training services	15
Local supplier quality	17
Local supplier quantity	20
D. Context for firm strategy and rivalry	
1. Incentives	
Efficacy of corporate boards	14
Favoritism in decisions of government officials	15
Intellectual property protection	21
Property rights	23
2. Competition	
Effectiveness of antitrust policy	20
Extent of market dominance by business groups	21
Intensity of local competition	22
Prevalence of trade barriers	27

Source: Global Competitiveness Report 2007-08 State of the Region Report 2007

The diamond of business environment quality

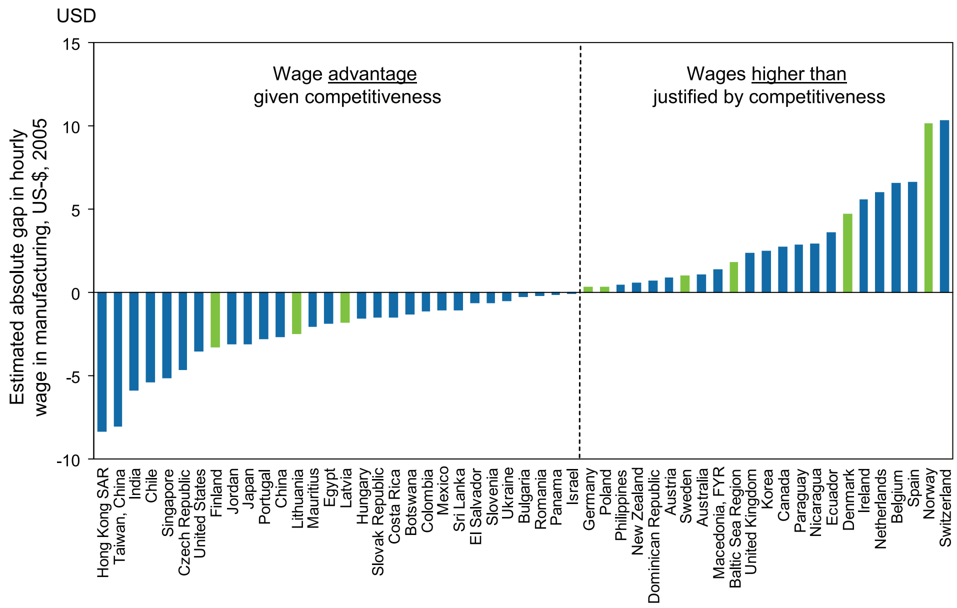
Many things affect the productivity and innovative capacity that companies can reach in a given location. The diamond, a conceptual tool introduced by Michael Porter in his 1990 book The Competitive Advantage of Nations, provides an organizing principle to capture the main dimensions that are important.

Factor conditions, including skills, infrastructure, but also administrative capacity, have been the intuitive priority of many center-left governments, giving a clear notion for how public policy can strengthen the economy. The context for strategy and rivalry – the nature of local competition, the exposure to global competition, the incentives provided by government for economic activity, and the influence of government on markets – have been the intuitive priority of many center-right governments, setting an agenda for letting market forces work more effectively.

Demand conditions – the sophistication of local consumers and the nature of rules and regulations on products, services, and process – have only recently been understood to be an important factor, especially for innovative capacity.

The presence of related and supporting industries – the access to specialized suppliers and service providers and the emergence of vibrant regional clusters of interconnected companies and other institutions – also has become an increasing focus. Clusters enable higher productivity and innovation and often become the platform for organized collaboration, between companies but also with universities and many different government agencies.

Figure 20: Wages versus competitiveness



Source: Global Competitiveness Report 2007, ILO, US DOC.

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Relative to its competitiveness, wages in the Baltic Sea Region are slightly too high to be supported by the productivity level that companies are able to achieve. The gap is smaller than in most other European economies, while it is less advantageous when compared to non-European OECD countries or emerging Asian economies like Taiwan, Singapore, and India. Internationally comparable wage data is available only until 2005. By 2005, it was becoming clear that wage growth was starting to outpace the speed of competitiveness upgrading in the Baltic Sea Region. All evidence suggests that this has indeed been the case in the last two years. But it is a trend that has also been evident for other European economies. Compared to its European peers, wages in the Baltic Sea Region remain attractive. On a global scale, however, the challenges of wage costs are rising. They are further exacerbated by exchange rate movements that have made the Euro-zone, including the European countries that have their currencies closely tied to the Euro, a much more costly place to do business than the United States or Asia.

Relative to its competitiveness, legacy, and governance structure, prosperity in the Baltic Sea Region should be slightly higher than it actually is; the statistical analysis points towards a gap of about 7% of GDP per capita. Candidates to explain this gap are the level of taxation, the labor market rules and regulations, the economic geography of the Region, and its location at the periphery of Europe.

Within the Baltic Sea Region, *individual countries* face different challenges for upgrading their microeconomic competitiveness. Five countries from the Baltic Sea Region are in the top 15 for both the BCI and the Doing Business assessment. Most countries in the Region do better on overall competitiveness measured by the BCI than on the specific business regulations measured by the Doing Business analysis. The exceptions are the Baltic countries that have rapidly upgraded their legal and regulatory environment while making slower progress on broader dimensions of competitiveness.

Germany (ranked 2nd in the world in the BCI) continues to draw strength from the export orientation of companies (it ranks 1st on the extent of regional sales and the breadth of international markets), unique company positioning (1st on the nature of competitive advantage, the capacity for innovation, and production process sophistication), clusters (1st on local supplier quality and local supplier quantity, 2nd on local availability of process machinery and of specialized research and training services), and the quality of the regulatory and legal framework (1st on intellectual property (IP) protection, the effectiveness of antitrust policy, the presence of demanding regulatory standards, and the stringency of environmental regulations). Germany's key problems are related to education, labor market relations, and the capital markets. Since 2001, Germany improved most on the availability of scientists and engineers among a stable sample of countries. Germany is the country in the Baltic Sea Region in which actual GDP per capita lags most behind what the country should be able to achieve given its context and competitiveness. This gap points towards other structural issues, possibly related to taxation or labor market rules not covered in the BCI. In the Doing Business index, Germany only ranks 20th in the world, down four from last year. It ranks high on credit rules but remains weak on labor market rules and regulations. Weaknesses in investor protection, starting a business, and paying taxes have increased. On economic freedom, it ranks 20th as well, up two ranks from last year.

Finland (3rd) remains strong in its government administrative infrastructure (it ranks 1st on the reliability of police services, business costs of corruption, and freedom from corruption); competitive environment (2nd on IP protection and the effectiveness of antitrust policy), and the educational system (1st on the quality of primary education and the quality of math and science education). It also has strengths in the telecommunication infrastructure (1st) and access to debt (1st) and venture capital (2nd). Finland suffers from an imbalance between a generally very strong business environment and on average weaker company sophistication. Since 2001, Finland dropped more than ten ranks in equity market access, labor market relations, and the extent of performance-based compensation. Overall, Finland has registered the lowest level of dynamism in terms of competitiveness upgrading since 2002 among all Baltic Sea Region countries. Among high income countries, only Italy registered even lower dynamism. On rules and regulations for business, Finland ranks 13th overall in the Doing Business index. It is strong on bankruptcy procedures and the ease of cross-border trade but weak on labor market regulations and on taxation procedures. On economic freedom, it ranks

16th, unchanged from last year.

Sweden (4th) draws its strength from modern management structures (ranking 1st on the efficacy of corporate boards, willingness to delegate authority, value chain breadth, and reliance on professional management), a focus of businesses toward innovation (2nd on university-industry research collaboration, the local availability of specialized research and training services, and companies' capacity for innovation), and a regulatory and policy environment oriented toward open and innovation-based competition (1st on property rights and 2nd on government procurement of advanced technology products, laws relating to ICT, the stringency of environmental regulation, and the absence of trade barriers). The main worries exist about the adequacy of the educational system and, too a smaller degree, the physical infrastructure. Sweden's largest improvements over the last six years were in equity market access, the local availability of process machinery, the absence of trade barriers, the efficiency of the legal framework, and the procurement of advanced technology by the government. Despite the recent improvements, Sweden ranks second worst on competitiveness dynamism since 2002 among the Baltic Sea Region countries. On rules and regulations for business, Sweden ranks 14th in the Doing Business index, closely behind Finland. Sweden is also weak on taxation procedures but not as bad as Finland; it has other inefficiencies in the enforcement of contracts. On economic freedom, it ranks 21st, up one rank from last year.

Denmark (5th) is particularly strong in measures related to administrative efficiency (ranking 1st on efficiency of the legal framework and laws relating to IT, 2nd on the reliability of police services and judicial independence, and 3rd on the absence of corruption). The country also ranks high on aspects of its infrastructure (1st on electricity supply), the collaboration between its labor market partners (1st), and the level playing field for competition (3rd on absence of favoritism of government officials and IPR protection). Companies are particularly strong in staff training and the willingness to delegate (rank 1 on both). Weaknesses exist in the technology area, equity market access, supplier presence, and some aspects of competitive vitality. Since 2001, Denmark has made impressive progress in areas related to advanced education (gaining ten or more ranks on quality of math and science education, quality of management schools, availability of scientists and engineers), in laws related to IT, and in the extent of local competition. Denmark ranks also 5th in the Doing Business index, highest among all Baltic Sea Region. It continues to be very efficient in procedures on cross-border trade and licensing, and after a significant improvement since last year also in bankruptcy procedures. The country's biggest weaknesses remain the registration of property and the enforcement of contracts. On economic freedom, it ranks 13th, up one rank from last year.

Norway's (13th) biggest strengths are in the capital market (2nd on the access to loans, 3rd on the availability of venture capital, and 6th on the access to the local equity market) and on some dimensions of the administrative infrastructure (5th on the neutrality of government officials, 7th on the absence of corruption, 8th on laws relating to IT, and 9th on the reliability of the police). Norway's main problems are its trade barriers and some other measures of the intensity of competition, but it also ranks relatively weak on measures of supplier presence education, and technological capability. Norway's main gains since 2001 have come in laws relating to IT, the procurement of advanced technology by the government, and local equity market access. Trade barriers, however, have become an increasing problem, despite a slight improvement over the last year. Norway ranks 11th in the Doing Business Index and is strong on bankruptcy procedures and the ease of cross-border trade but weak on labor market regulations, despite some recent improvements. On economic freedom, it ranks 30th, unchanged from last year.

Iceland (16th) ranks highly on specific measures of physical infrastructure (1st on Internet density, 3rd on telecommunication infrastructure, and 4th on electricity supply), of administrative capacity (4th on absence of corruption and on the neutrality of government officials, 5th on reliability of the police), and 4th on access to loans. The main weaknesses exist in the presence of related and supporting industries and the vitality of competition. Since 2001, Iceland gained in some aspects of supplier presence but suffered from more dominant business groups. Iceland ranks 10th in the Doing Business index and has made significant progress on protecting investor rights, which nevertheless remains its biggest weakness. On economic freedom, it ranks 15th, down two ranks from last year.

Estonia's (26th) main strengths are in the vitality of competition, in some aspects of administrative capacity, in human resources, and in Internet/telecommunication infrastructure. Business sophistication continues to rank far behind business environment quality, and there are problems in the presence of qualified suppliers and the availability of scientists and engineers. Since 2001, there have been strong improvements in cell phone penetration, equity market access, the quality of police services, laws relating to IT, and supplier quality. However, Estonian companies have narrowed their presence along the value chain, there are rising concerns about the efficiency of corporate boards, and skill shortages have developed for scientists and engineers. Estonia ranks second best on overall competitiveness dynamism since 2002 among the Baltic Sea Region countries. Estonia ranks highest among the Eastern countries in the Baltic Sea Region on the Doing Business index. At 17th globally it does significantly better on rules and regulations than on competitiveness overall. It has efficient cross-border trade rules and has made significant improvements in the regulations to start a business. However, the country ranks lowest of all Baltic Sea Region countries on labor market rules and regulations. On economic freedom, it ranks 12th; the gain of three ranks since last year puts Estonia in the top position in the Baltic Sea Region on this measure.

Lithuania (39th) ranks fairly similarly across a wide range of microeconomic competitiveness indicators. Cell phone penetration and math and science education are areas that stick out as key advantages. Weaknesses are most apparent in demand conditions and aspects of the financial markets. Since 2001, the country has improved its position on a wide range of measures, in particular aspects of administrative infrastructure, human resources, and cell phone use. But there is also some worrying slippage on the efficiency of boards, the intensity of local competition, and the favoritism of government officials. Overall, Lithuania registered the strongest dynamism in terms of competitiveness upgrading since 2002 among all Baltic Sea Region countries. Lithuania ranks 26th in the Doing Business index, and like the other Baltic countries above its overall performance on competitiveness. It ranks very highly on the registration of property but low on labor laws, protection of investors, and tax procedures. On economic freedom, it ranks 22nd, a gain of two ranks since last year.

Latvia (54th) remains relatively strong on most aspects of the physical infrastructure and on education, especially at the primary and secondary level. But it is weak on overall company sophistication, on some dimensions of administrative capacity, especially the legal system, on technology, on the presence of related and supporting industries, and on many aspects related to the nature of domestic competition. Since 2001, there have been significant improvements in some aspects of infrastructure, especially the airport, and in the reliability of the police. But domestic markets have become less contested, the availability of suppliers has fallen, and there are some concerns about the capital market situation for companies. Latvia has the highest gap in the Region between modest overall competitiveness and attractive rules and regulation for business; it ranks 22nd in the Doing Business index. The country ranks very well on contract enforcement but weak on labor laws, registration of property, and dealing with licenses. On economic freedom, it ranks 41st, a drop of five ranks since last year. Some of the deterioration was related to the measures introduced on the financial markets to slow down credit growth.

Latvia - a case study on microeconomic development and macroeconomic challenges

Latvia's economic development over the last 15 years has been a remarkable success story. But over the last few months there have been growing signs that Latvians can not take it for granted that this success story will continue. Inflation remains high and there are many indicators of an overheating economy. Parts of society continue to feel excluded from the brisk growth and opportunities of the Latvian economy. What has happened? And what ought to be done?

Latvia's economic growth of recent years has been build on a simple but very powerful formula: Take a legacy of a well skilled labor force at relatively low wages and a location close to developed markets of Northern and Western Europe. Add a commitment to open markets, low taxes, and a limited role of government. And combine it with EU membership as a guarantee against the instability of a young political system prone to frequent changes in policy. You get strong growth and a dramatic re-orientation of the economy towards Western Europe and the global market.

Latvia's current ailments are symptoms of the success that this formula has delivered, not a sign of failure: The current account deficit is to a large degree matched by the investments made by foreign and domestic companies. The inflation is the result of high growth exerting pressure on the real exchange rate that – given the monetary regime with fixed exchange rates – reveals itself in rising domestic prices. The emerging skill shortages are the consequence of attractive opportunities abroad and at home for skilled employees. And the widening prosperity differences in Latvian society are the result of the increasing returns to knowledge, mobility, and risk taking; qualities that are unevenly distributed across society. That Latvians increasingly feel these challenges is a sign that the country is entering a new stage of its economic development.

What are the characteristics of the new economic policy approach needed? A key element – and probably the biggest challenge – is a new role for government policy. Latvia needs to create a business environment where rapid productivity growth is increasingly based on new ideas and the application of world-class knowledge, not only the investment in modern production capacity. It needs a business environment in which domestic and foreign companies compete successfully based on sophisticated strategies, not just on access to relatively low wages. And it needs a business environment in which economic growth translates into widespread improvements in the standard of living, not just opportunities in parts of the economy.

The new stage of economic development requires a new model for economic policy. Just getting out of the way is no longer enough for government. But old style government-led economic development will not do the trick either. Government and companies need to find a productive partnership for aggressively upgrading competitiveness and productivity.

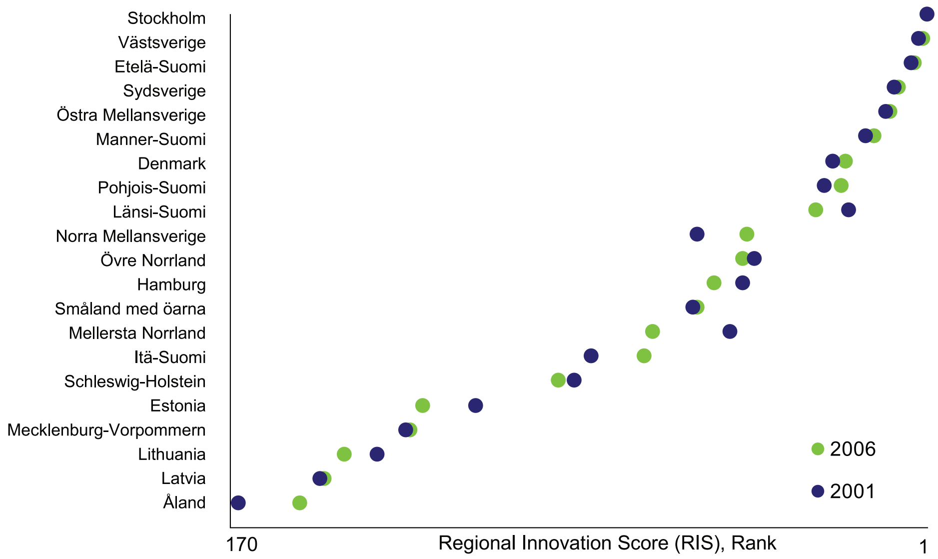
Poland (56th) registers the educational system as the key strength, followed by a relatively broad range of available related and supporting industries and a surprisingly strong position in companies' innovative capacity. Weaknesses are most prevalent in the context for rivalry and strategy, but also in the efficiency of the legal system and some aspects of the physical infrastructure. Since 2001, there has been an erosion of the country's position in physical infrastructure, the general technological capability, and the quality of the legal system. However, labor market relations have improved and companies are seen to have strengthened their competitive advantages and their presence along the value chain. Poland dropped to 74th place in the Doing Business index, a loss of six ranks. It gets very low marks for licensing procedures, starting a business, and rules and regulations on taxation. In labor market regulations, it suffered from measures that made hiring more difficult for companies. On economic freedom, it ranks 87th, a staggering loss of 18 ranks since last year related to changes in general business regulations.

Russia's (71st) main strengths are its general technological capabilities, its educational system at the primary and secondary level, and the solid railroad infrastructure. Weaknesses are most obvious in administrative infrastructure and the context for strategy and rivalry. Since 2001, has suffered from an erosion of property rights and increasing favoritism of government officials as well as narrowing positions in related and supporting industries. Russia is the country in the Baltic Sea Region in which actual GDP per capita is furthest ahead of what the country should be able to sustain given its context and competitiveness. The future prosperity of the Russian economy is in doubt, unless competitiveness can be improved. Russia remains at the bottom of the regional ranking in the Doing Business index as well, ranking 106th globally, despite a gain of seven ranks. Licensing procedures rank worst at a staggering 177 rank among 178 countries. Rules surrounding trading across border, tax payments, and labor market rules far only slightly better. In access to credit, Russia improved its position significantly due to the launch of a private credit rating agency. On economic freedom, it remains on the bottom of the Baltic Sea Region as 120th, a gain of one rank since last year.

The European Union's Regional Innovation Scorecard (RIS) provides data on the innovative capacity of subnational regions, including 21 regions located in the Baltic Sea Region. This data complements the assessment of innovative capacity at the Baltic Sea Region and national level discussed in last year's Report.

Stockholm stands out as the leading European region in the RIS, a position it has held since data was col-

Figure 21: Innovative capacity, regions in the Baltic Sea Region



Source: European Commission (2007)

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Table 6 Universities: Leading universities, Baltic Sea Region

		Natural sciences	Engineering, IT	Life sciences	Medicine	Business, Law	ARWU 2006 Rank
Karolinska Inst Stockholm	Sweden			16	9		48
Univ Copenhagen	Denmark	76-110		77-106	76-108	77-104	56
Uppsala Univ	Sweden		77-106		76-108		65
Univ Oslo	Norway					77-104	68
Univ Helsinki	Finland			77-106	51-75		74
Stockholm Univ	Sweden	51-75					84
Lund Univ	Sweden	76-110	77-106	50	76-108		90
Aarhus Univ	Denmark	76-110					102-150
Univ Hamburg	Germany				76-108		102-150
Tech Univ Denmark	Denmark		51-75				151-200
Chalmers Univ Tech	Sweden		51-75				201-300

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lected five years ago. Stockholm leads the European rankings in life long learning, the presence of knowledge workers, and the presence of high-tech services, and ranks among the top five regions in business R&D spending and patenting. The Stockholm region is also home to three of the leading universities from the Region, with the top universities focusing on life sciences and medicine. It ranks lower on high-tech manufacturing.

Western Sweden follows on rank 2, with an overall similar profile but more high-tech manufacturing instead of services. The region leads the European rankings on business R&D, a result of the strong expenditure of the automotive companies located there. This is also reflected in strong position of Chalmers, the leading regional university, in engineering.

Southern Finland (Etelä-Suomi) is ranked 4th overall, with strong positions across all dimensions of innovative capacity. Compared to the leading Swedish regions, it is less well positioned on patenting and business R&D.

For the Baltic Sea Region, skills are a critical part of what makes the Region competitive in the global economy.

Denmark, two more Finnish, and two more Swedish regions are also among the top 25 European regions overall. Denmark has in Copenhagen the only university in the Region that has a meaningful international position across many disciplines. Hamburg is at 53 the highest ranking region outside the Nordic countries, with a clear focus on high-tech services and a university that has achieved a strong position in medicine. Estonia tops the Baltic countries at 124, with relative advantages in public R&D and in the presence of knowledge workers. Both Hamburg and Estonia have lost some position relative to other European regions over recent years.

Special focus: Skills and cluster

In this year's Report, we discuss two areas in some more depth that are of particular interest to the Region. Both are perceived as critical to the value proposition of the Region and many of its countries. And both are areas in which cross-national collaboration at the Baltic Sea Region level would clearly have a positive impact.

Skills are a central foundation of an innovation-driven economy. They alone are not sufficient, as other dimensions of the business environment need to be in place as well, but without a sound skill base it is close to impossible for companies to compete based on innovative products and services. For the Baltic Sea Region, skills are a critical part of what makes the Region competitive in the global economy.

The skill base of the Baltic Sea Region continues to be strong. Companies perceive the availability of well educated employees as a key strength of the Region. This positive situation is the result of many decades of investments in education, both within the public education system and in companies. But the strong current position cannot be taken for granted: many other countries focus on skill upgrading and the global competition for skills is getting increasingly intense as the benefits of skill are rising.

Virtually all countries in the Baltic Sea Region are reporting increasing skill gaps, i.e. firms facing problems finding employees that have the right skill set for the jobs that need to be filled. A study for Germany quantified the economic costs of these shortages with €20 billion a year. These skill gaps not only exist among very highly skilled employees, they also affect a number of manual occupations like construction services. Wage pressure is increasing as companies compete for the employees that have the sought-after skills. These developments are to a large extent the result of a booming economy. Skills gaps also exist in other countries that experience rising economic growth; the Baltic Sea Region does not seem to be more affected than others. The situation is more critical for the Baltic countries and Poland. In the Baltic countries in particular, there are signs that a meaningful share of the highly skilled workforce has moved abroad, largely to the UK and Ireland, but also to the Nordic countries. A moderation of growth rates will reduce the demand for higher skills, but do little to attract back high skilled employees.

Education data
The OECD has recently published a major review of education systems in the OECD countries. Education at a Glance (despite its title a book of more than 400 pages) provides data on many aspects of the educational system.

A significantly higher level of the population in the Baltic Sea Region than in the OECD average has at least a secondary education. The only countries that fall below the OECD benchmark are Poland and Iceland. Russia and Estonia register the highest levels of formal education. The gap between the Baltic Sea Region and the OECD average will, however, shrink in coming years: the expansion of education has been higher outside the Region. In terms of the specialization of the workforce, Germany and Finland have a particularly high share of people with university education in engineering. Denmark, Finland, and Germany are in a problematic situation: they will have more engineers leaving than entering the workforce over the next decade. In Iceland, the focus is clearly on business/law, in Denmark, and to a smaller degree in Sweden, on health/welfare, and in Norway on other fields. All countries in the Region for which data is available, have a smaller share of university graduates with degrees in the sciences than the OECD average.

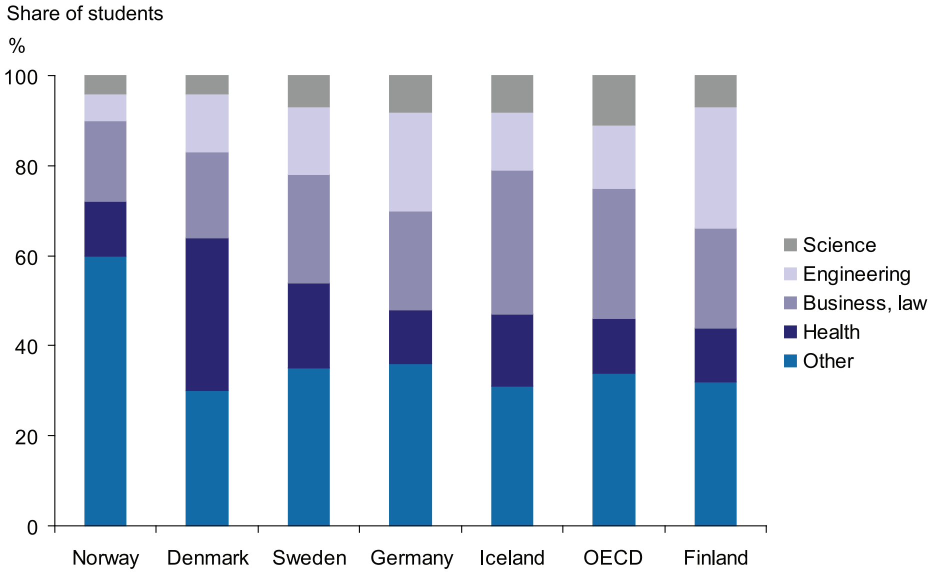
Spending on education is at the OECD level, but there are significant differences across countries in the Baltic Sea Region. Norway spends 40% more per student than the Region overall, followed by Denmark (30%) and Sweden (21%). Russia spends only 23% of the regional average per student, Estonia and Poland about 45%; differences that are much larger than differences in GDP per capita. Educational attainments are generally in line with the level of spending. Finnish students, however, register high performance not only in absolute terms but also relative to spending. In Norway the absolute student performance is similar to many other OECD countries but is weak relative to the high level of spending. There have been reforms in many countries to improve the quality of education. These reforms seem to have been more effective at the pre-school and primary level, while less has happened at the vocational, secondary, and university level. The vocational level in particular seems to have been squeezed by the efforts to prepare a higher share of the student population for university education. In the Baltic Sea Region, virtually all educational spending is public, while in the OECD average private spending on education accounts for close to 15% of total expenditures. A significant share of the public spending on education in the Scandinavian countries goes towards subsidies for tertiary education (scholarships, grants, loans, etc.); in Norway this ratio reaches 40% compared to 18% in the OECD average.

Returns to education are generally lower in the Scandinavian countries than in the leading OECD countries. The higher level of wage compression, i.e. lower differences between wages across skills levels, reduce the benefits from education. High public subsidies improve the attractiveness for the individual but then reduce the public benefits. Sweden provides the most dramatic example: The private (public) internal rate of return for obtaining a university degree is 8.2% (6.3%) for a woman in Sweden compared to 13.1% (13%) to a woman in the United States and 19.6% (16.1%) a woman in the UK. The results for men are similar across countries; interestingly women in Sweden and the US benefit less financially from a university degree than women in the UK. The lower returns to education might also explain why the median age of university students in the Baltic Sea Region is on average about two years above their peers in the EU average. Students in the Region seem in less of a hurry to enter the labor market, exacerbating shortages in skill supply.

There is an increasing perception that choices about which educational programs to pursue are not in line with the needs of the economy or the financial opportunities that exist. While there is little comparable data across countries, there is concern about falling student numbers in areas like information technology, natural sciences, and engineering. In many countries including the Baltic Sea Region there is insufficient information for students to assess the economic impact of their choice of area for study.

The BCI data indicates how the educational system is reflected in companies' perspectives on the availability of skill and the intensity of skill upgrading. Somewhat surprisingly, skill does overall not feature as a relative strength of the Region compared to its overall ranking on microeconomic competitiveness.

Figure 22: Fields of education, Baltic Sea Region countries



Source: OECD (2007) State of the Region-Report 2007

Table 7 Skills: BCI skill rankings, Baltic Sea Region

	BCI	Extent of staff training	Availability of scientists and engineers	Quality of primary education	Quality of management schools	Quality of math and science education
Finland	3	12 (-9)	3 (2)	1 (0)	12 (-2)	3 (8)
Denmark	5	1 (3)	11 (10)	9 (2)	8 (13)	19 (18)
Sweden	4	2 (-1)	7 (5)	22 (-1)	16 (-8)	35 (-1)
Iceland	16	16 (-5)	16 (0)	16 (-5)	18 (5)	36 (-9)
Germany	2	7 (-1)	18 (-10)	25 (-5)	26 (-5)	34 (5)
BSR		16	20	22	27	30
Estonia	26	29 (0)	69 (-15)	20 (4)	32 (-4)	22 (-3)
Norway	13	11 (7)	24 (2)	21 (5)	22 (-4)	52 (3)
Lithuania	39	36 (22)	43 (-7)	37 (5)	42 (11)	17 (13)
Latvia	54	51 (-1)	101 (-12)	35 (5)	48 (2)	43 (-2)
Poland	56	64 (3)	60 (-22)	44 (-2)	43 (5)	40 (-9)
Russia	71	94 (1)	34 (-4)	48 (1)	85 (-11)	42 (-9)

Source: Global Competitiveness Report 2007-08 State of the Region Report 2007

The strongest result is on the extent of staff training within companies; a sign of the willingness but also the need for company level skill upgrading. Availability of scientists and engineers also registers as a relative strength, even though the positive legacy in the former Communist countries is clearly eroding. The biggest concerns exist about the quality of math and science education.

The skill situation in the Baltic Sea Region remains favorable, despite the cyclical increase in skill shortages. But there are a number of structural challenges that will need to be addressed: the demographic trends will reduce the absolute number of graduates in many fields. The rising mobility of students and high-skilled employees will increase the likelihood that they will move outside the Baltic Sea Region if local universities and job prospects are not attractive. And the demands for excellence in skills, not just sound average quality, will grow. While many of the necessary changes needs to happen at the national level, action on the level of the Region can provide an important complement. Policy learning on successful reforms is an area where current activities could be extended. The creation of a truly integrated Region for science and higher education is another. Nordforsk, the joint platform of the Nordic countries to allocated research funds discussed in last year's Report, is one step towards organizing R&D funding around excellence across the Region and ScanBalt provides the opportunity for students in Life Sciences to draw on leading expertise around the Region; more such efforts are necessary

Clusters - geographic agglomerations of companies, research institutions, and other organizations specialized in related economic activities - are crucial for increasing the productivity and innovative capacity of existing skills and capabilities. They cannot substitute for poor business environments but their presence can enable regions and countries to reach significantly higher levels of performance. For the Baltic Sea Region, clusters are an opportunity to overcome the challenge of small absolute size through specialization and integration of existing strengths focused on a particular area of the economy.

Last year's State of the Region Report documented the high political focus on the development of clusters in the Baltic Sea Region. Many countries in the Region have over the last few years launched individual cluster initiatives or national cluster programs like the Finnish Centers of Excellence, the Norwegian Centers of Expertise effort, and the Swedish Vinnväxt/Visanu programs. This year, we can draw on a new European database, the European Cluster Observatory, to complement this assessment of political activity with an assessment of the economic reality of clusters as revealed in actual employment agglomerations.

Cluster data

The European Cluster Observatory (http://www.clusterobservatory.eu) provides the first quantitative database to systematically compare economic specialization patterns across European regions. It covers 258 so-called NUTS-2 regions from the 27 European Union member countries as well as from Iceland, Israel, Norway, Switzerland, and Turkey. For each region, it provides employment data across 40 cluster categories.

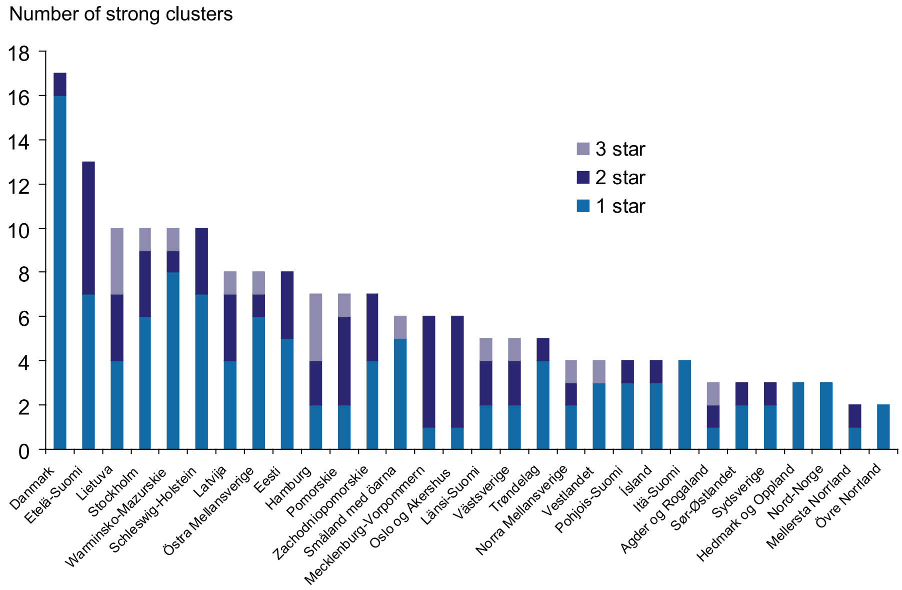
Currently, only employment data is available. In the future, the plan is to also include other performance data on a regional cluster level as well as providing information about cluster initiatives and cluster policies across Europe.

BSR InnoNet is an initiative of a number of government agencies from the Baltic Sea Region that is using this data as the basis for more detailed analysis. On behalf of the initiative, FORA at the Danish Ministry for Economic and Business Affairs is in the process of putting together cluster-specific data on productivity and competitiveness for the Baltic Sea Region.

The Baltic Sea Region is home to 30 NUTS-2 regions, most of them with relatively small absolute size. Twenty of the regions have smaller total employment than the median European region. Denmark, which unfortunately is covered as one NUTS-2 region in the European statistics, is the largest region in the Baltic Sea, ranking 7th among all European regions by total employment. The smallest region covered in the statistics is Hedmark og Oppland (Lillehammer) in Norway, 6% of the size of Denmark.

The Baltic Sea Region has 36% of its employment in the cluster sector, with the remainder in activities serving the local market or in government. This makes the cluster sector in the Region about 3%-

Figure 23: Regions with strong cluster portfolios, Baltic Sea Region



Source: European Cluster Observatory (2007), author's analysis

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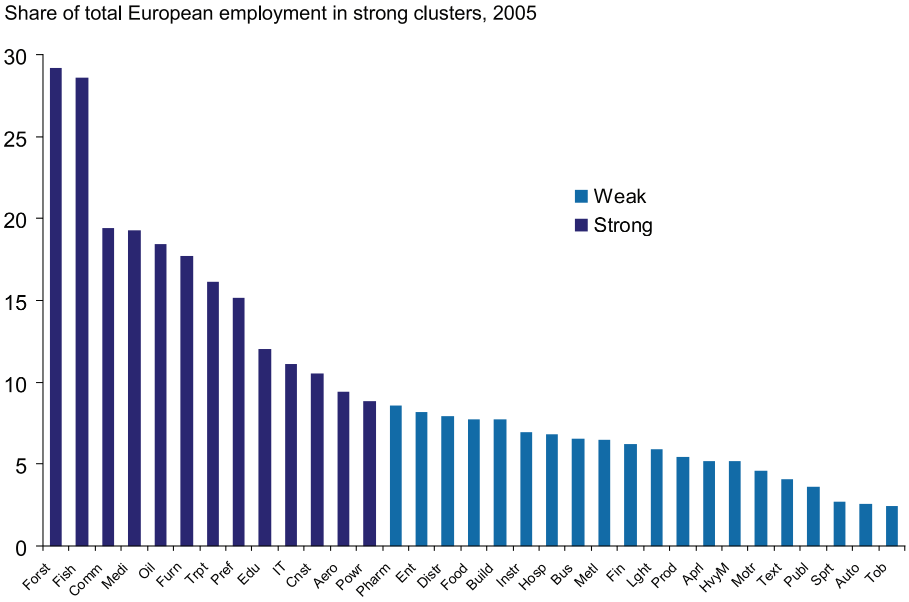
points smaller than in the rest of Europe. The difference is driven by a higher local sector, not by higher relative employment in government. The higher local sector employment is consistent with a stronger focus on services, most of which are local, rather than manufacturing. The Baltic Sea Region has already gone further than the rest of Europe in the direction of the United States, where the cluster sector accounts for about 32% of employment.

Of its total cluster employment, the Baltic Sea Region has 18.5% in regional clusters that exhibit a high level of regional specialization, i.e. where the number of employees is at least twice as large as would be expected given the overall size of the region. This share is smaller than in the average of other European regions, where it stands at 21%. The difference matters, because a higher share of employment in strong clusters is statistically associated with higher prosperity. On a broader measure of cluster strength, the number of regional clusters that meet either the specialization criterion or stand out in terms of absolute employment size or their dominance in the regional economy, the Baltic Sea Region fares better: its share of regional clusters that meet one or more of these criteria is higher than its overall share in European cluster employment. This suggests that the Baltic Sea Region is specialized in a number of cluster categories with small employment and has weaker positions in large cluster categories.

Across the 40 cluster categories, the Baltic Sea Region is most specialized in fishing products, followed at some distance by forest products, transportation and logistics, and communication equipment. Looking specifically at the employment in strong regional clusters, i.e. those that have at least twice as much employment as expected, the Baltic Sea Region accounts for close to 30% of European top cluster employment in fishing products and in forest products. In communication equipment, medical devices, oil and gas, furniture, transportation and logistics, and prefabricated enclosures, the Region accounts for between 15% and 20% of European top cluster employment. The average share of the Region across all clusters is 8.7%. These patterns are in line with the cluster specialization of the Baltic Sea Region in exports.

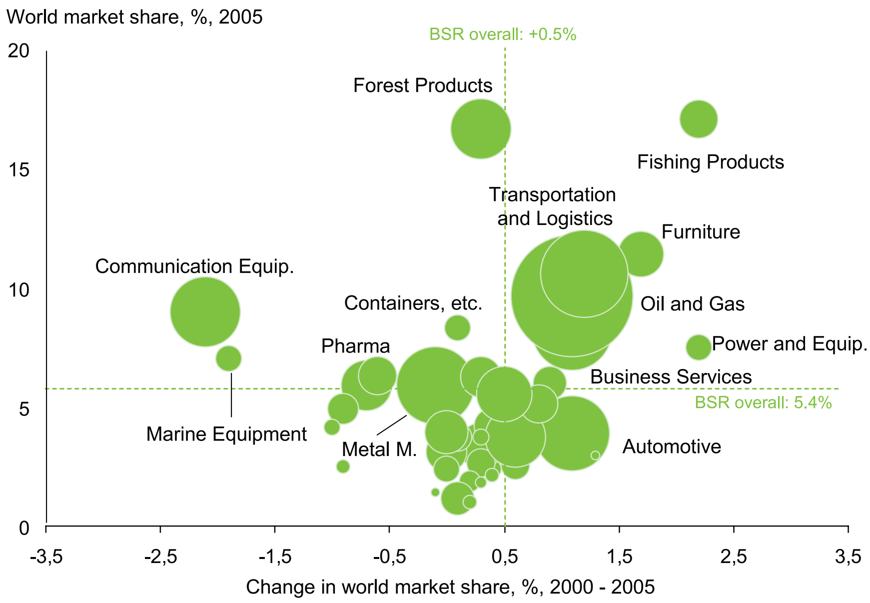
Of all regional clusters across the Baltic Sea Region, 17 reach high values in all three dimensions, i.e. specialization, absolute size, and regional dominance. Hamburg and Latvia both have three such clusters, another eleven regions each have one. Hamburg is strong in transportation and logistics, financial services, and business services. Latvia's positions are in

Figure 24: Strengths of clusters by cluster category, Baltic Sea Region



Source: European Cluster Observatory (2007), author's analysis — State of the Region-Report 2007

Figure 25: Export specialization by cluster category, Baltic Sea Region



Source: WTO (2006), Institute for Strategy and Competitiveness, author's analysis. — State of the Region-Report 2007 construction services, food products, and education.

The Baltic Sea Region has a healthy base of regional clusters, despite its small regions and limited overall size. European clusters will need to consolidate further, increasing the level of specialization of regions. Clusters and regions in the Baltic Sea Region need clear strategies, including strong linkages across borders, to make sure that they will be among the locations that benefit from the ongoing relocation of activities. Cluster efforts in the Region need to be clearly rooted in regions' current cluster portfolios, strengthening clusters that exist and providing opportunities for new clusters to emerge. While many of the necessary activities need to happen on the level of subnational regions or nations, the Region can play an important supporting role. Policy learning in networks like the BSR InnoNet provides clear benefits. And the creation of networks of clusters in one area, like ScanBalt for life sciences, can supplement regional cluster capabilities with complementary skills of neighboring clusters.

Clusters and regions in the Baltic Sea Region need clear strategies, including strong linkages across borders, to make sure that they will be among the locations that benefit from the ongoing relocation of activities.

Overall assessment

The Baltic Sea Region continues to be among the most competitive economies in the world, and there have been few changes in the Region's overall position since the 2006 State of the Region Report. Where changes were visible, they tended to be positive, reflecting the benign economic climate that the Region is experiencing.

The Baltic Sea Region strengths continue to be its sophisticated companies, its asset base, its innovative capacity, and its equal rules for all in competition. Weaknesses exist in the burden that rules and regulations impose on the vitality of competition, in the incentive structures for entrepreneurship and skill development, in labor market structures in many countries of the Region, and in some aspects of the education system. In addition to these trends on the Baltic Sea Region level are apparent, the data reveals that each country faces its own priorities in upgrading competitiveness.

The skill base remains strong for now but there are concerns whether it will remain competitive in a changing future environment. The premium for skills is increasing in the global economy, but in the Baltic Sea Region economic incentives to develop skills that are economically valuable and to then remain in the Region are relatively low. The cluster portfolio of the Region is solid, but needs to be actively developed to meet the new competitive realities. Clusters are becoming increasingly important in the global economy as drivers of productivity and innovation, while the level of competition and linkages among them is rising. In the Baltic Sea Region, established clusters need to address these challenges and opportunities for new clusters to emerge need to be explored.

3. The Lisbon Agenda

The Lisbon Agenda, originally launched in 2000, outlines Europe's ambition to become the most competitive region in the world economy. From the outset, the Lisbon Agenda introduced two important new aspects in the European policy debate. It strongly raised the focus on microeconomic foundations of competitiveness, giving a much more significant weight to innovation and enterprise policies. And it changed the interaction between the European institutions and the EU member countries, adding a new role for the Commission as a moderator of change at the member country level. The relaunch of the Lisbon Agenda in 2005 reinforced both elements. It created a stronger focus on core microeconomic policies and strengthened the role of the Commission in monitoring progress at the national level.

The European Commission provides a detailed set of indicators covering six different policy areas to track countries' progress on the Lisbon Agenda. We select the broader categories for these indicators for our calculations. The only indicator we drop is the regional dispersion of unemployment rates, because it is not available for the many countries in the Baltic Sea Region that are equivalent to NUTS-2 regions.

To aggregate the data, we first normalize the raw data. For each indicator, the value reached by the best country in 1995 is normalized to 10 and the value reached by the worst country in 1995 to 1. All other values become values between 1 and 10 using a linear transformation. This normalization does allow for higher than 10/lower than 1 in later years, enabling us to track overall improvements over time. The normalized values are than averaged within each of the six categories. The values for the six categories are then simply summed up to create a Lisbon score for each country and year. Finally, GDP weights are used to create a weighted average for the Baltic Sea Region.

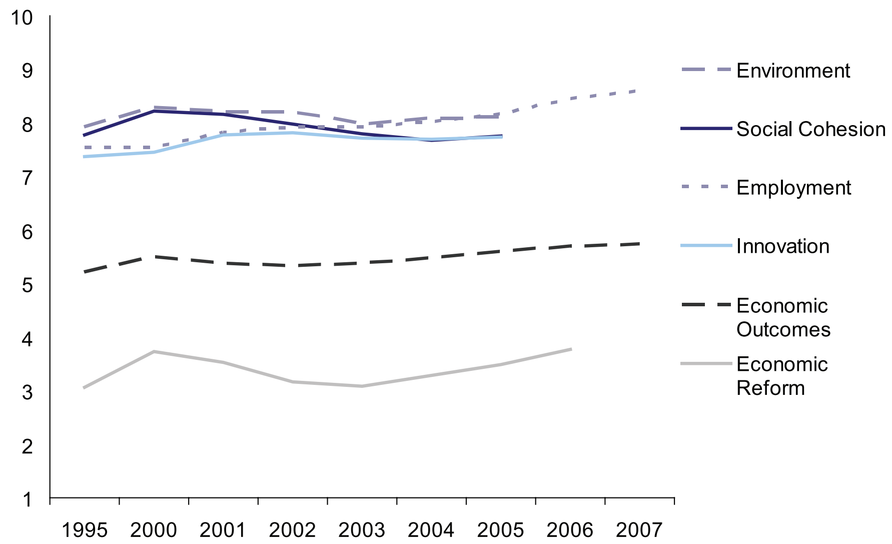
Compared to last year, we introduce a few smaller changes. First, Bulgaria and Romania are included in all our calculations. Second, we add one indicator – the change in volume of freight transport relative to GDP – in our calculations for the environmental policy area. The results for previous years are very stable compared to the data published last year despite

- The countries from the Baltic Sea Region remain ahead of their European peers in achieving progress on the Lisbon Agenda
- The Region also registers the strongest track record on national policies consistent with higher competitiveness
- Taking on the Lisbon Agenda as a Region rather than only as individual countries remains an opportunity that has not been exploited

Figure 26: Lisbon Agenda categories

	Group	Indicator
Outcomes	General economic background	• GDP per capita • Labor productivity per employee
Business environment quality	Economic reform	• Domestic price levels • Business investment rate
	Employment	• Total employment rate • Employment rate of older workers
	Innovation and research	• Youth education attainment level • R&D expenditure as % of GDP
Context	Environment	• Change of greenhouse gas emissions • Energy intensity of the economy • Transport intensity of the economy
	Social cohesion	• At risk of poverty after transfers • Long-term unemployment rate

Figure 27: Lisbon Agenda performance, Baltic Sea Region



Source: EU Structural Indicators (2007), author's analysis. State of the Region-Report 2007 these adjustments. And third, we use the additional year of data that has become available.

The Baltic Sea Region on the Lisbon Agenda

The Baltic Sea Region continues to perform well on the Lisbon Agenda criteria. Its average performance in 2005, the last year for which all data is available, would put the Region on rank 5 of all EU member countries.

The Baltic Sea Region performs best on innovation (4) and employment (7). With a small gap follow social cohesion, environment, and general economic conditions, where the Region ranks between 10 and 13. The worst performance is on economic reform, an area measured through its impact on investment rates and price levels, where the Region reaches a rank of 25. This puts efforts to raise the incentives for competing vigorously on the domestic market high on the Region's agenda.

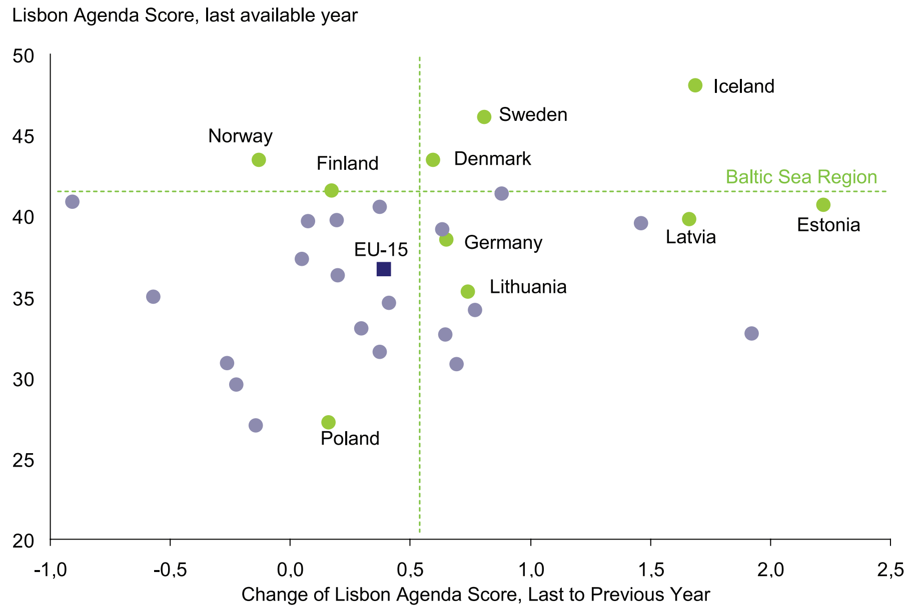
Relative to last year, the Region continued to improve both in absolute Lisbon Agenda score and in rank. As many other parts of Europe, the Region had experienced falling overall Lisbon Agenda scores in 2002 and 2003 but has improved its performance since. The policy dimensions for which 2006 and preliminary 2007 data is available, suggest that this strong trend is going to continue.

The improvements were most evident in cohesion and general economic conditions. Smaller improvements relative to other EU countries were registered in economic reforms and environment, while the strong position in innovation remained stable.

Countries in the Baltic Sea Region on the Lisbon Agenda

The countries from the Baltic Sea Region continue to dominate the top positions of the Lisbon Agenda ranking. Iceland, Sweden, Norway, Denmark, and Finland had the leading five positions in 2005. Norway surpassed Luxembourg in 2005, while the other top positions remained unchanged Estonia (12) moves ahead of Germany (14). Latvia advances one rank to 16 while Lithuania remains on 19. Poland gains one rank but is at 28 still by far in the weakest position of the Baltic Sea Region countries.

Figure 28: Lisbon Agenda performance, European countries



Source: EU Structural Indicators (2007), author's calculations

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Iceland is the leading country on the Lisbon Agenda within the European Economic Area, i.e. the EU and the EFTA countries. The country is in the top position on employment and cohesion, and performed relatively well on general economic outcomes. On environment, innovation, and economic reform, the country ranks in the second half of all countries. The biggest improvement in the last year was in economic reform, where Iceland benefited from higher investment rates.

Sweden's main strengths are innovation (rank 1), cohesion (2), and employment (4). The main weakness remains economic reforms, where the country only ranks 28 among 29 countries with available data. Relative to the previous year Sweden kept its strength and marginally improved its position in areas of weakness.

Norway is strong on general economic outcomes (rank 2), cohesion (3), and employment (3) but weak on economic reform where it holds the last position in Europe (29). In environment it ranks 21, largely due to high domestic transport volume given the geography of the country. Relative to the previous year, it lost slightly in relative position on cohesion and economic outcomes as the rest of Europe started to grow more strongly.

Denmark's strengths are, like Sweden's, innovation (4), cohesion (4), and employment (5) and the weakness is as well in economic reforms (26). The country's position remained stable relative to the previous year.

Finland is strong on innovation (2) but weak on economic reforms (27) and environment (25). Relative to the previous year, the country registered improvements relative to other European countries in employment.

Estonia's key strengths are economic reforms (2) and the environment (3). General economic outcomes (25), cohesion (22), and innovation (20) are so far relatively weak. Relative to the previous year, the country registered improvements in environment, cohesion, and to a smaller degree also in innovation.

Germany's relative strengths are the environment (6) and innovation (8), while economic reform (21) remains the largest weakness. Relative to last year, Germany slipped slightly on environment and innovation.

Latvia' key strengths are economic reforms (1) and the environment (1). In all other areas, especially general economic outcomes (29), cohesion (24), and innovation (24), the country ranks much lower. The country lost ground on cohesion but made small gains on employment, innovation, and economic reforms.

Lithuania is strong on the environment (2), followed in some distance by economic reforms (7). Its main weaknesses are general economic outcomes (29) and cohesion (24). Relative to last year the country gained significant position relative to its EU peers in innovation, with smaller improvements on employment, cohesion, and economic reforms.

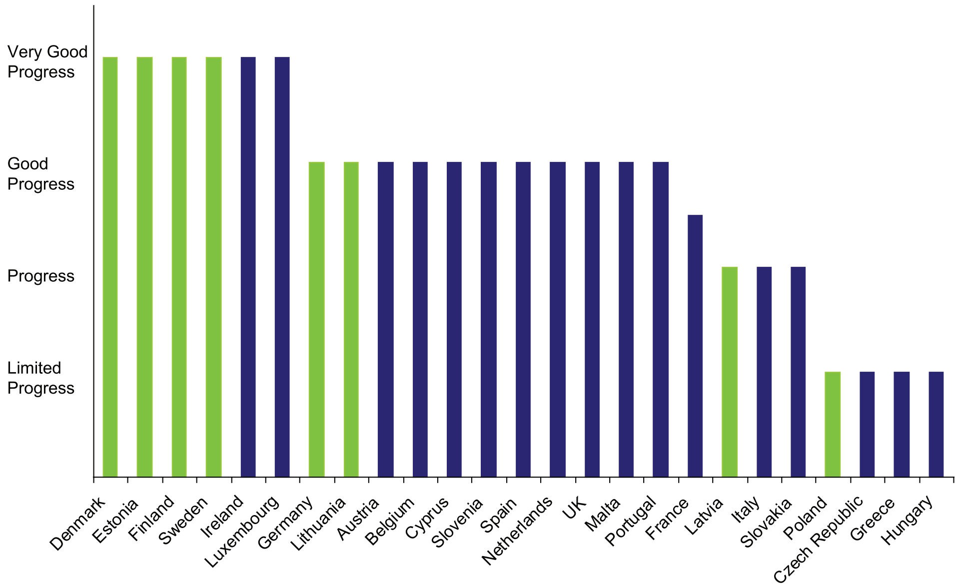
Poland's most positive ranking is on environment (5). On employment it ranks 31, followed by cohesion (29) and general economic outcomes (27). Innovation and, to a smaller degree, economic reforms, showed signs of improvement relative to last year, while general economic outcomes dropped.

Overall, the analysis reveals that the countries around the Baltic Sea Region differ quite significantly not only in their overall position on the Lisbon Agenda but also in terms of their profile of strengths and weaknesses. Policy responses need to be country-specific and cannot follow one blueprint across the Baltic Sea Region. But cooperation across the Baltic Sea Region can make these national action agendas more effective.

National Reform Programs

A major policy innovation in the relaunch of the Lisbon Agenda in 2005 was the introduction of national reform programs (NRPs). In these programs, national governments had to outline their strategic plans until 2010 with a view to how these actions were going to achieve the goals laid out in the Lisbon Agenda. The European Commission was charged with reviewing and commenting on these NRPs. Annually, national governments were to give updates on their performance and the Commission was to review and publicly assess these performance reports.

Figure 29: National reform programs, European countries



Source: EU Assessments of National Reform Programs (2007), author's calculations

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In last year's State of the Region Report we discussed the content of the NRPs that the countries from the Baltic Sea Region had submitted. By now, the first results are in and the European Commission has given its assessment of the first year of implementation.

Overall, countries in the Baltic Sea Region are among the strongest performers within the EU in implementing NRPs that are consistent with the Lisbon Agenda. Denmark, Estonia, Finland, and Sweden received the highest assessment, and Germany and Lithuania came at the second highest level. The majority of all EU member countries came at this second out of four levels.

Overall, countries in the Baltic Sea Region are among the strongest performers within the EU in implementing NRPs that are consistent with the Lisbon Agenda.

Denmark was applauded for the high level of integration across its policies, presumably helped by the existence of the country's globalization council. The flexicurity labor market system and the country's macroeconomic policies were also remarked upon positively. The main areas for future action were seen as additional efforts to increase labor supply, strengthening competition in areas of remaining barriers, and overall focusing on implementing the ambitious targets set in many policy areas.

Estonia received support for setting up a strategy office, increasing labor market flexibility, introducing environmental taxes, and strengthening innovation policies. It was also commended for the ambitious breadth of its reform agenda. However, the Commission also point out the need to set clear priorities and strengthen coordination across the different reform projects.

Finland was praised for its efforts on pension reforms, its general macroeconomic policies, and its continued focus on knowledge. Challenges remain, however, in competition, especially in the service sector, and in labor market flexibility.

Sweden got acclaim for its innovation policies, its efforts on environmental sustainability, its general macroeconomic policies, the recent tax and labor market changes to increase labor supply, and its efforts to reduce the administrative burden on businesses. Labor supply remains an issue for further action and competition in the service sector needs to be improved more.

Germany's achievements in stabilizing public finances, in supporting innovation, and in reducing bureaucracy were positively acknowledged by the Commission. But the Commission also pointed out that macroeconomic policies still need to be strengthened, competition improved in specific sectors, and labor market regulations further liberalized.

Lithuania was credited for its achievements in infrastructure upgrading, pension, tax, and health care reform, and its movement towards active labor market policies. The Commission sees as priorities for the future innovation policies and measures to increase the labor supply.

Latvia has made some progress on business regulations and labor market flexibility. But the Commission had clear concerns about macroeconomic policies, innovation, and the labor supply in the country.

Poland's tax reforms were noted as a positive step. But the Commission also had a long list of actions to be launched, from fiscal policy, competition, innovation, to active labor market policies.

Why not formulate a joint Regional Reform Program and propose it to the European Commission as a role model for other parts of Europe to follow?

Whether or not one agrees with all the country assessments by the Commission, the process is generating positive results. Countries have to engage in an external dialogue about their policies that directly connects these policies to the goal of increasing competitiveness. And the attempt is made to view policies not only on their own, but as part of an integrated package where the individual pieces are mutually reinforcing.

So far the NRPs process has not been used to launch joint strategies that bring countries in a part of Europe together. While the process was not designed with such cross-national cooperation in mind, they are not inconsistent with its spirit. Why not formulate a joint Regional Reform Program and propose it to the European Commission as a role model for other parts of Europe to follow? The countries in the Baltic Sea Region should explore this opportunity as they continue to implement their strategies directed at 2010. Efforts to increase innovation are a typical example; they are part of NRPs in virtually all countries and could be more powerful if supported by a regional component.

Prosperity is ultimately created in goods and services that consumers value more than it costs companies to provide them. Competitiveness and regional integration across the Baltic Sea Region are important for the standard of living in this Region through their impact on what companies located here do and how well they do it. This section of the State of the Region Report takes the perspectives of companies in the Region and reviews from different angles how being located here influences their performance. It aims to provide decision-makers in the Region with a better view on the realties of doing businesses when considering public policy choices.

SECTION C: Doing business in the Baltic Sea Region – the company perspective

In this Report, we provide overall observations and comments on the attractiveness of the Baltic Sea Region as a place to do business. Conditions naturally vary significantly across industries but there are a number of common themes relevant for many businesses in the Region.

The role of location on company success is emerging as an increasingly important topic in the debate on what drives economic performance. Traditionally, the analysis of companies has focused on aspects internal to companies, in particular their activities and capabilities, and on market structures. Even the analysis of market structures was done with little concern for geographic location, comparing market structures across industries or market segments within a country rather than across national borders. Globalization is radically changing this perspective: companies compete not only with other companies' internal assets and abilities, they also compete with the business environments that these rivals have access to.

In this Report we capture the role of location as a driver of company performance along three dimensions.

- First, we look at the Baltic Sea Region as a market. The attractiveness and integration of markets across the Region is of first-order importance for companies but tends to be neglected in many public policy discussions about competitiveness.

- Second, we look at the Baltic Sea Region as a source of competitive advantages. Many companies located in the Region compete on global markets where their success depends both on their internal qualities but also on the unique opportunities and challenges that a home base in the Baltic Sea Region offers them.

- Third, we look at the Baltic Sea Region as a platform for competitiveness upgrading. Companies evaluate locations based on their ability to improve competitiveness and react to unforeseen changes in the future, not just on their current business environment conditions.

Companies in the Baltic Sea Region

The heterogeneity among companies in the Baltic Sea Region is huge, as it is in most countries and regions.

Understanding the company perspective on the Baltic Sea Region

The analysis is based on qualitative interviews and public statistics. The interviews were conducted with a number of business leaders from different industries and countries in the Baltic Sea Region. The interviews do not provide a statistically representative impression of the view that companies in the Baltic Sea Region have about the conditions for doing business here. But they give important insights into the perspectives of business leaders that are engaged in this Region and work towards achieving the best possible results given the conditions they face. We would like to thank these business leaders for their openness and willingness to provide insights into their views on this Region. They are not responsible for any of the conclusions drawn in this Report.

There are large numbers of small- and medium sized companies that traditionally account for the majority of employment and GDP. These companies tend to be especially strong in services and in activities that serve local markets. The large companies traditionally account for the majority of exports and R&D, with one group, often in manufacturing, serving global markets and the other, often services and utilities, serving national markets. These patterns remain largely intact, even though smaller companies have become more important in exports and are becoming crucial in innovation in a number of science-driven clusters like life sciences.

In the Baltic Sea Region, firm demographics differ quite significantly across countries. Sweden stands out as the home base for a significant number of large multinational companies that play a more important role in the national economy than in most other countries. In Norway and Finland the number of large companies is smaller, although they too are important. Denmark is particularly dominated by small- and medium-sized companies. Iceland has a number of aggressively internationalizing companies, some of which have quickly reached significant global size. Germany has both large multinationals but also a vibrant SME sector, often with strong global market positions. Northern Germany, however, tends to have fewer strong SMEs and few headquarters of the large German multinationals. Poland and the Baltic countries have significant numbers of very small companies but few medium-sized companies able to compete across borders. Large companies are equally few and, in the case of Poland, largely headquartered in the central and southern part of the country. The Russian economy is dominated by large companies and business groups while the small company sector continues to be relatively small.

The largest companies in the Baltic Sea Region reflect the general patterns of economic activity in the Region. Swedish companies are the largest group, in line with the country's share in Regional GDP. Denmark is underrepresented, reflecting the strong SME-bias of its economy. Germany and Russia, too, are underrepresented, a consequence of most headquarters

Table 8: List of largest companies in the Baltic Sea Region

Company	Country	Industry	Sales (€bn)	Profits (€b)	Assets (€bn)	Market Value (€bn)
Top 20						
Statoil Group	Norway	Oil & Gas Operations	51.44	4.93	38.32	41.38
Nokia	Finland	Technology Hardware & Equip	41.12	4.31	21.81	65.48
Edeka-Group	N Germany	Retail	37.17	n/a	n/a	n/a
Gazprom	Russia	Oil & Gas Operations	36.48	8.20	114.59	163.83
Volvo Group	Sweden	Capital Goods	26.59	1.67	27.80	23.57
Möller-Maersk	Denmark	Transportation	25.06	2.41	34.04	32.12
Norsk Hydro	Norway	Conglomerates	24.38	2.11	28.42	28.74
LM Ericsson	Sweden	Technology Hardware & Equip	19.69	2.90	22.29	42.80
Danske Bank Group	Denmark	Banking	19.09	1.82	367.27	23.95
IKEA	Sweden	Retail	17.80	n/a	n/a	n/a
OTTO-Group	N Germany	Retail	15.25	n/a	n/a	n/a
Stora Enso	Finland	Materials	14.59	0.58	17.39	9.85
Skanska	Sweden	Construction	13.91	0.40	7.68	6.45
Nordea Bank	Sweden	Banking	12.94	3.00	345.91	29.81
Neste Oil	Finland	Oil & Gas Operations	12.73	0.63	4.34	6.23
SCA-Svenska Cellulosa	Sweden	Household & Personal Products	11.23	0.60	14.79	9.16
Telenor	Norway	Telecommunications Services	11.06	1.93	18.87	23.53
Electrolux Group	Sweden	Consumer Durables	10.67	0.27	7.31	4.73
SEB-Skand Enskilda Bank	Sweden	Banking	10.22	1.39	214.18	15.68
TeliaSonera Group	Sweden	Telecommunications Services	10.08	1.88	20.74	28.62
Top companies in remaining countries						
Mazeiku Nafta	Lithuania	Oil & Gas Operations	3.43	0.06	1.21	n/a
Grupa Lotos	N Poland	Oil & Gas Operations	2.98	0.10	1.56	n/a
Kaupthing Bank	Iceland	Banking	2.64	0.78	40.19	9.89
ELKO Gruppa	Latvia	Technology, media & telecom	0.47	n/a	0.14	n/a
Eesti Energija	Estonia	Energy production & distribution	0.54	0.14	1.50	n/a

Sources: Forbes, Die Welt, Deloitte

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of large companies in these countries being located outside their northern/northwestern regions. Poland and the Baltic countries register no entries. The top companies from the southeastern parts of the Baltic Sea Region are Mažeikių nafta AB in Lithuania and Grupa Lotos in Northern Poland, two companies in the oil refinery business.

Successful companies enable countries and regions to sustain high levels of prosperity. They provide more and better jobs and create attractive returns for their owners. Productivity growth at the company level is linked to productivity growth at the aggregate level in three possible ways: First, existing companies can become more productive. Second, existing companies with higher than average productivity can gain higher markets shares. Third, new companies with higher than average productivity can enter the market, while old companies with lower than average productivity can exit it.

In the Baltic Sea Region, entry and exit rates are on average smaller than in the most dynamic countries in the global economies. But there are significant differences within the Region. In the Baltic countries, entry of more productive companies has been a major driver of recent productivity growth. While this is a healthy sign in terms of market openness, this inflow of new companies will eventually slow down as the Baltic countries approach more stable structures. Productivity growth will then have to come from changes within (and between) existing organizations, often a much more complex process.

- Markets around the Baltic Sea are not integrated because customers want to be served locally and regulations and market structures differ across the Region
- Companies increasingly combine national sales and marketing organizations with structures on the Baltic Sea Region level that manage investments and production
- Markets in the Baltic Sea Region are attractive where the base of customers with purchasing power and willingness to pay for advanced products outweighs the costs of serving many small markets
- As markets are integrating more, Baltic Sea Region management structures are becoming more important and the markets in the Region more attractive

1. The Baltic Sea Region as a market

Companies' first interest when looking at a location is its attractiveness as a market for their products and services. Market structures often differ from region to region, driving companies to adopt different strategies to compete across locations. While some of these differences are the result of natural market evolution, differences in business environments, particularly in the rules affecting competition, also play an important role. Understanding the similarities and differences of market structures across the Baltic Sea Region provides an important insight into the level of market integration actually achieved.

Competitiveness sets the level of productivity with which a company can operate at a given location. Market structures then define how much of the value created the company, by both its owners and its employees, it will be able to keep, and how much of it will be captured by consumers.

The Five Forces-framework provides a structured approach to identify whether markets across the Baltic Sea Region are attractive for companies. It also gives insights into whether these markets are integrated. Integrated markets have the same structural characteristics across geographic areas and companies' competitive advantages in one geographic market easily translate into competitive advantages in another. Integration reveals itself in the names of leading companies within an industry across different locations within the Baltic Sea Region and in the organizational structures that individual companies have created to serve the markets in the Baltic Sea Region.

Market structures differ widely across industries, even within a country. And comparable data on the average profitability of companies in national markets is not readily available. But the available data provides a qualitative view on how conditions in the Baltic Sea Region tend to differ from these in other markets, particularly in the main economies of Europe. It provides important insights into the perceptions that companies have about the Baltic Sea Region as a market.

The Five Forces-framework

The most popular tool for analyzing market structures is the five forces-framework, developed by Michael Porter in the 1980s. It looks at the relative power of customers, suppliers, competitors, and substitutes as well as at the nature of competition between direct rivals. The specific nature of these factors can be different from location to location as a consequence of differences in public policy, legacy market positions, or customer needs. If there are strong differences across regions along any of the five dimensions, markets are considered to be local or national; if these differences are small the markets are considered to be global. In local markets, companies' success in one local market does not automatically translate into success in another local market. Global companies can compete in many national or local markets; their presence alone is not indicative of whether a market is global.

Market integration

Markets in the Baltic Sea Region today are largely national and need to be approached by companies as such. This is the clear view of business leaders interviewed for this Report and it is reflected in the comparison of leading companies in selected industries across the countries of the Baltic Sea Region.

Trade barriers or infrastructure problems play an increasingly smaller role in explaining the lack of market integration across the Baltic Sea Region. Russia remains the exception while the EU and EFTA members in the region have removed most import barriers and have a generally efficient transport infrastructure to connect national markets. Other interventions into the functioning of markets that create artificial advantages for local companies are also increasingly absent. Factors that continue to work against market integration, however, are differences in customer needs, regulations, the nature of competitors, and, to some degree, the presence of different currencies across the Region.

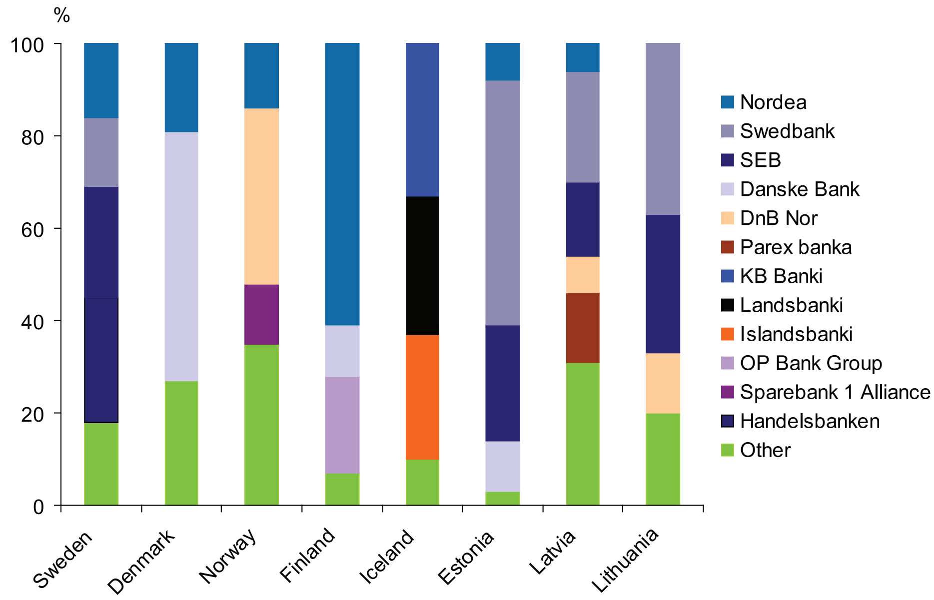
Trade barriers or infrastructure problems play an increasingly smaller role in explaining the lack of market integration across the Baltic Sea Region.

Customers across the Baltic Sea Region expect to be served locally, even when their actual needs are similar. Companies report that even between the Nordic countries and the Baltic countries the differences in customer needs are small. Standards of living do affect purchasing power and the relative size of different market segments, but within market segments the customer needs are rapidly converging. Companies pursue a local approach to delivering goods and services to customers, while the goods and services themselves are increasingly similar. Swedbank, for example, speaks of its expansion to the Baltic countries as a move from one to four home markets. Business markets, like commercial shipping, tend to be more integrated than end consumer markets, like ferry cruises.

Regulations across the Baltic Sea Region require local compliance, even when their basic standards are similar. In financial services, for example, regulators in the Baltic countries and the Nordic countries cooperate well. Nevertheless, regulatory filings have to be made to the national authorities, not an integrated Baltic Sea Region agency. In security services, differences in privacy rules affect the ability to use modern surveillance technologies. In telecommunications, the regulatory treatment of incumbents versus new entrants differs from country to country. In food products, the European Union provides minimum standards but national governments have introduced regulations that define additional requirements, largely related to health or environmental objectives. Sweden requires pressed oil to be used in all margarines while other EU member countries do not. Norway imposes high import tariffs on products that use raw materials locally available. Denmark imposes extra taxes on sugar and other products. Countries also use different labels for products that preserve the environment.

Competitors across the Baltic Sea Region differ by national market, even when the overall market structure is similar. First, in many markets there is a two-tier structure with local providers active only on one national market and global providers active on many national markets. The local competitors differ from country to country, while the global competitors are the same across the Region. Second, market shares are strongly affected by legacy positions. In telecommunication, market shares between TeliaSonera, Telenor, and TDK differ significantly across the Nordic countries depending on incumbency even though all three companies are present to different degrees in most Nordic markets. Similar patterns exist in energy, financial services, and food retail. In financial services, Swedbank, SEB, and Nordea have strong positions across different countries in the Region. In food retail, ICA group has market shares above 20% in Sweden, Norway, Estonia and Latvia.

Figure 30: Market shares in banking, Baltic Sea Region



Source: Competition in Nordic Retail Banking (2005), national banking associations

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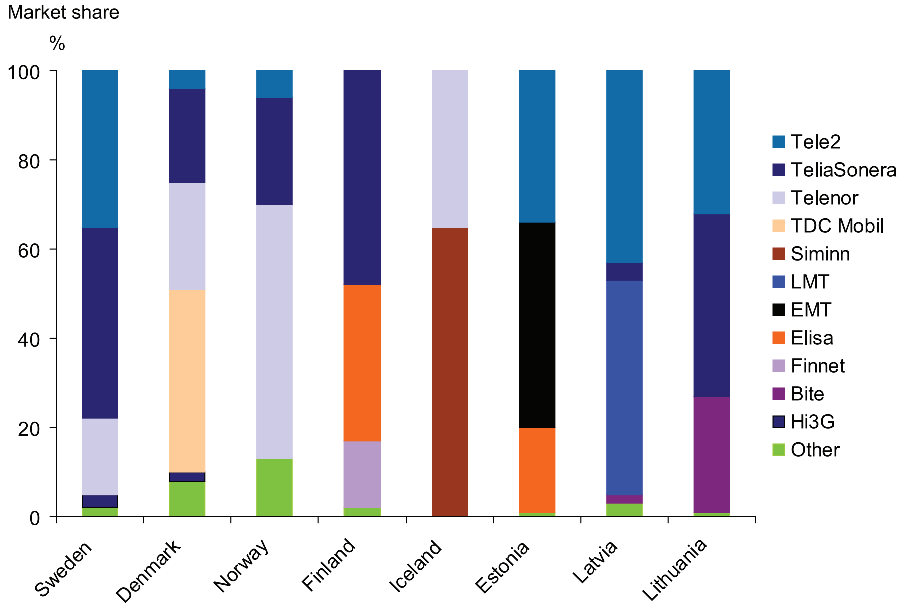
Figure 31: Market shares in mobile phone services, Baltic Sea Region



Source: Competition and regulation in the Nordic mobile markets (2005), Swedish Trade Council (2005)

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Finally, the presence of different currencies across the Baltic Sea Region hampers market integration. A company like American Express, operating in consumer finance, faces additional transaction costs from handling multiple currencies and needs to deal with the risk of exchange rate fluctuations.

Company organization

As a result of these differences, companies in the Baltic Sea Region are organized largely alongside national borders. Companies need national organizations, because particularly sales and marketing require a national approach. Large multinational companies like General Electric or American Express have matrix organizations where responsibilities are defined by product group and region.

Most international companies operating in the Baltic Sea Region have set up organizations above the national level to manage operations across groups of countries. There is a more general trend in this direction; IBM, for example, has in 2006 moved from one regional headquarters for all of Europe to a number of smaller regions, including one organization for the Baltic Sea. These organizations tend to cover the Nordic countries and sometimes also include the Baltic countries. A study by the Öresundinstitutet in 2006 found that 56% of these regional headquarters were in Sweden and 32% in Denmark, with the remainder in Norway and Finland. Germany, Poland, and Russia are almost always the responsibility of other organizational units. In the world of companies, the Baltic Sea Region includes the Nordic and Baltic countries, not more. One of the few exceptions is Maersk where the market responsibilities for the Nordic countries, the Baltic countries, and Russia have recently been integrated in one unit.

In the world of companies, the Baltic Sea Region includes the Nordic and Baltic countries, not more.

An increasing number of multinational companies are creating Nordic headquarters, some as an important layer of management, others as the base for shared services. An example is Bayer AG, the German chemical and pharmaceutical company. It decided to set up a Nordic headquarter in Copenhagen, and national companies in all Nordic countries, later extending to the Baltic countries as well. This structure has become a role model, and Bayer now operates 13 regional headquarters around the work. Copenhagen functions as the centre for shared services in the region, including administrative functions, marketing, sales, product support and research. The table below provides further examples of such organizational structures from Denmark and Sweden.

Table 9: Regional headquarters and shared service centers, Denmark and Sweden

Company	Location	Activities
Akzo Nobel	Sweden	Internal auditing
Daimler Chrysler	Sweden	Logistics
DHL	Sweden	Customer service, finance, IT, marketing
Goodyear Dunlop	Sweden	Finance, Accounting, Customer service, Sales support, Logistics
Honda	Sweden	Sales administration, Marketing, Finance, Accounting, HR, IT, Technical training, logistics
Ingram micro	Sweden	Logistics
Motorola	Sweden	Finance, Accounting
Siemens Financial Services	Sweden	IT, Accounting, Controlling, Funding
Schneider Electric	Denmark	IT, Telecom
Fuji Heavy Inds. Subaru	Denmark	n/a
Bayer AG	Denmark	Administrative functions, sales and marketing, product support, research

Source: Invest in Denmark, Invest in Sweden

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Many companies from the Nordic countries, particularly from Sweden, have used the new market opportunities in the Baltic countries and, so far to a lesser extent, in Poland and Russia, to grow. These growth strategies have exported successful products and service concepts from their respective home bases, serving a new set of customers. Companies have grown the size of their existing business models, but have not used geographic expansion as a trigger for significant changes within these business models.

Companies have grown the size of their existing business models, but have not used geographic expansion as a trigger for significant changes within these business models.

Market attractiveness

Market attractiveness is not an economic policy objective per se; if it signals the pricing power of strong companies, it is negative for the prosperity of the population. But it is important to understand market attractiveness as a magnet for investments by companies, both existing domestic and new foreign.

Markets in the Baltic Sea Region differ widely in their attractiveness relative to comparable markets elsewhere:

- In markets with heavy government involvement in the setting of prices like pharmaceuticals, the average profitability of companies operating in the Nordic countries and Germany is similar to other European markets but below the level of the United States. The Baltic countries and Poland are different, with a much higher share of generics.

- In markets with strong local rivalry between incumbents like financial services, profitability, too, is comparable to many other European markets but only for companies that can achieve high levels of cost efficiency in their operations. Operating costs in Nordic banks are significantly lower as a share of revenues than in most other parts of Europe, making it less attractive for foreign banks with higher cost structures to enter the market.

- In markets with a mix of global and local competitors, prices are attractive for companies that can create economies of scale in their business models. The competition in these markets in the Nordic countries tends to be less intense than in Germany or the UK, which are large markets that automatically attract the attention of all globally operating companies.

Market attractiveness also differs across countries of the Baltic Sea Region. The Nordic countries and Germany provide an attractive base of affluent consumers, often conscious of fashion, brands, and quality. Market shares are largely distributed between existing rivals and new entrants have to gain business from them to grow. The Baltic countries, Poland, and Russia are still smaller markets and many consumers are more price sensitive. But purchasing power is growing quickly, often especially in the high-end segments, and the large growth of the market creates opportunities for new companies to grow by tapping into the new demand.

Overall, the attractiveness of the Baltic Sea Region as a market depends on the balance between two factors: on the positive side, the Region does provide a reservoir of attractive consumers and a business environment that allows for relatively efficient operations; on the negative side, the lack of integration across national markets in the Baltic Sea Region multiplies the fixed entry costs for setting up operations in markets with limited absolute size. Companies that can exploit this balance to their advantage have clear opportunities.

Trends

The current levels of market integration and market attractiveness across the Baltic Sea Region reflect the underlying structural conditions of the past, not of the present or the future. The Baltic Sea Region has over the last decade seen trade barriers falling and transportation linkages improving, a trend that will further continue. Customer needs and regulatory procedures are also going to converge more over time.

These trends will contribute to a gradual reorganization of companies and markets. Companies will increasingly be able to create business structures that combine national sales and marketing functions with Baltic Sea Region platforms for production and operations. The new opportunities will drive related changes in the way companies compete, in the way companies are organized, and in the way foreign companies will view market opportunities in the Baltic Sea Region.

- Companies will have increasing opportunities to compete with a common business model across the markets in the Baltic Sea Region. They will be better able exploiting economies of scale while providing products and services of predictable quality through the Region.

- Companies operating in different markets across the Region will benefit from the strengthening of integrated management functions at the Baltic Sea Region level. Many decisions about production and operations will be more efficiently made at level of the Region, while decisions about marketing and sales will continue to require a local or national approach.

- Foreign companies will find increasingly interesting opportunities in the Baltic Sea Region. They will be able to spread the fixed costs of setting up an organization across a larger potential market.

More integration will contribute to higher prosperity; companies will be able to increase the efficiency of their operations and rivalry is likely to increase price pressure on companies, allowing consumers to capture a significant share of the productivity improvements.

But more integration will happen neither automatically nor instantly. It requires public policy to remove remaining barriers, and it requires businesses to actively take advantage of the opportunities created, where early movers will be able to benefit most.

Overall assessment

Markets in the Baltic Sea Region are attractive but suffer from their small size. Many of the Region's consumers have significant purchasing power and are willing to pay for advanced and high-quality products and services. But the absolute number of them is limited, especially relative to growth markets outside of Europe. There is no integrated Baltic Sea Region market, but a collection of national markets that are linked through many companies that are active across them. The lack of market integration raises operating costs for companies and raises the complexities of investing in the Region, especially for foreign companies.

The trend is towards more market integration and stronger pan-Baltic Sea Region organizational structures. Companies that are first movers in serving national markets with an integrated Baltic Sea Region business model will benefit most from these changes. And foreign investors will find the Region increasingly attractive.

- The Baltic Sea Region provides clear attractions for companies looking for test markets, technical skills, design capabilities, environmental expertise, strengths in specific clusters, and more
- The Baltic countries have opened up new opportunities that companies from the Nordic countries have benefited from
- Successful companies from the Baltic Sea Region have leveraged the specific opportunities that they have found in the Region

2. Competitive advantages in the Baltic Sea Region

Companies compete on international markets not only with the internal capabilities of their rivals; they also compete with the business environments that these rivals have access to in their home locations. In some industries the advantages of these home locations are so large that companies from a few locations around the world come to dominate its markets. Locations that become global hubs in such industries stand to reap considerable benefits from the value that these companies create.

Competitiveness sets the level of productivity with which a company can operate specific functions at a given location. Companies that have to decide where to put which activities need information about the specific qualities of a location, not just the aggregate level of competitiveness that determines prosperity. The interviews with business leaders have given an indication to which qualities of the Baltic Sea Region are most important for companies.

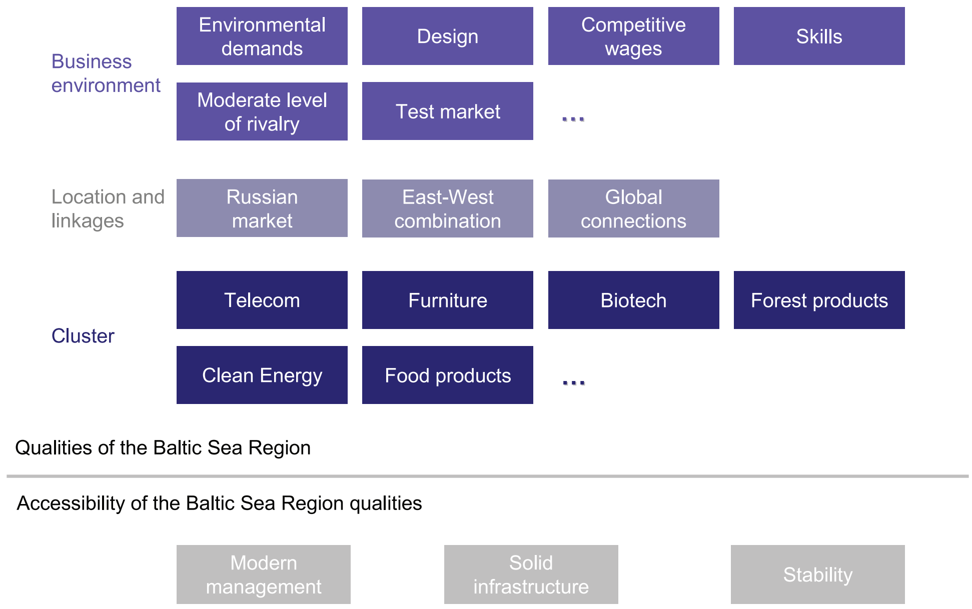
Companies react to the qualities of a location by placing specific functions, like R&D or the management of a business units or product line, there. The statistical data and the interviews provide interesting example of this process for the Baltic Sea Region. But it also shows that this process is slow and many times the location of specific activities remains loyal to the historical legacy. And it is a process that is related to the attractiveness of a location as a market.

Qualities of the Baltic Sea Region

Companies are able to draw competitive advantages from their location in the Baltic Sea Region through a number of channels. The characteristics of the business environment across the Baltic Sea Region, especially the Nordic countries, provide benefits for a specific set of activities and industries.

The sophistication of demand in the Baltic Sea Region, especially in the Nordic countries, is a more important magnet for companies than is widely realized. The behavior of consumers in this Region foreshadows the behavior of consumers in other parts of the world. The consumer market is fashion and brand conscious which creates opportunities for niche players and differentiated strategies. The con-

Figure 32: Attractiveness of the Region



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sumer market is also technology-savvy and willing to test new devices. The consumer market is demanding in terms of ease of use and environmental qualities.

None of these factors makes the Baltic Sea Region an easy market. In fact, stronger environmental standards raise the cost levels for a company like Tallink that has to use more expensive low-sulphur fuels not required from its competitors incorporated outside the Region. But it makes the Region a good platform to develop and test new products and service concepts. A good example is the focus on functional foods, i.e. foods that provide health benefits. Consumers in the Baltic Sea Region are very health conscious, and are often willing to pay more for functional foods. In 2000 Finnish Valio was the first company to enter the market with cholesterol-reducing margarine. Danish Arla is innovative in the milk products that it produces, and to an increasing degree, exports. Swedish Tetra Pak has been strong in environmentally-friendly packaging for food products, another innovation attractive for global markets.

The Region is not an easy market, but a good platform to develop and test new offerings.

Government regulations, especially in terms of environmental regulations, contribute to the demands that companies have to meet in the Baltic Sea Region. Interestingly, however, very few of our interview partners mentioned that the governments in the Region were particularly active or sophisticated as buyers of advanced technologies. One example is the e-government strategy in Estonia: With local partners, IBM created solutions for electronic document management that will become a model for new solutions to be rolled out outside of Estonia as well.

The presence of clusters provides companies with a concentration of specialized knowledge and capabilities. This has driven GE to make a major investment in the Life Sciences cluster in Uppsala. It has motivated BMW to establish a presence in the car testing cluster in Arjeplog. It has convinced WIPRO to invest in the Finnish ITC cluster. And it has been the reason for Huawei and ZTE, two of the largest Chinese telecom equipment manufacturers, to each locate an R&D center in the telecom cluster in Kista. Companies increasingly look for such concentrations as hubs to tap into.

Factor input conditions like available skills and technologies are an important influence, too, although many competing locations provide similar qualities. What makes the Baltic Sea Region especially attractive is the relatively low cost level and consistent quality at which skills are available, especially in technical disciplines. For years the wage compression has limited the wage growth in such skill categories, even as global demand for them has increased dramatically. The challenge for the Region is the relatively small size of its locations: Maersk, for example, found it hard to staff all management positions at its Copenhagen headquarters, which was one of the reasons for managing the Baltic Sea Region business out of Gothenburg instead.

The modern management structures and capabilities in many companies make it easy to integrate Nordic and Baltic operations into global organizations. This has made it easier for companies created in the Baltic Sea Region to internationalize and for foreign companies to come to the Baltic Sea Region. Many foreign companies try to move towards local management teams some time after they have acquired or launched an operation abroad. In the Baltic Sea Region this has been relatively easy, and the multinational companies were quickly able to recruit competent local managers. The same happened within the Region; Swedbank, for example, has largely local management teams in its subsidiaries in the Baltic countries.

The Baltic countries are significantly more important for the competitiveness of the overall Region than their economic size alone would suggest.

The general openness of the markets around the Baltic Sea Region with their level playing field for domestic and foreign companies is not a source of competitive advantages per se. But just as the many business linkages that are already in place between the Baltic Sea Region and other parts of the world, they are an important enabler that allows foreign companies to tap into the qualities that exist here.

Interestingly, the Baltic Sea Region plays literally no role in the branding of companies from this Region. The national base or the location in the Nordic or Scandinavian countries is used slightly more often, but most companies from this Region that are active on global markets want to be perceived as global companies, not companies from the Baltic Sea Region. The exceptions, like Swedbank which found that the relationship to Sweden has positive connotations for potential clients, target a market in or close to the Region.

The impact of the Baltic countries on the Baltic Sea Region

Most of the factors discussed so far refer to qualities of the Nordic countries and to some degree, of Germany, but not of the Baltic countries, Poland, or Russia. But we heard from many of our interview partners that the Baltic countries in particular play an important role in increasing the attractiveness of the Baltic Sea Region. The Baltic countries are significantly more important for the competitiveness of the overall Region than their economic size alone would suggest.

First, the Baltic countries have for some companies, especially for those from the Nordic countries, become an important source of experience for how to compete in the context of an Eastern European economy. The stage of general economic development, but even more so, the specific cultural legacy of the communist system, has made the Baltic countries a training ground for Nordic companies that are now expanding into the Ukraine, Belarus, and Russia. Linstow, a Norwegian-owned property developer, is an example of a Nordic company that uses its Latvian base to test markets further east—markets which it might not have entered without the experience of being active in the Baltics. It has also helped some companies from the Baltic countries in their expansion eastward. Elko, for example, a Latvian IT distributor active in a number of CIS countries, could apply its knowledge of the economic environment in a post-Communist economy while being able to leverage the much more efficient business conditions in Latvia as a platform for its eastern operations.

This is less relevant for companies from outside the Baltic Sea Region, including other parts of Poland and Germany that can enter Eastern Europe and the CIS countries from other directions. And it does not necessarily mean that new businesses in Russia or elsewhere in Eastern Europe should be managed through the subsidiaries in the Baltic countries. Swedbank, for example, entered Russia through an acquisition made by its Estonian subsidiary Hansabank but was facing problems when the political relations between Russia and Estonia cooled down this summer. But it adds business opportunities for companies based in the Region.

Second, the Baltic countries offer companies an opportunity to experiment with the most modern business models without any legacy restrictions and at lower costs. In financial services, for example, Swedbank was able to exploit the full potential of new technologies, in particular the internet, when developing its banking activities. There was no legacy of an established branch network that customers expected to be there, even when their actual interaction with the bank had shifted much more to the phone and the internet. In retail, Narvesen could try new store designs in Latvia at much lower costs than in its Norwegian home market.

Third, the Baltic countries offer a level of entrepreneurship and dynamism that challenges more mature and settled organizations in the rest of the Region. In many companies, the willingness of organizations in the Baltic countries to aggressively pursue market opportunities and move beyond established ways of doing things has challenged the established Nordic companies that they are part of. The maturity of Nordic markets made it less likely for new ideas to be implemented. The dynamism of the Baltic markets offers plenty of opportunities to do so.

Fourth, the Baltic countries add growth potential that makes the entire Region more attractive for companies to invest in. The absolute market size of the Baltic countries is small; Poland is significantly larger, but is also perceived as a different, stand-alone market. But the Baltic countries do generate high growth and this growth is important because it creates opportunities for new investments. For multinational companies like GE Consumer Finance the potential of tapping into growing new markets made an important difference for its investment in the Baltic Sea Region. For Baltic companies like Tallink the growth in traffic between the Nordic and Baltic countries became a platform to take market shares in the much more mature Nordic market.

For foreign investors, there is a clear connection between the attractiveness of the Region as a market and the willingness to make investments that use the Region as a platform for activities with global reach.

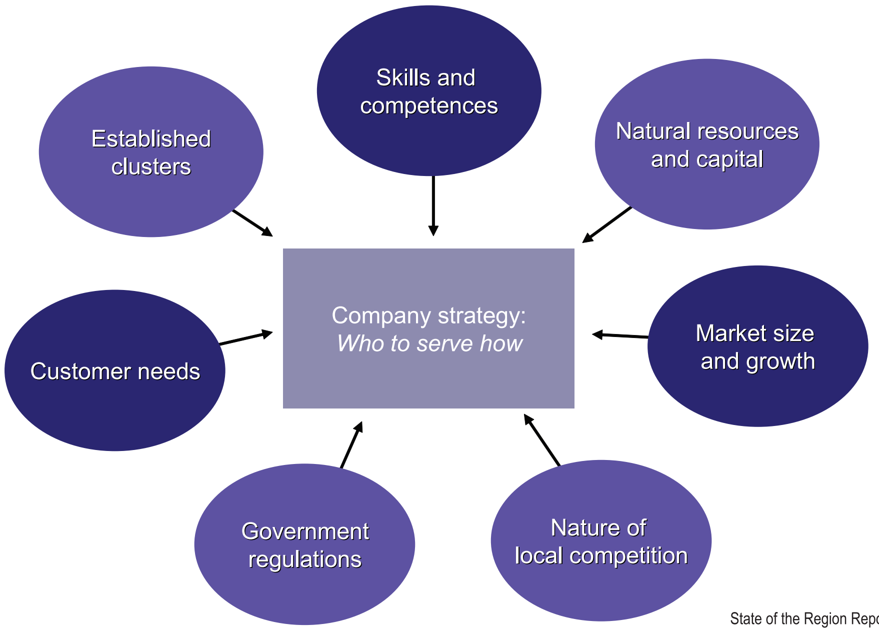
The impact of the Baltic Sea Region on company strategy

Choices about a company's strategic positioning on the market are among the key decisions that business executives have to make. But while these decisions are fully taken within the company, it is becoming increasingly recognized that the available choices are significantly influenced by the environment in which the company operates. In our interviews with executives from the Baltic Sea Region, a number of factors came up that left their mark on how these companies operate.

The Baltics Sea Region's *small market size* has been an important factor that influenced the way that companies have operated. It has been widely recognized that the small home market drove companies from the Baltic Sea Region to internationalize more aggressively than many of their peers in other countries. But it has also influenced how companies compete in markets at home and abroad: they needed to be much more flexible in terms of reacting to different customer needs, and of being customer-focused in the services provided. Where US companies like American Express roll out their business model without larger adjustments across many countries, Baltic Sea Region companies create customer-specific solutions. This has been the case in mobile phones for Nokia that through its history was open to operators' wishes in terms of network technology. It has been the case in mobile telephone services for Telenor as it developed new operating models for markets outside the Baltic Sea Region. And it has been the case for SecuritasSystems that focused on providing more customer-oriented service packages in their expansion to the UK and other countries than their technology-driven competitors.

The Baltic Sea Region's *technological capabilities* have been another feature that allowed companies to develop differentiated market positions. Even where the companies from the Region lacked the size or marketing clout of others to target the end user market directly, it could provide the technology inside. OMX developed a strong position in trading platforms for security exchanges around the world, not just in securities trading. FAST Search & Transfer became one of the most successful providers of internet search technology to web portals and company websites, even though it could not compete with Google in the consumer market. Skype developed a technology for internet telephony that was then acquired by a U.S. company with superior capitalization

Figure 33: Location and company strategy



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and end-customer reach. And Ericsson has been more successful in focusing on network equipment and mobile phone technology, even though it decided to match up with Sony as an expert in consumer electronics to operate in the consumer market.

The Baltic Sea Region's *sophisticated consumer demand* in connection with rich design tradition has been another feature that supported the emergence of a class of companies that have developed strong consumer brands. In consumer electronics, Bang & Olufsen have established a strong market position based on superior design. This has allowed them to charge prices that the technology alone would have not supported. IKEA and H&M are both examples of companies that have combined design with affordability, creating a market segment that did not exist in this prominence in many other countries before.

Activities with global reach in the Baltic Sea Region

Most business activities located in the Baltic Sea Region that have global reach, either by serving global markets or being integrated into global value chains, are controlled by companies that have their roots in this Region. This is not surprising and reflects patterns that also hold in many other parts of the world economy. The geographical relocation of activities to tap into a portfolio of clusters around the world, that the management literature has proposed for years, is a slow process. Legacy effects matter, and the pull of growing markets is often much stronger than the impact of business environment differences that, especially between advanced economies, are often small.

GE Healthcare is one example of a part of a global multinational company that has allocated global responsibility for its Life Sciences division to the unit located in the Baltic Sea Region. After making a significant acquisition in Sweden, the Uppsala-based company became responsible for all of GE's activities in this area. The strong research capabilities within the company and the clusters it is part of made it an attractive basis for this role. Another example is Suzlon Energy's investment in Denmark where it has located its global headquarters for the wind turbine business. Denmark is home to one of the strongest wind energy clusters in the world.

Although the process of relocation is often slow, it is clearly happening. When a significant number of multinational companies from the Baltic Sea Region, especially Sweden, became foreign-owned in the 1990s, concerns were raised about the relocation of key company functions. At that time, the main discussion was around headquarter functions. But other types of functions, such as research, product development, production, logistics, and the provision of outsourced services, are relevant as well.

The experiences of Astra and the automotive divisions of Saab and Volvo under foreign ownership provide an indication of the strengths and weaknesses in the Baltic Sea Region. AstraZeneca still retains its global R&D headquarters in Södertälje, drawing on the strong local capabilities that Astra had developed in the past. While the company might not make a Greenfield investment of this type in the Baltic Sea Region today, the conditions are strong enough to sustain and upgrade the legacy assets that exist. Saab and Volvo have continued to have significant manufacturing capacities in Sweden, even though especially the Saab factories were under strong competitive pressure from other European locations. The Swedish locations have also continued to play an important role in terms of product development, especially in terms of safety features.

For foreign investors, there is a clear connection between the attractiveness of the Region as a market and the willingness to make investments that use the Region as a platform for activities with global reach. Markets with small market potential face significant barriers in the attraction of, for example, research or product development activities, even when consumers are sophisticated and could provide an interesting source of ideas. For Unilever, for example, the harmonization of legislation relating to food products in the Baltic Sea Region in line with other European countries could increase the likelihood of attracting a regional innovation center. With the increasing integration of the Baltic Sea Region, not only did the Region become more attractive as a market but it also raised its chances of playing a larger role in the company's product development activities.

Overall assessment

Companies located in the Baltic Sea Region have access to a number of locational conditions that can be turned into sources of unique competitive advantages, from technological capabilities to sophisticated customers. Many companies from the Baltic Sea Region have in the past been successful because they leveraged these opportunities. Some foreign companies have also come into the Region to do the same. But more could happen and would happen, if the Baltic Sea Region would be a more attractive market. The qualities of locations as markets and as sources of competitive advantages are conceptually different, but tightly connected in the reality of companies.

The Baltic countries, and to some degree also Northern Poland and Northwestern Russia, have had an impact on companies in the Region that is more significant than their mere economic size would suggest. They have provided important growth opportunities, interesting skills, new opportunities for innovation, and helped to rejuvenate mature organizations in the Nordic countries. At the same time, however, companies from the Nordic countries and Germany have only rolled-out their existing business models to the Baltic countries; they have not created new business models that take full advantage of the combination of assets and skills provided in the different parts of the Baltic Sea Region.

- While competitiveness policies in the Region are better than in many other countries, companies want to see more focus on fundamental issues like infrastructure and incentives
- Large companies tend to be more engaged in clusters efforts in this Region than elsewhere
- The dialogue between business and government works generally well on the national level, but the Baltic Sea Region has so far not become an important arena for public-private policy discussions

3. Competitiveness upgrading

The competitiveness of a location is not only a static assessment of current business environment conditions. It is also affected by improvements of the business environment over time, and the ability to identify and address barriers towards higher productivity and innovation. These dynamic capabilities depend on the internal qualities of government and public agencies but the also depend on the engagement of the private sector and its ability to mount collective action.

Companies have a view on whether the priorities that governments set in their competitiveness efforts are appropriate. Ultimately, these government efforts need to result in changes within companies. If they do not, because they address areas that are only of marginal relevance to companies' operations, their impact on prosperity will be small.

Companies have a role on competitiveness upgrading. They are engaged in cluster and in competitiveness efforts at different levels of geography. Which companies participate, and how, have an important impact on the effectiveness of these efforts. And the companies are partners in the policy dialogue with government. How productive this dialogue is, and how well companies are able to organize their voice, have an important impact on the effectiveness of the dialogue in supporting better policy decisions.

Focus of current public efforts to upgrade competitiveness

Traditional dimensions of the business environment need to remain a focus for policy; this is true of emerging, but also of highly advanced economies. This was a clear message from the business leaders in the Baltic Sea Region that we talked to. Investments in science, cluster upgrading, and other efforts to improve the capacity for innovation are welcome and important. But they are not a substitute for a continued focus on infrastructure, skills, and incentives.

- Infrastructure, particularly transportation infrastructure, is of increasing importance in the global economy and in a Baltic Sea Region economy that is becoming more integrated. In addition, high growth over the last few years has added to the demands on the infrastructure. In the Nordic countries, Sweden in particular, it is crucial that further investments are made to keep the generally high level of transportation infrastructure that exists. For SAS, for example, further investments in the facilities it uses at Arlanda airport are crucial for its ability to compete.

- Skills and incentives were mentioned, but seem less of an urgent priority for business leaders. Skill shortages are growing, but the situation in the Baltic Sea Region is generally still better than elsewhere. Weak incentives as a result of high income taxes are a concern but have been so for a long time. Business leaders seem to see few chances for achieving substantial change in this area in the foreseeable future.

Traditional dimensions of the business environment need to remain a focus for policy; this is true of emerging, but also of highly advanced economies.

- One interesting perspective was offered about the need to develop a clear national economic strategy. Current government policies, especially in Sweden but also in other countries in the Baltic Sea Region, seems focused on managing the business cycle and making general investments in the future. These policies are welcome and necessary but they do not answer the question that, for example, the Danish Globalization Council is asking: how is our country going to compete in the future, in what areas, and based on which competitive advantages? Countries need to develop an answer and start taking steps in the direction they identify.

In the Baltic Sea Region, political leaders are engaged in discussions on how to increase the efficiency of the many institutional structures that currently exist. Business leaders were quite clear in their assessment that marginal improvements in the internal efficiency of such bodies would not have any meaningful impact on companies. Larger steps, in terms of policy decisions but also institutional reorganizations, would be necessary to register with the business community.

In the Baltic Sea Region, many large companies participate in cluster initiatives.

While this view of business leaders does not indicate that the current discussions about better coordination between existing bodies is wrong, it does suggest that one has to have realistic expectations as to what they will mean for the economy of the Region. If significant impact on the economy is the benchmark for success, more is needed.

Company participation in competitiveness efforts

Companies in the Baltic Sea Region have become increasingly active in cluster and competitiveness efforts. Some of these efforts take the form of individual cluster initiatives while others provide discussion platforms to improve the competitiveness of specific regions or countries within the Baltic Sea Region.

Cluster initiatives have become a popular tool for economic development across the Baltic Sea Region, especially in the Nordic countries. While many of these initiatives are similar to equivalent efforts in other European countries, it seems that the Baltic Sea Region is better placed to avoid some challenges faced elsewhere. In the Baltic Sea Region, many large companies participate in cluster initiatives. GE Healthcare in Uppsala, ABB in Robotdalen, Scania, Volvo, and Saab in IVSS Intelligent Vehicle Systems, NovoNordisk in MediconValley, and Danfoss in Southern Jutland play an important role in these efforts. In many other countries large companies have been engaged much less, and many cluster efforts have been essentially SME development schemes. There are also a number of cluster initiatives, like ScanBalt in Life Sciences, that have a cross-border approach. This is largely driven by the small size of the countries in the Region but can still be a positive step towards a more natural combination of internal collaboration and external linkages of clusters.

Large companies in Denmark and Sweden are also engaged in the respective globalization councils. In Denmark, these Councils are now rolled-out on the regional level, an effort that builds on the work of the private sector-led growth councils.

Interaction between the public and private sector

Many of the company leaders that we spoke to in the Baltic Sea Region had a generally positive opinion of the quality of the public administration. Compared to many other countries, public agencies were seen as fair, transparent, and relatively efficient. An interesting example is Telenor's initiative to bring regulators from the other countries in which it operates to Norway, for them to meet and learn from the Norwegian regulatory authority. This does not mean that companies in the Baltic Sea Region do not demand for less bureaucracy and more efficiency improvements in the public sector. But they also recognize that the situation could be significantly worse, and is so, in many other countries.

There was also a generally positive assessment of the level of dialogue between business and government. Especially in the Baltic countries, where economic growth is on the top of the government agenda, there is the perception that politicians understand, for example, the role of investments in airport and other infrastructure investments in facilitating further economic growth. In Latvia, the Foreign Investors Council (FICIL) has for some years now established a well functioning dialogue with the Latvian government. In the Nordic countries and Germany, business interests have to compete with a broader set of other interests, and conflicts are more natural.

Despite these good examples of effective public-private dialogue the interviews with business leaders also pointed towards a clear imbalance in the way the voice of the private sector is organized. The focus of traditional business organization, as well as of many business leaders individually, is to influence national or in some cases European policy makers. The Baltic Sea Region is not high on the agenda and there is not much of an organized voice of business across the Baltic Sea Region present at the moment. With the political side aiming to increase the efficiency of its own institutions at this level, at least partially with a view to better engage the private sector, there is no obvious counterpart that could speak for the leading company interests in the Region.

Overall assessment

Companies and governments in the Baltic Sea Region work quite well together. There are many areas in which improvements are possible, but compared to other countries and world regions the dialogue in this Region seems productive. The dialogue is, however, largely national or European. From the perspective of companies, the Baltic Sea Region has not yet established itself as a critical level of policy making.

Final observations

It has been a good year for the Baltic Sea Region. Economic outcomes are generally strong, current competitiveness is solid, and the medium term outlook is positive, even though the risks have increased in the last few weeks. There are serious challenges in parts of the Region; the Baltic countries need to manage the transition to a new growth model without suffering overheating, and Russia needs to finally get serious about addressing its weak governance structure and low levels of competition. But these challenges have to be addressed at the national level. The Region can at best play a supportive role and ease the necessary changes.

The real test for the Baltic Sea Region is whether it can create the mechanisms that will make its economies fit for the challenges of the future. For the impact of increasing global mobility and competition on the ability of this Region to nurture, retain, and attract world-leading skills and individuals. For the impact of the demographic trends on the relative position of this Region in the world economy, on the supply of skilled employees, and on the solidity of public finances. For the impact of climate change and increasing environmental challenges on consumers, producers, service providers, and governments in the Region. And for whatever other challenges might develop.

At the level of individual countries in the Baltic Sea Region, the evidence is mixed on whether the preparation for the future is under way. Some countries, notably Denmark, have invested significant energy in discussing what it will take to sustain competitiveness in a changing global environment. But many others have been preoccupied with managing the business cycle, making sure that the macroeconomic context will remain healthy. This is necessary, but not sufficient. Competitiveness requires more than reducing removing weaknesses and distortions to the functioning of markets. Competitiveness requires a strategy for developing a clear profile of strengths in the microeconomic business environment that companies can leverage to develop unique competitive advantages.

At the level of the Baltic Sea Region, a healthy debate has been launched about the institutional architecture for regional cooperation since the publication of the last State of the Region Report. Swedish Foreign Minister Carl Bildt has been instrumental in questioning whether the multitude of existing government institutions provides the optimal platform to steer regional cooperation ahead. The Council of Baltic Sea States declared at its June 2007 Malmö meeting that it would welcome the development of a Baltic Sea Region strategy with clear action priorities, the basis for defining which institutional architecture to choose. In the same month, the Prime Ministers of the Nordic countries discussed opportunities for developing Nordic cooperation in the face of increasing globalization at their Punkaharju meeting. The Nordic Council of Ministers will discuss the impact of globalization on regional cooperation at a high-level meeting in April 2008.

For this process to make the Region fit for the future has to be driven forward aggressively:

- First, the structure of public institutions governing cooperation in the Baltic Sea Region needs to be revamped. Improving the cooperation and allocation of responsibilities between existing institutions will lead to some improvements but is not sufficient to achieve the step-change in institutional capability that the Region needs. A new architecture needs to be found, even if the process of changing and maybe closing down existing institutions is politically complex.

- Second, there needs to be an effective private sector counterpart on the level of the Region for the public sector institutions. Such a voice for Baltic Sea Region business does not exist today. Institutions like the Baltic Chamber of Commerce Association (BCCA) play a useful role but do not have the institutional strengths to credibly speak for all businesses affected by the Region, as a place where they do business. A new platform has to be found, bringing together those companies, including foreign investors that have a significant stake in furthering regional integration and collaboration.

- Third, the private and public sectors will need to find a platform for working together in order for the Region to meet the challenges of the future. Current structures are largely dominated by government. The Business Advisory Council (BAC) of the CBSS provides an important role but is ultimately just what its name suggests: an advisor, not an equal partner. Other countries and subnational regions have created competitiveness councils; a Baltic Sea Region Competitiveness Council could become a key coordination mechanism for this Region as well.

These steps are well within reach for the Baltic Sea Region. This Report hopes to make a contribution to the many discussions that will necessary on the way to make the Region fit for the challenges ahead.

About the author

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