STATE OF THE REGION REPORT™

2009

Boosting the Top of Europe

NORDIC INVESTMENT BANK

norden
Nordic Council of Ministers

Baltic Development Forum
sustainable growth · innovation · competitiveness

Key messages

- The Baltic Sea Region has been hit disproportionately hard by the global crisis but is now expected to rebound quicker than others
- The impact of the crisis is going to widen the significant existing economic differences across the Region, ending a catch-up process that had become unsustainably rapid
- The level of regional collaboration remains strong, with innovation and environment frequent themes and the EU Baltic Sea Region Strategy emerging as a coordinating mechanism
- The crisis has shifted the focus to policies controlled at the national level and led to a divergence of needs and perceptions across the Region; regional collaboration is becoming more difficult
- The Region remains one of the most prosperous regions internationally with balanced positions on labor productivity and mobilization, despite the current drop in prosperity and productivity
- The significant heterogeneity of competitiveness levels and profiles across the Region is further increased by the crisis and the policy responses now under way
- The Baltic Sea Region remains Top of Europe on the Lisbon Agenda goals and has a significant contribution to make to the Agenda's post-2010 renewal
- The Region needs to continue deepening its integration, marching ahead on its way to an innovation-driven economy, and becoming better prepared to deal with economic shocks
- The EU Baltic Sea Region Strategy is an important step forward for regional collaboration; it now needs further actions within the Region to meet the high expectations created
- The EU Baltic Sea Region Strategy has the potential to become an important role model for a new approach towards European integration

Acknowledgement

By Dr. Christian Ketels

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

The author would like to thank Professor Örjan Sölvell, Stockholm School of Economics, who played an important role in launching the State of the Region series. The author would also like to acknowledge the support of the Institute for Strategy and Competitiveness and the World Economic Forum who provided international data and thank the Asia Competitiveness Institute, Singapore, where much of the Report was written, for its hospitality.

Foreword

The 2009 edition of the State of the Region Report offers like most economic reviews over the past 12 months troubling but essential reading. The Baltic Sea Region has been hit hard by the financial and economic crisis, although there are substantial differences across the region. While some countries will most probably get through the crisis relatively well, the Baltic States and Iceland - the symbols of the high growth on Top of Europe are battling with severe problems. So is Russia to some extent. Although the fundamental competitiveness of the region has not changed substantially, Christian Ketels concludes that the crisis has changed the perceptions as well as the actual conditions.

The repercussions of the crisis have kept all governments fully occupied on the national level. On the international level, it is also clear that we need strong international institutions that can help weather the storms when the forces of economic globalization set in motion. We need the EU, IMF and well-consolidated banks to address the problems. The networks that characterize the open method of co-ordination in the Baltic Sea Region do not suffice in such a situation.

This is also why the EU strategy for the Baltic Sea region comes exactly at the right moment. Over the last year, it has become more complex to push for regional collaboration. But the importance of working together has not diminished. There is now a clear need to bring regional co-operation onto the next level by combining the networks and organizations of the region with the strong institutions of the EU.

This year's State of the Region Report evaluates the defining factors for regional integration: the effects of the crisis on the macro-economic situation and on competitiveness, the EU's Lisbon Agenda and EU strategy for the region. What is interesting and forward looking is the potential link between the three. If decision makers embrace the EU strategy, it might develop into a regional Lisbon agenda with the aim of creating jobs and growth in a sustainable way.

Christian Ketels presents many clear and brave conclusions and recommendations. It is what is needed in times of uncertainty – ideas that can help decision makers sharpen the policy response to the crisis. This being said the conclusions are those of the author only and do not necessarily reflect the views of our organizations. We wish everybody good reading.

Copenhagen/Helsinki

September 2009

Hans Brask
Director
Baltic Development Forum

Johnny Åkerholm
President & CEO
Nordic Investment Bank

Halldór Ásgrímsson
Secretary General
Nordic Council of Ministers

Table of contents

Key messages 2
Foreword 3
Executive Summary 5
Introduction 10

Section A: The context for cross-national cooperation in the Baltic Sea Region **13**
1. Macroeconomic environment 14
   The global context 14
   The Baltic Sea Region 17
   Countries in the Baltic Sea Region 19
   Assessment 36
2. Cross-national cooperation in the Baltic Sea Region 37
   Assessment 43
3. Political context 45
4. Implications for Baltic Sea Region collaboration 46

Section B: Competitiveness in the Baltic Sea Region **49**
1. The economic performance of the Baltic Sea Region 51
   Prosperity 51
   Prosperity accounting 53
   Intermediate indicators and enablers of competitiveness 59
   Overall assessment 64
2. The foundations of prosperity in the Baltic Sea Region 67
   Natural conditions 68
   Macroeconomic competitiveness 70
   Microeconomic competitiveness 71
   National competitiveness across the countries of the Baltic Sea Region 81
   Overall assessment 90
3. The Lisbon Agenda 93
   The Baltic Sea Region on the Lisbon Agenda 95
   The Lisbon Agenda: 2000, 2010, and beyond 96
4. Implications for the Baltic Sea Region 100

Section C: The EU Baltic Sea Region strategy **103**
1. Drafting the EU Baltic Sea Region strategy: the perspective from the European Commission 104
   Background 104
   The formation of the Strategy 105
   Content of the EU Baltic Sea Strategy 105
   Governance and implementation 106
   Next Steps 107
   The vision of prosperity in the Baltic Sea Region macro region 108
2. Implementing the EU Baltic Sea Region strategy: the perspective from VINNOVA 108
   The Flagship Program on Innovation, Clusters and SME Networks 109
   A framework for assessing the EU Baltic Sea Region 111
3. Assessing the EU Baltic Sea Region strategy 111
   Where to from here? 114

Final observations 115

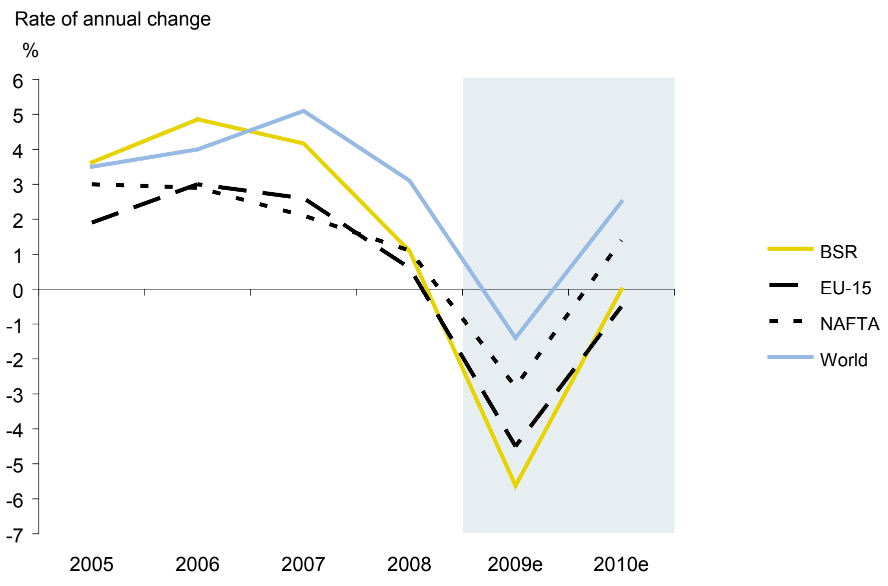
Executive Summary

The 2009 State of the Region Report, the sixth in this series of annual evaluations of competitiveness and cooperation across the Baltic Sea Region, provides a perspective on the radical change in the economic climate of the Region over the last year, and of the global economy at large. The Report puts the dynamics of the crisis into the context of the Region's fundamental competitiveness to assess the impact on the trajectory of the Region over time. In light of the high pressure for short-term policy reactions and a frequently changing outlook, the objective of the Report is to inform decisions that address current challenges with a view to their long-term impact on the Region's economic position.

Part A of the Report tracks the context for competitiveness and cooperation in the Region. A large share of the discussion is devoted to the macroeconomic situation across the Region, with the remainder of the section documenting the activities of the main regional institutions over the last year. Part B gives an overview of different aspects of competiveness. Actual economic outcomes, from prosperity to investment flows, are most visibly affected by the crisis. Measures of fundamental competitiveness are naturally more stable but the crisis has changed perceptions as well as actual conditions. Part C is devoted to the EU Baltic Sea Region strategy, providing an overview of its emergence and content, an example of the activities it will generate, and an assessment of what the strategy process has achieved.

The Baltic Sea Region has been disproportionately affected by the global crisis. A combination of high opennenss across the Region and severe macroeconomic imbalances in a number of its countries are the key forces behind a drop in GDP that is more severe than in the rest of the EU and many other world regions. Governments and central banks in the Region have reacted forcefully. Where they could, they aggressively tackled the problems in their financial sectors, eased monetary policy, launched agressive stimulus packages, and let economic stabilizers work. The solid fiscal policy in most parts of the Region gave room to engage in such efforts without jeopardizing long-term fiscal sustainability. In these countries, there is the potential for a relatively swift recovery, pending

Figure A: Economic growth in main world regions



Source: EIU (2009), IMF (2009)

State of the Region-Report 2009

developments in the global economy. Among the countries of the Region with less favorable public finances at the outset of the crisis, many were also suffering from severe macroeconomic imbalances as the result of overheating. For these countries, the outlook remains much more challenging; even if the global economy rebounds more quickly than expected, they still face the task of adjusting. The dramatic change in the macroeconomic environment has made regional collaboration across the Baltic Sea Region significantly more difficult. The Baltic Sea Region is not the appropriate policy level to react to the current crisis, even if neighboring countries have played an important role for Iceland and Latvia. And the different ways in which the crisis has affected countries across the Region might have reduced the common ground necessary for effective collaboration. The crisis is experienced very differently in Stockholm and Hamburg than in Riga and Reykjavík, making it much harder for political leaders to convince their electorates of the value of Baltic Sea Region collaboration.

Collaboration across the Baltic Sea Region continues, following pretty much the broad trends already described in last year's Report. So far, the dramatic changes in the economic environment have not resulted in any meaningful change in the direction or level of activity. The crisis might have a stronger impact over time, but the network of collaborative efforts seems solid enough overall to remain in place even then. The broad themes of innovation and environmental sustainability underpin many of the regional activities. The trend of the recent past, to better coordinate activities and truly collaborate between organizations, has continued, even without the existence of a central structure with the mandate to set an overarching strategy. The EU Baltic Sea Region Strategy has emphasized the political support for regional collaboration and is implicitly accepted by many institutions in the Region as a key organizing factor. The institutional structure remains largely shaped by the legacies of the past, with the lack of an effective private sector voice of particular concern.

The global crisis is having a strong impact on the full range of economic outcome indicators for the Baltic Sea Region as well as for the world economy at large. But this does not differentiate the Baltic Sea Region from its competitors around the globe. It is still too early to be sure whether the crisis will change the competitive position of the Region. But the indicators available so far do suggest that the fundamentals of the Region remain broadly intact and should support a gradual return to a path of solid prosperity and growth. The Baltic Sea Region has taken a significant hit in terms of its prosperity. It is becoming clear that the rate of catch-up had become too high. The global crisis triggered and deepened the downturn, but clearly the seeds for a slowdown in the Region had been sown before the crisis. The impact has so far been strongest

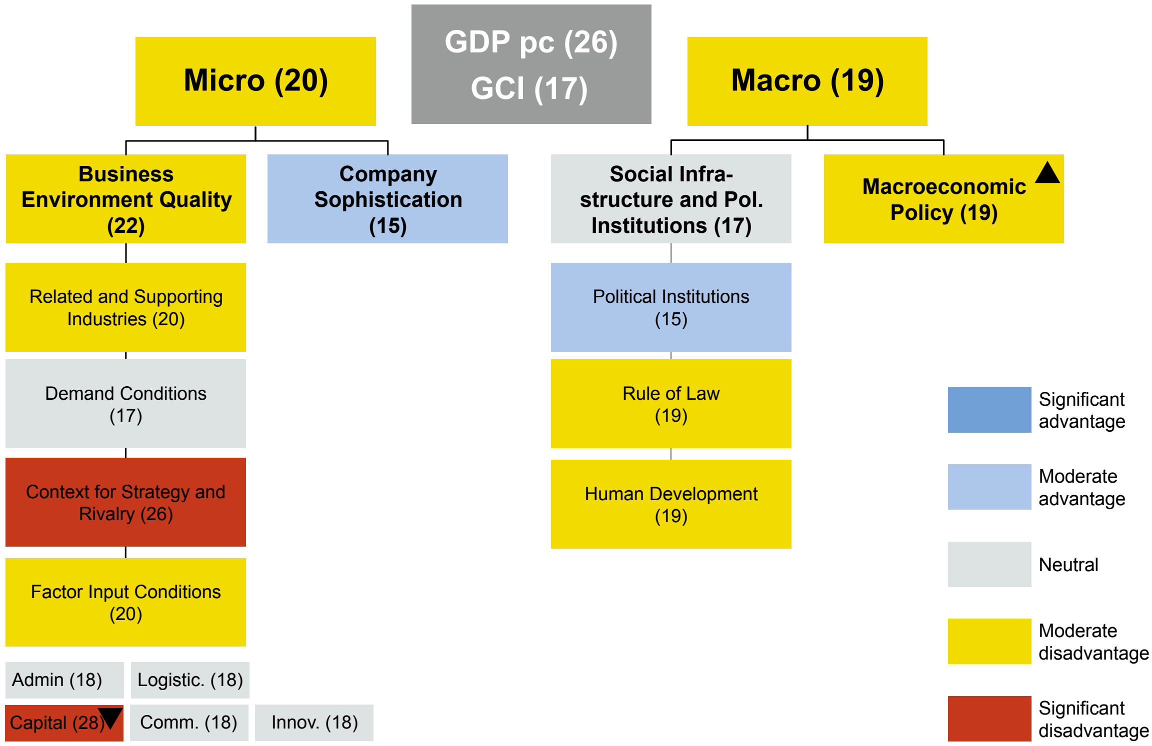
Figure B: Prosperity decompososition for main world regions

GDP per Capita (PPP)		Purchasing Power-Factor		Employment-Factor		Productivity-Factor
OCEANIA (+1)	=	ASEAN	x	ASEAN	x	EU-15
NAFTA (-1)		BRIC		BRIC		B ISLES
B ISLES		EU-8		OCEANIA		NAFTA (+2)
EU-15		CER (+1)		EU-8 (+2)		OCEANIA (-1)
IBERIA		OCEANIA (+3)		Baltic Sea Region		IBERIA +1)
CER		B ISLES (+1)		NAFTA (-2)		Baltic Sea Region (-2)
Baltic Sea Region		NAFTA (-4)		CER		CER
EU-8		IBERIA (-2)		B ISLES (+1)		EU-8
BRIC		Baltic Sea Region (+1)		IBERIA (-1)		BRIC (+1)
ASEAN		EU-15 (-1)		EU-15		ASEAN (-1)

Source: Groningen Growth and Development Centre and The Conference Board (2009), IMF (2009), authors' calculations

State of the Region-Report 2009

Figure C: Competitiveness profile of the Baltic Sea Region



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

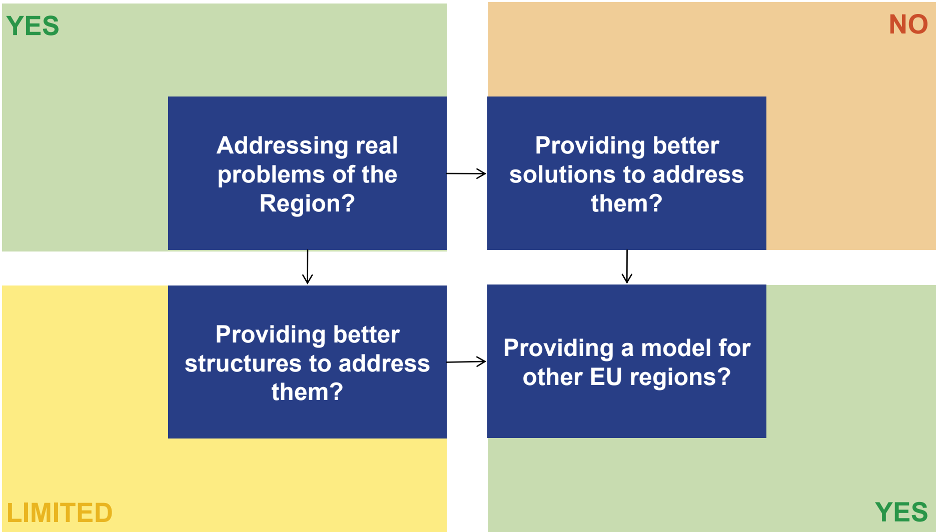
State of the Region-Report 2009

on productivity, while employment rates remained relatively stable. The exceptions are Iceland and the Baltics, countries in deep economic crisis. Despite these developments, there has not been a fundamental change in the profile of the Region's prosperity generation; the combination of solid labor productivity and mobilization continues to distinguish it from its European peers.

On exports and FDI, the Region continues to be deeply integrated into the world economy. This is one of the reasons why the impact of the global crisis has been felt so strongly. The increasing imbalance between the Region's very active position abroad, and the merely average level of attractiveness for investment at home, remains a concern, as does the slow loss of position in the global innovation market. The Report shows a Region that is ailing under the impact of a global crisis, and a number of domestic ones. But it also shows a Region that has reached a solid position with a level of prosperity that many other world regions can only aspire to. There is reason to be alert and address the weaknesses that exist, including those that the crisis has brutally exposed. But there is no reason for despair. Being at the Top of Europe remains a very realistic goal; it is not a futile dream that has evaporated in the crisis.

The Baltic Sea Region remains among the most competitive economies in the world, despite the economic turmoil. The Region's key strengths continue to be in its sophisticated companies and, despite a slight deterioration this year, its solid public institutions. Macroeconomic policy is the area in which the Region has gained the most relative to its global peers. The negative incentive effects of the tax system, however, continues to be a great weakness. The Region also doesn't rank too highly on policies affecting FDI attraction. The strongest drop has been registered in capital market infrastructure; this has, traditionally, been among the lowest ranked elements among factor conditions, and the crisis has fully exposed existing weaknesses. As in the past, these aggregate rankings obscure the huge differences that exist across the Region, not just in level but also in the profile of strengths and weaknesses. The crisis is exposing and, even more worryingly, increasing

Figure D: Assessing the EU Baltic Sea Region strategy



the competitiveness differences across the Region. The gap between the capacity for innovation and high productivity in the advanced versus the emerging economies of the Region is likely to grow. The size and nature of stimulus packages will further reinforce this trend, with advanced economies investing more in their innovation capacities while emerging economies either lack the resources for any investment, or focus on infrastructure upgrading.

The crisis initially hit all countries in the Region, irrespective of their level of competitiveness. Highly competitive economies like the Nordic countries are also highly open, increasing their exposure to global shocks. But they stand a good chance of recovering relatively quickly once the global shock dissipates. Economies with levels of prospertity not supported by their economic fundamentals— – in the Region the case for the Baltic countries, Iceland, and Russia— are affected through the economic imbalances with which such a situation is associated. Their outlook is much more problematic, as they have to unwind these imbalances before being abe to return to growth.

Apart from the actions that need to be taken at the national level, the analysis suggest three broad policy areas in which the Region needs to work together. *Deepening regional integration* remains at the top of the list. As small economies, the countries in the Region suffer in multiple ways from the market separation that exists: consumers pay higher prices, foreign investors are staying away, companies remain less productive than they could be, and innovative entrepreneurs face more barriers to launch a profitable product or service. The crisis has made regional collaboration politically more complex, but not less important for achieving higher competitiveness. *Continuing the path towards a sustainable innovation economy* also continues to be critical. Progress has been made, but as this Report shows again that there is also enough work ahead. Much of this work will need to be done on the national level, but the collaboration in the Region can continue to help. A Baltic Sea Region Lisbon strategy could organize these joint activities and become a key pillar of the EU Baltic Sea Region strategy. The need to *prepare the Region for a changing economic environment* is new on the list, pushed on by the crisis. Mechanisms need to be put in place that can avoid a repeat of the current crisis. The Baltic Sea Region has limited ability to influence the necessary global architecture, but its voice can be heard through the EU. Within the Region, closer cooperation on macroeconomic surveillance could help to stop overheating at the national level earlier. Advice from close neighbors, already given through multiple formal and informal channels, might be more in linw with a country's needs and easier to accept than from a far-away international organization. But even with these improvements, shocks will continue to occur. To be prepared, the Baltic Sea Region needs to review and, where necessary, strengthen the domestic policy structure, from labor and financial markets to exchange rate regimes, fiscal policy rules, and the nature of automatic stabilizers and emergency measures.

The EU Baltic Sea Region strategy process has already been a significant accomplishment. It reinforced the many connections across the Region, mobilized people in a common effort, and acted as a stabilizing factor for regional collaboration at a time when the economic turbulences tend to work in another direction. The EU Baltic Sea Region strategy is an important step forward. The strategy addresses key challenges the Region is facing, a clear reflection of the care thas has been taken in listening to stakeholders from around the Baltic Sea makes some progress on the structures through which they should be tackled, but provides few if any genuinly new answers or solutions. Maybe ironically, the strategy might have a more important long-term impact on the European Union than on the Baltic Sea Region itself. If decision-makers across Europe grasp its potential, the strategy could become a significant innovation in how the EU is organized, reinvigorating the European integration process. And the Baltic Sea Region could become the role model for this new approach.

Introduction

Why a State of the Region Report? Economies around the globe are in turmoil. The downturn is significantly deeper and more global than anything experienced since the Great Depression. This time around, policy makers have reacted strongly, bailing out banks, launching stimulus packages, and using old and new monetary policy instruments. The outlook now seems slightly more positive: the rate of decline has fallen and the hope is increasing that while a drawn-out period of adjustment lies ahead, it will not be the abyss that bankers and exporters were facing in late 2008 and early 2009. However, in this period of dramatic shocks, forecasts have become much less accurate than in periods of stable trends and calm. So far outside the normal parameters, there is little reliable experience on how consumers, investors, and producers will react to the massive government efforts under way. This uncertainty affects not only the short term but also the longer term. Will the crisis only be a – albeit historically deep – bump on the road or will it change the course of economic development for individual countries and regions?

The 2009 State of the Region Report provides data and analysis to inform the discussion on the impact of the crisis on the medium- to long-term development of competitiveness and collaboration across the Baltic Sea Region. It does not aim to provide a better forecast on what will happen over the next six or twelve months; many financial institutions, research centers, and government agencies in the Region provide in-depth coverage of this data. Instead, the ambition is to put the short-term developments into the context of the economic fundamentals that will drive economic development over longer periods of time. Clearly these are related: many of the policy choices made today will impact the fundamentals that exist tomorrow, even if their primary motivation now is to deal with the immediate crisis at hand. The Report's discussion of the medium-term fundamentals in this time of economic crisis aims to contribute to a solid recognition of these linkages.

The 2009 State of the Region Report, the sixth in this series, continues to take an explicitly regional perspective. In the current environment, this is not an obvious choice. The macroeconomic crisis requires action that for the most part is under the control of national governments, either on their own or in international institutions. This leaves relatively little room for Baltic Sea Region collaboration. In addition, the impact of the crisis is exposing and accentuating the differences across the Region. And in some cases it makes neighbors in the Region the easy scapegoats for what is happening. This Report highlights how dangerous it would be to let slip the achievements of the past years on regional collaboration across the Baltic Sea. Macroeconomic crisis in one part of the Region has the potential of generating costly repercussions elsewhere in the Region. Support and advice to a country is need is likely to be much more effective if neighbors with a more comprehensive understanding of the specific context play a significant role rather than leaving the task to far away global institutions. The impact of the Region in the discussions of a new regulatory infrastructure for the global economy, a topic of huge relevance for the export-oriented economies around the Baltic Sea, will be miniscule if individual countries act on their own. The Report aims to provide the facts and analysis for pursuing effective regional collaboration in these troubled times.

What is the Baltic Sea Region? As in previous years, for our analysis we define the Baltic Sea Region 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 is home to close to 60 million people, about 500,000 less than at its peak in 1997. The Nordic countries—together now representing about 45% of the Region's inhabitants—have gained in population but the decrease elsewhere, especially in north-western Russia and the Baltics, was even higher. In 2009 the Region's labor force of 27.5 million employees is decreasing, breaking the positive trend of the last decade. Despite the fall in population and the economic crisis, the Region still registers 1.5 million more employees today than in 1998. The Nordic countries accounted for two-thirds of this gain, despite having less than 50% of the Region's total employment in 2009. The Region will in 2009 create an annual GDP of slightly above €1,200 billion (US$1,770 billion), evaluated at current exchange rates. The Nordic countries account for about 71% of the total, slightly less than last year. Northern Germany comes second with a share of 14%, followed by Northwestern Russia at 7%, the Baltics at close to 5% and Northern Poland with the remaining 2.9%.

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 regions in Germany, Poland, and Russia are not included, because only the regions closest to the Baltic Sea count the interaction with other parts of the Region as constituting an important part of their economic reality. For comparisons, the Report looks at the EU, different regions within Europe, and some other world regions.

The structure of the State of the Region Report
Following the structure developed since 2004, **Section A** provides a discussion of the broader context in which regional cooperation and competitiveness occurs. This year, there is a significantly stronger focus on the macroeconomic environment and policy response across the Baltic Sea Region. The economic data incorporate the current projections for 2009 to enable a meaningful discussion of the impact the crisis has on the Region. The Report also continues to track the competitiveness-related activities by major cross-regional institutions in the Region. **Section B** discusses the competitiveness of the Baltic Sea Region, looking at economic performance, underlying microeconomic competitiveness, and the position of the Region's countries in terms of the European Union's Lisbon Agenda. The chapter on the Lisbon Agenda also covers also the current debate about the future of the Lisbon Agenda after 2010, an issue that has been taken up by the Swedish EU Presidency and some other countries in the Region. **Section C** is devoted to the EU Baltic Sea Region strategy, a document developed with extensive input from stakeholders in the Region and now in front of the European Council. The Commission provides an overview of the strategy, followed by a closer look at one of the suggested flagship projects from the perspective of the lead institution in charge. Finally, there is an assessment of what the strategy achieved and what remains to be done given the overall analysis in this Report.

This section of the State of the Region Report describes the context for cross-national cooperation in the Baltic Sea Region. In the last twelve months, the global financial and economic crisis has been the dominant external factor influencing economic events across the Baltic Sea Region. Political conditions have remained stable, with the EU Baltic Sea Strategy and the Swedish EU Presidency key topics affecting the Region. Organizations and networks in the region have reacted to these new challenges, but also continued in their longer-term efforts to improve collaboration across the Baltic Sea.

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

Regional cooperation among neighboring countries, on upgrading competitiveness as well as on other policies, does not happen in a vacuum. In the minds of policy makers it is one of several potential levers for policy action. Whether politicians use this lever or not depends on the political, economic, or environmental challenges they face, on the structures of institutions they can use, and on the political incentives they have, given the pressure from important interest groups. These mechanisms work in the Baltic Sea Region as well as in many other regions. To motivate political action, understanding and addressing this political context is at least as important as identifying the right action steps through an economic analysis of the competitiveness of the Region.

This section of the Report looks mainly at the first two of the three following dimensions that have been discussed in last year's report, reflecting their relative importance:

The **macroeconomic climate** in the region, in individual countries, but also in the global economy in which companies from the Baltic Sea Region operate, has a huge impact on the action priorities that governments face. The financial and economic crisis currently engulfing the global economy has had deep repercussions on all countries around the Baltic Sea. It has forced governments to shore up their financial systems, where possible to launch efforts to stimulate economic demand and help companies and individuals in economic trouble, and where needed secure the support of external partners for financing the fiscal needs of the public sector. In such an environment regional cooperation is not a key priority for governments, unless it helps to support them in their core crisis management tasks. At the same time, the global nature of the crisis has forced countries to look for international solutions in revamping demand and creating financial market structures that are more resilient in the face of systemic challenges. The dialogue on these issues tends to be among the national governments of leading economies in the world. For most countries around the Baltic Sea Region this has limited their access to these international discussions to their participation in the relevant structures of the EU.

The **institutional cooperation structures** in the Region tend to have action plans that are set with the medium- to long-term development in mind. They have thus been less focused on the immediate tasks of crisis management, continuing on the course of regional collaboration set out over the past few years. Their efforts are a stabilizing force to keep regional collaboration on course, even if the short term demand for regional solutions has been reduced. The development of the EU Baltic Sea Region Strategy has played a central role in the discussions over the last year. A more detailed look at its content and its potential is provided in Part C of this Report.

The **political context** for collaboration in the Baltic Sea Region has changed relatively little over the course of the last twelve months. Europe continues to struggle with the adoption of the Lisbon Treaty and to find a way to reignite the enthusiasm of people across all 27 member states. The Swedish EU Presidency will naturally shift more attention to the Baltic Sea Region and its integration efforts. There continue to be disagreements about Russia's actions in the Caucasus but political relations have returned to a more normal state after the public conflicts in the summer and fall of 2008. There have been government changes in a few countries of the Region but they have had no meaningful impact on countries' collaboration efforts.

- **The dramatic deterioration in the global economy has triggered major stabilization efforts to shore up financial systems and led to monetary and fiscal policy actions of an unprecedented scale**
- **The Baltic Sea Region was disproportionately hard hit by the crisis, driven by the high openness of the Region and imbalances in some of its countries**
- **The latest projections indicate that the Region will rebound more forcefully than its peers; some countries in the Region, however, face a much longer path to return to growth**
- **Policy reactions across the Region were strong where governments had the policy instruments and resources available**
- **The economic crisis has further accentuated the significant heterogeneity of economic performance across the Baltic Sea Region**

1. Macroeconomic environment

When last year's State of the Region-Report was finalized, the global economy was just turning from a standard cyclical slow-down into an economic free fall. After a number of years in which the global economy had provided a benevolent environment for the Baltic Sea Region, it was clear that the Region was going to enter a significantly different phase in its development. One year later, the macroeconomic outlook remains uncertain. But there is increasing clarity about what has happened and about what type of factors will shape future developments.

The global context

How could the global economy fall into the abyss so quickly after the Lehman Brothers bankruptcy in September 2008? First, there was a quick and radical reassessment of risks. Around the world, investors became highly risk-averse almost overnight. Financial institutions immediately started to do everything they could to unwind positions perceived as risky. They became highly restrictive in using any capital to support new lending. They sold, wherever possible, assets that had higher risks. And they deleveraged individual positions as well as their own balance sheets. For the global economy, this had a number of direct consequences. International capital flows to emerging markets dried up and went into reverse. Currencies of smaller economies (e.g., Iceland, Sweden) and emerging economies (e.g., Poland) lost value. Credit became not only more expansive but often simply unavailable, leaving companies with no capital to finance trade, investments, or even refinance existing debt positions.

Second, the deterioration of financial market conditions had an immediate effect on business sentiment and consumer expectations. Even though the actual situation in the real economy had not changed much, companies immediately ring-fenced their cash-flows by reducing activity and postponing investments wherever possible. Consumers, faced with a more uncertain outlook on their employment and income situation, started to put off discretionary spending on bigger items such as cars. And with an ever more connected global economy and media, this expectation-driven change in behavior happened simultaneously across a whole range of countries. For the global economy, this translated into a fairly synchronized drop in production and demand. With global value chains connecting consumers in the US and Western Europe to suppliers and assembly lines throughout the global economy, the effects were felt everywhere in a matter of days.

Third, the fall in asset prices reduced the wealth of individuals and thus their willingness and ability to consume. In the US in particular, rising house prices had financed much of the consumption spree driving economic growth over the recent past. With these positions now being worth much less, consumers must cut back on spending. This is further reducing the sales outlook for companies.

The extent of the economic crisis soon led to comparisons with the great recession of the 1930s. This time around, policy makers across the globe were determined not to stand idly while the economy went into a tail-spin.

The most immediate attention was directed to the financial system. A significant number of banks and other system-relevant institutions were nationalized or bailed out. Monetary policy was eased, employing a host of non-traditional

Analyzing the impact of the global crisis: Initial conditions, impact channels, and outlook scenarios

The current economic crisis is exceptional not only because of its sheer extent, which pushed the global economy into its worst downturn since the great recession of the 1930s. While many of the attributes of the crisis are well known, the new context of a much more integrated global economy has given these dynamics a new face.

In the past, similar crises were the results of domestic economic conditions getting out of line with the fundamentals of the economy. This was the case, for example, during the Nordic banking crisis of the 1990s, where the (necessary) liberalization of the domestic financial sectors led to an overshooting in credit that ultimately was not sustainable. In the current crisis, the changes in the global financial system, including the build-up of huge current account imbalances that created a seemingly endless pool of capital, were important external economic drivers that allowed the emerging real estate bubble in the US to reach ever increasing heights. The global integration of financial and real markets then led to massive contagion effects from the US to other economies around the world.

Three channels are particularly important for the way individual countries have been affected by the crisis. First, direct engagement of local financial institutions in the US financial markets at the source of the crisis will directly impair financial conditions at home. Second, the higher integration in the global economy, well approximated by the share of exports in GDP, exposed countries more to the sudden drop in foreign trade. Third, external and internal imbalances increased the vulnerability of countries in the face of a deteriorating economic context. External imbalances are indicated by, for example, high current account deficits, especially if they are not used to invest in upgrading underlying productive capacity. Internal imbalances are visible through, for example, rampant credit growth, asset price bubbles, or an oversized construction sector.

On the outset, countries affected through either one of these channels will suffer comparable drops in economic activity. Over time, however, the expected outcomes will be quite different. As US financial markets and the global economy slowly return to their normal level of activity, countries highly exposed to either will recover. Countries with high initial imbalances are unlikely to be so lucky: the new global economic environment after the crisis will most likely not support the development and sustenance of such imbalances. And adjusting towards a more balanced macroeconomic situation will take time.

instruments. As the traditional interest rate channel was not working sufficiently, Central Banks started to purchase a much broader set of financial instruments directly to provide liquidity to the financial system. The massive interventions averted the total collapse of financial systems, evidently a real threat in late 2008. The interbanking markets, too, started to normalize again. However, the impact on actual capital availability to companies was much less certain. While Central Banks created liquidity, the deleveraging on many markets reduced the liquidity which was ultimately available. And with banks in dire need of readjusting their balance sheets, the additional capital available was mainly absorbed by the financial system itself, rather than being made available to companies and consumers. There are now concerns that the huge expansion of Central Bank activity could plant the seeds of future inflation, if there is no clear exist strategy.

The second main pillar of the policy reaction has been the stimulus that governments have tried to provide in order to make up for the shortfall of private demand. Some of this anti-cyclical spending occurs through so-called automatic stabilizers: as the economy goes down, the private sector pays less tax and receives more social spending from the government. In addition, governments use discretionary spending, for example on infrastructure, or incentives for private consumption, like the German Cash-for-Clunkers program, to increase demand. The direct impact of these efforts has been mixed. In many cases, government spending programs are only now starting to result in actual projects. The impact of incentives for private consumption has been more visible. The indirect impact on expectations, and thus the private decisions of consumers and companies, has been more important. Governments were seen as reacting strongly to the crisis and this has improved the private sector's expectations about the future development of the economy. Governments had to walk a fine line on these issues, however, as in several countries the public has significant concerns about the long-term sustainability of public finances. With government debt increasing fast at the moment, governments need to balance the short term need for stimulus with long term balancing of budgets.

A third element has been the discussion about possible government interventions to support companies outside the financial sector that have run into trouble. The argument was that some fundamentally sound companies were facing bankruptcy because of the dramatic short-term drop in demand and the lack of available finance. Government efforts could help to overcome liquidity problems between now and the end of the macroeconomic crisis. In some countries, Germany in particular, one key focus of such interventions has been on employees, subsidizing reductions of work hours to keep employees from losing their jobs. Other programs provided credit or guarantees directly to companies. The discussions around GM's European operations in Sweden (Saab) and Germany (Opel) indicated the tension between helping to support jobs while recognizing the limitations of government as an owner or manager of companies.

The final element of the discussion concerns the necessary steps to avoid future crises. Re-regulation of financial services but also more generally the policy architecture for the global economy is under discussion. Within the Baltic Sea Region, individual countries are also discussing whether the crisis has implications for their stance on keeping an own currency or adopting the Euro. On the global level there has been some general agreement on the need to act, but not much specific action. New financial regulations in key countries like the US and the UK are still very much under discussion. The global macroeconomic system that has provided much of the fuel to the exuberant speculation on financial markets, through the build-up of large current account imbalances, has been widely identified as in need of change. But there are few suggestions on the table and even less agreement on whether to implement them.

The latest projections by the IMF from July 2009 see the world economy contracting at an annual rate of 1.4% in 2009 and returning to 2.5% growth in 2010. For the advanced economies the outlook is more negative, with a drop of -3.8% this year followed by an anemic recovery of 0.6% in 2010. While Asia is expected to produce respectable growth and the US seems to be recovering slowly, the outlook for Europe remains among the weakest of all world regions.

After having finally caught up with US growth rates in 2006, Europe is now again in danger of falling behind.

These forecasts have been subject to numerous changes over the past year; the depth of the crisis has reduced the ability to accurately predict activity patterns for the future. The most recent economic data reported suggests that there are signs of the crisis at least slowing, if not bottoming out. One reason has been the fall of companies' inventories, a result of production activity having been reduced much more aggressively than the actual fall in consumer spending that followed. Companies are now increasing production again to meet the existing demand. Another reason, although still hard to quantify exactly, is the impact of the governments' monetary and fiscal policy measures to stabilize the economy. Furthermore, Asian economies, increasingly important markets globally, seem to be bouncing back faster than expected, driven by stronger domestic growth rather than accelerated exports to the US or Europe. Financial markets, too, have normalized, but in most countries this has so far only improved the access to capital for non-financial enterprises to a limited degree.

Financial markets have been surprisingly quick in pricing, in the wake of the better news of recent weeks. Stock markets have done well since the beginning of the year and exchange rate movements indicate a willingness to return to smaller currencies. The reality remains, however, that it is hard to project how the economy is going to develop because much of the downturn was based on rapidly changing expectations, and the economy is now so far from equilibrium. Most economists still expect a relatively drawn out recovery. In 2010, some of the government's stimulus spending will continue to be active but the trend will be for both fiscal and monetary policy to become less expansionary. The short-term support from companies having to react to falling inventories will also have vanished. What will remain is the slow process of readjusting balances, i.e. especially US consumers spending less and countries with high current account deficits increasing their domestic consumption.

Figure 1: GDP growth in main world regions

Source: EIU (2009), IMF (2009) State of the Region-Report 2009

The Baltic Sea Region

The global economic crisis is playing out around the Baltic Sea Region in a highly diverse way. Countries differ significantly in the way they have been affected and in the path that now lies ahead of them. After a brief discussion of how the economy of the Region is faring on an aggregate level, this section will therefore then address each country individually.

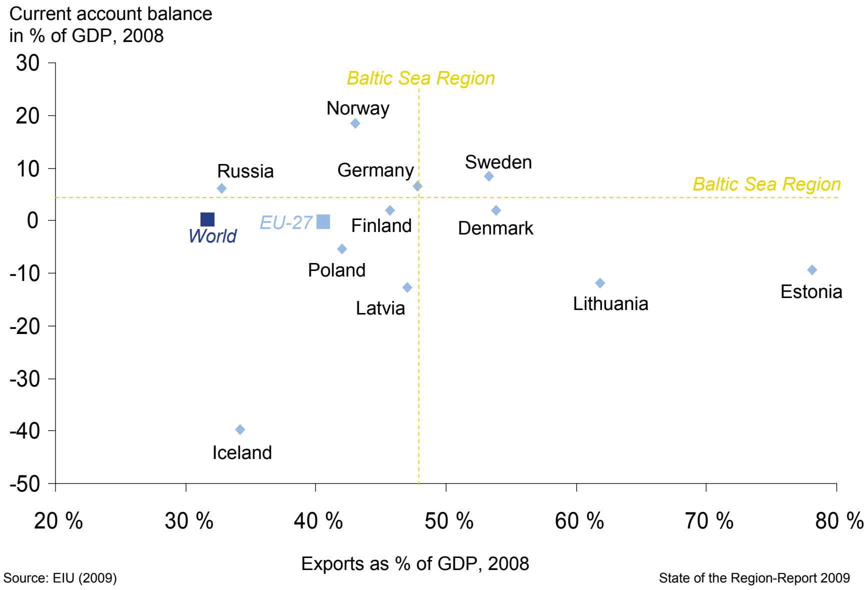
On an aggregate level, the Baltic Sea Region entered the crisis with high growth that was reaching the end of a long cycle. By 2008, unemployment had been dropping to an aggregate level of about 5% while inflation had moved up to close to 5%. Exports accounted for about 48% of GDP, higher than for the EU (41%) and the world economy (31%). The current account surplus for the Region overall was strongly positive at about 6% of GDP, and up to 2007 the government budget surplus had been close to 3% of GDP.

When the crisis hit, it did so mainly through three channels: exports, capital flows, and business sentiment. When global trade slowed down, the export-oriented economies of the Region were bound to be significantly affected. With exports worth almost 50% of the Baltic Sea Region's GDP, the Region started to slow significantly once its main export markets in Europe, not just the US, were contracting. Initially the financial market conditions in the US did not seem to matter that much – banks from the Baltic Sea Region had a very small exposure to the US market.

But the worsening global financial market conditions quickly affected the markets in the Baltic Sea Region. Those countries in the Region that were dependent on foreign capital faced a particular challenge as global capital markets dried up and smaller currencies came under pressure. The drop in equity markets, in some countries also house prices, and tighter financial market conditions reducing access to capital, affected the economy in the entire Region. Economic sentiment, which already had fallen since early 2007 as signs of an end to the growth period became evident, dropped rapidly in 2008, especially after the summer.[1] This had a major impact on consumption, business investment, and companies' production plans.

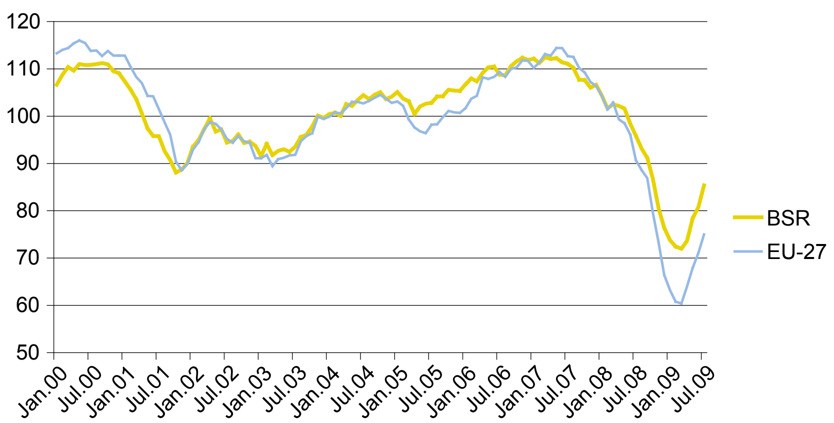
In the last quarter of 2008 and so far into 2009, the economies around the Baltic Sea Region have contracted. The overall outlook is for the Region to register a drop of GDP by between 5%

Figure 2: Immediate exposure to global crisis



Source: EIU (2009) State of the Region-Report 2009

Figure 3: Economic sentiment



Note: BSR excluding Iceland, Norway, and Russia
Source: EU (2009) State of the Region-Report 2009

1 The Economic sentiment indicator is calculated monthly based on a set of standardized questions about current and expected future economic conditions, posed to companies from industry, construction, retail, and other services as well as consumers. See http://ec.europa.eu/economy_finance/db_indicators/surveys11283_en.htm for details.

and 6% in 2009, following a 1% growth rate for the total of 2008. For 2010, GDP is projected to be flat. The actual outcome for 2009 and 2010 could very well be somewhat more positive if the recent data from a number of countries in the Region as well as from their trading partners elsewhere turn out to signal a faster recovery.

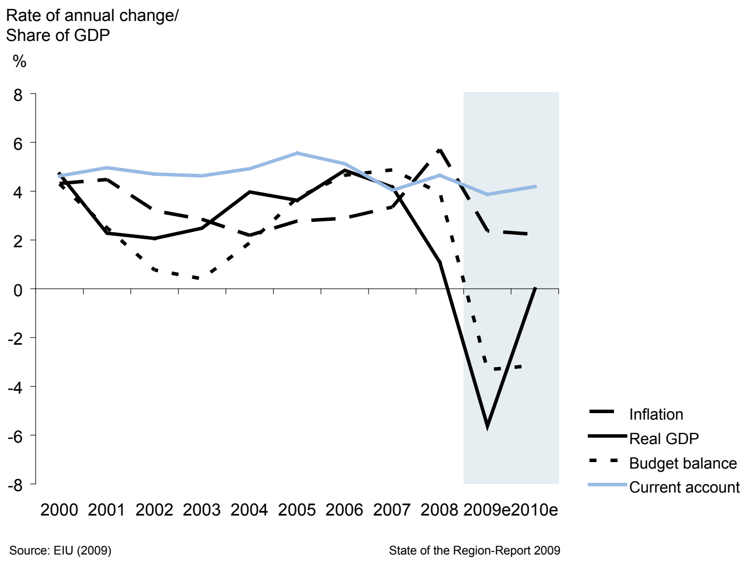
Domestic consumption has dropped, leading to a significant fall in imports. With exports contracting even faster, however, the overall current account surplus of the Region is set to drop to 3% of GDP before improving to about 4% in 2010. Within the Region, countries that previously had significant current account deficits, i.e. primarily the Baltics and Iceland, are moving towards a balanced external position. Countries with strong current account surpluses, i.e. the Nordic countries, Russia, and Germany, have seen their surpluses reduced.

A 2008 budget surplus of 1.8% of GDP turned into a 2009 deficit of -2.4%. For 2010 the budget outlook is even more negative as the full effects of stimulus efforts, higher unemployment, and falling tax revenues will show up in government budgets. Especially in the Nordic countries with high tax and social welfare rates, the effect of the automatic stabilizers on public balances is very high. In the Baltics, the massive drop in GDP could not be offset by savings in public sector consumption, despite the painful wage and employment cuts that have been made.

Overall, the Baltic Sea Region has seen GDP growth drop much faster than the advanced economies, but it can now hope for a faster recovery than its European neighbors.

The fast downturn in late 2008 and early 2009 can be explained by two factors. First, a significant part of the Region was close to or had already entered a cyclical downturn for purely domestic reasons. With hindsight, it is now plain to see that the Baltic countries and Iceland had been growing much faster than normal convergence rates would have suggested. The global crisis then amplified the downturn significantly. Second, the Region is highly export-oriented and has many countries that rely on foreign capital, hidden behind the significant current account surplus on the aggregate level of the Region. The global crisis created significant challenges for these countries, worsening the economic contraction.

Figure 4: GDP growth in main world regions



The perspective of a faster recovery, also visible in the significantly better economic sentiment in the EU-countries of the Baltic Sea Region versus the EU at large, suggests that this sudden contraction should not be seen as an indication that the fundamentals of this Region are weak. The high export exposure is already providing support to growth as some foreign markets are developing better than initially assumed. And the generally solid fiscal policy in the Region prior to the crisis has given the governments' ammunition to react forcefully. This has in turn had a positive impact on the view taken by consumers and companies on the outlook for the economy.

Countries in the Baltic Sea Region

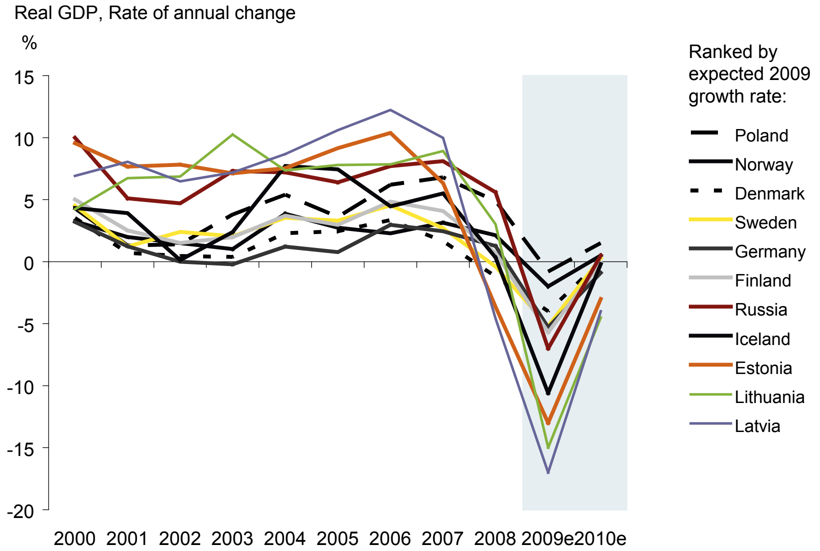
Already last year it became clear that the global economic crisis was going to increase the differences in economic conditions across the countries of the Baltic Sea Region. While all parts of the Region suffered from the impact of the crisis, there have been significant differences in the depth of the effects, in the policy response that was taken, and in the longer-term outlook for economic growth.

The Nordic countries have been significantly hit by the crisis, but despite some painful reactions, there is a widespread sense that their economic model will provide solid foundations for a healthy recovery. Already, there is an international debate that looks at the lessons that can be drawn from the Nordic experience when thinking about restructuring the architecture of the global economy. The strongest asset of the Nordic countries has been their solid fiscal policy regime of recent years. With stronger government finances to begin with, there was more potential for governments to pursue a more expansionary spending policy without immediately raising concerns about fiscal sustainability. The structure of the taxation and welfare system delivered much of the spending increase automatically, without the long delays and complex political processes involved in setting up new spending programs.

Sweden, the largest of the Nordic economies, saw its economy rapidly deteriorate in the second half of 2008, leading to a slight drop in GDP for the overall year. For 2009, the latest outlook of the IMF foresees a reduction in GDP by 4.3% before the economy stabilizes again in 2010. In its latest projection the Swedish government sees GDP even falling by 5.2% in 2009 but is more optimistic about the following years.

At the start of the crisis, Sweden was already approaching the end of a domestic growth cycle with strong consumption, rising housing prices, increasing inflation, and falling unemployment. Government finances had been running at a solid

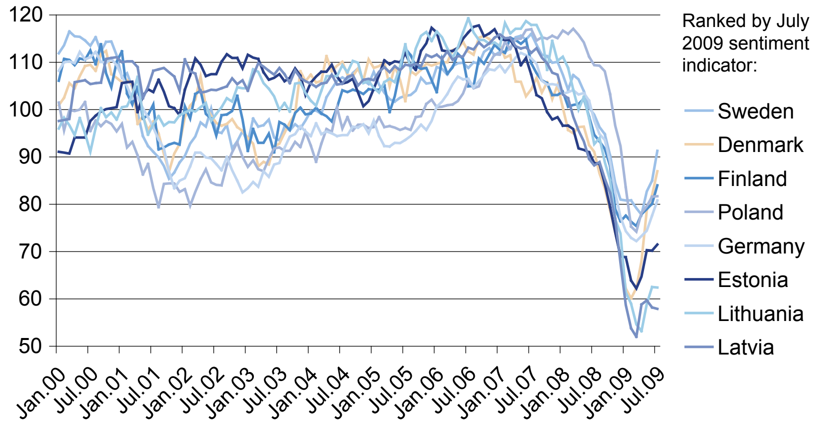
Figure 5: GDP growth across Baltic Sea Region countries



Source: EIU (2009), IMF (2009)

State of the Region-Report 2009

Figure 6: Economic Sentiment across Baltic Sea Region countries



Note: BSR excluding Iceland, Norway, and Russia
Source: EU (2009)

State of the Region-Report 2009

surplus for the most recent years, reaching 3.8% of GDP in 2007. An important driver of growth had been the rising current account surplus, which had reached 8.6% of GDP in 2007. In 2008, exports accounted for more than 50% of total GDP.

In the last quarter of 2008 it became evident that Sweden was also going to be struck by the global crisis. Initially, exports had held up quite well and the Swedish banks were not that active in the US financial markets. With the Lehman bankruptcy in the US, the Swedish financial markets took a nosedive, following the example of many other markets around the world. Between November 2008 and March 2009 Sweden, along with Poland and the UK, was among the group of countries in the EU that experienced the strongest fall in bank loans to non-financial institutions. Over time, the domestic markets stabilized but Swedish banks increasingly suffered from the fall-out from their weakening Baltic operations. In the real economy, things started to deteriorate materially once the German economy, still Sweden's main export market, started to slow down. As a consequence of these changes, GDP dropped by -0.2% in 2008, driven by a sharp fall in the fourth quarter. In the first two quarters of 2009, the downward trend continued but showed signs of slowing down. Unemployment reached 9.1% in the second quarter of 2009. Industrial production dropped by more than 20%, one of the highest rates in the Region. Gross capital investment, an indicator in which Sweden had finally started to show some improvement, fell by 23.5%. The current account surplus dropped as exports fell faster than imports. The Swedish krona depreciated against the US dollar and the euro, partly because of a general "flight to safety" that punished smaller currencies and partly because of the concerns about the exposure of Swedish banks to the dramatic downturn in the Baltic countries. This devaluation has had some stabilizing effect, further redirecting local demand away from imports and supporting the cost competitiveness of Swedish exports. Due to the weak demand on foreign markets this has generally not led to a rise in exports, but it has helped Swedish firms to maintain higher margins in their own currency. With signs that the global recession might be bottoming out, the krona has most recently started to regain some of the ground it has lost.

Figure 7: Policies to Support the Financial Sector across EU countries

	Guarantees	*Re-capitalisation*	*Total stabilisation*
	bn€	**bn€**	**% of GDP**
Germany	449.8	106.6	5-10%
Sweden	150	4.8	5-10%
Denmark	0	13.5	5-10%
Finland	50	0	1-5%
Latvia	1.25	0	1-5%
Poland			
Estonia			
Lithuania			
Ireland	400	8.5	>10%
Belgium	300	16.2	>10%
Netherlands	200	36.8	>10%
UK	286	63	5-10%
Austria	75	15	5-10%
Luxembourg	0	2.876	5-10%
France	320	43	1-5%
Spain	200	0	1-5%
Portugal	20	4	1-5%
Italy	0	20	1-5%
Greece	15	5	1-5%
Hungary	5.2	1	1-5%
Slovenia	12	0	
Czech Republic			
Cyprus			
Malta			
Slovakia			
Romania			
Bulgaria			

Source: EU (2009) State of the Region-Report 2009

The main focus of the policy response was initially on the financial sector. The total contributions to stabilize banks, essentially increasing their capital base, were estimated at 5-10% of GDP by the European Commission. The Swedish Central Bank, which had long been more concerned about the threat of rising inflation, started to lower rates in October 2008. Since then, the repo rate has been reduced from 5.5% to 0.25%, the lowest rate on record. With traditional monetary policy at the limit of its toolkit, the Central Bank has also engaged in "quantitative easing", i.e. providing liquidity directly to the market. The efforts to support the real economy were initially cautious. With strong automatic stabilizers in place, fiscal policy was going to turn expansionary without any additional measures. Over time, however, significant funds were made available for training and other measures to help the unemployed, tax incentives for the building sector, increased funding to guarantee trade credit, and additional resources for local and regional governments which are responsible for a large share of government spending. In terms of more support for the business sector, the SEK 28 billion package in loan guarantees to the automotive industry stands out. Other measures were limited, although the government pushed ahead with its previously made decisions to reduce the corporate tax rate and social security contributions.

The outlook for 2010 is characterized by a slow recovery. The Swedish krona is gaining in strength against both the euro and the US dollar. GDP growth should reach positive territory again as the situation on financial markets normalizes and export demand slowly recovers. The expansionary fiscal and monetary policy decisions made will support this trend. An important factor will be the development of private consumption, which has so far held up well but could suffer if unemployment rates go up. Unemployment, traditionally a lagging indicator of economic development, is expected to reach 11.4% in 2010 with only slow improvement afterwards. This will also affect government finances, which will suffer from both lower tax revenues and higher welfare costs. The Swedish government expects the public debt level to rise by 20% of GDP between 2008 and 2012.

Norway has always been a special case due to its strong oil and gas sector. The slowdown in the second half of 2008 was not as pronounced as in the rest of the Baltic Sea Region. After reaching a real GDP growth rate of 2% in 2008, Norway will face a contraction by -1.7% in 2009 and a 0.3% growth in 2010, according to the IMF. The changes in growth rates are somewhat lower for the Mainland economy, where the contraction in 2009 is expected to be only -1 % of GDP, the second smallest fall in the Baltic Sea Region behind Poland.

At the outset of the crisis, the Norwegian economy was struggling with the inflationary effects of strong wage pressure in a labor market with very low unemployment. Government finances were solid and aiming for a reduction of the non-oil government deficit to slow the overheating economy. The current account surplus was growing as a result of the rising oil prices. Despite the oil and gas exports, the Norwegian economy was overall less export-dependent than, for example, the Swedish one.

When the global crisis hit in late 2008, Norwegian consumers and businesses started to become much more cautious about the future. Private consumption and business investment fell. In addition, Norwegian banks applied significantly tighter credit standards, making it harder for companies to expand or refinance. Lower activity on export markets also had a dampening effect on the Norwegian economy, reducing Mainland economy exports by about 10%. The oil and gas sector was hit by the huge drop in oil prices. Unemployment started to rise moderately from very low levels, hovering around 3% in the first two quarters of 2009. The Mainland economy contracted by -1.3% in the first quarter of 2009 but registered a slow growth of 0.3% in the second quarter. The slight upturn was driven by higher government and consumer spending, while exports remained on a downward trend.

As in Sweden, the initial target of the policy response has been the financial system but over time more measures were added to support flagging demand. The Central Bank reduced its interest rates significantly and made additional liquidity available through a large scale swap-arrangement that allows banks to exchange covered bonds for government securities. The government also created two state funds to boost banks' capital (Norwegian State Finance Fund) and to buy company bonds (Government Bond Fund). The size of the total fiscal stimulus announced in January 2009 was estimated at around 3% of GDP, paid for by a temporarily higher use of the funds from oil revenues. Most of the stimulus will come in higher spending on infrastructure, renewable energy, and other investments with a smaller component dedicated to tax relief.

The outlook for 2010 is characterized by a slow recovery. GDP growth is expected to turn positive sometime in early 2010, maybe even in the second half of 2009. Private consumption is expected to pick up again as consumers reduce their savings rates. Real estate prices have already started to grow since the end of 2008, after a 10% decline late in the year. Company investment will take some more time to return to pre-crisis levels, and its recovery depends more strongly on the economic climate in Norway's main trading partners.

Denmark had been ahead of its Scandinavian neighbors in terms of the business cycle. Already before the full impact of the global crisis was beginning to be felt, Danish GDP growth rates had started to come down. In 2008, this resulted in a drop of real GDP by 1.1%, now followed by an expected further contraction of 4% in 2009. For 2010, the outlook is for a resumption of growth at 0.4%.

At the outset of the crisis, the Danish economy was already dealing with the repercussions of an overheating economy, and in particular a real estate sector that had moved into decline. This put some financial institutions in a precarious situation even before the global financial crisis became visible. Denmark's current account surplus of previous years had all but disappeared by 2007, as the growing local economy and a worsening relative cost position tilted activities away from the export sector. The government aimed to contain growth by running significant budget surpluses since 2005. Employment remained strong throughout this period, with unemployment slowly falling from about 5.5% in 2004 to close to 3% in mid-2008.

As the crisis hit in late 2008, it created further pressure on the financial institutions. Exports tumbled and in 2009 Denmark is facing the prospect of a current account deficit for the first time in a decade. For a number of weeks in 2008 the Danish krona was also under pressure, as the financial market turned against smaller currencies. As consumer demand, economic production and investment fell, the labor market started to see a moderate rise in unemployment, with the unemployment rate reaching 3.8% in June 2009.

The policy response in Denmark initially focused on supporting the stability of the banking sector (Bankpakken, October 2008), further extended through a second program in February 2009. The total support for the financial sector has been estimated at 5-10% of GDP. On the fiscal policy side, tax incentives for the building industry, spending programs for local government, and other programs, including extended opportunities for export credits were launched. According to EU estimates, the total discretionary stimulus for

Figure 8: Economic Policy Response to the Crisis across EU countries

	Labor Market				Investment			Business Support			
	Encouraging flexible working time	*Cutting labor costs*	*Retraining and activation*	*Supporting purchasing power*	*Energy Efficiency*	*Physical Infra-structure*	*R&D and Innovation*	*Sectoral Support*			*Access to finance*
								Automotive	Tourism	Construction	
Finland			**		*	*				*	*
Germany	**	*	**	**	**	*	**	**			**
Sweden		**	*		*	*	*	*			*
Poland					*	*		*			*
Denmark		**	*			*					*
Latvia				**							**
Estonia					**						*
Lithuania			**		*						*
Spain		*	*	**	*	*	*	**		*	**
Austria				*	**	*		*			**
UK			**	**	*	*		*		*	**
Czech Republic	*		*		*	*		*	*		**
Slovenia	*		*			*	*				**
Belgium		*		**	*	*				*	**
Cyprus						*		*	*	*	
Luxembourg					*	*		*			*
Netherlands	*	**	*		*	*	*	*			**
Ireland			**		*					*	*
Portugal				*	**	*		*	*		**
Italy								**			*
Malta					*	*			*		
Slovakia	*		**		*			*	*		**
France		*	**		*	*	*	**		*	**
Greece			*	*					*		*
Romania		*						*			**
Bulgaria		*	**								*
Hungary			*	*							*

Source: EU (2009) * = somewhat significant measure; ** = highly significant measure State of the Region-Report 2009

2009/2010 amounts to 1.5% of GDP, with most of the resources directed at the labor market. Because of the automatic stabilizers inherent in the Danish welfare system, the total change in the fiscal balance of the government will, however, be much more pronounced. As for monetary policy, in 2008 the Danish Central Bank was forced to raise interest rates for a while as a measure to defend the fixed relation to the euro. As currency markets normalized, it then followed other Central Banks in lowering rates repeatedly.

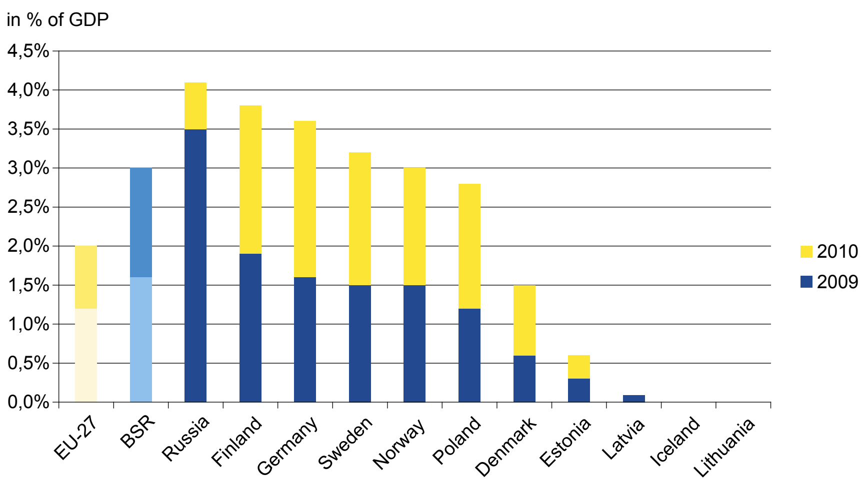
The outlook for 2010 is characterized by a slow recovery, following the general trend of the other Scandinavian countries. In particular, the Danish labor market has proved itself to be more resilient over the last period, which will be an important factor in getting Denmark out of the recession.

Of the larger Nordic countries, *Finland* was the one with the highest growth rate at the start of the global economic crisis. Driven by solid exports and a strong current account surplus of around 4% of GDP, the country achieved a real GDP growth rate of 4.2% in 2007. As the crisis hit, Finland's strong position in cyclical industries was quickly felt, and growth dropped to 0.9%, only on the positive side of the scale because of the fast growth in the first half of the year. For 2009, the economy is expected to contract by 5.6%, the most dramatic drop in the Nordic region outside of Iceland.

At the start of the economic crisis, Finland had the highest government budget surplus of all Nordic countries at 4.2% of GDP in 2008. Its banking sector was not strongly engaged in the international financial markets that suffered the most from the global crisis. Asset prices, both for equities and real estate, had appreciated less over recent years than in most other European countries. The country's export share, 46% of GDP, was below the Baltic Sea Region average and trailing behind all other Nordic countries except Iceland. The unemployment rate, traditionally the main weakness of the Finnish economy, had dropped to 6.4%. This was still higher than the Region's average but was a significant improvement compared to previous years. However, throughout 2008 rising wages and unit cost levels contributed to a significant reduction in growth already in the first three quarters of 2008.

When the crisis hit, the Finnish economy was already struggling with the effects of a domestically driven downturn. Weakening export demand and rapidly deteriorating expectations in the face of the global turmoil then led to a massive drop in investment (between -10% and -16%) and industrial production (-20%). The strengthening of the euro against the Swedish krona and other currencies created additional challenges for Finnish exporters; exports are expected to drop by 17.2% compared to 2008. With Finland still relying more heavily on industrial jobs than many other advanced economies, these changes had a significant impact on employment and overall growth. The unemployment rate reached 9.1% in June 2009. GDP is expected to drop by 6% over the year according to the latest government forecast. Government balances are

Figure 9: Fiscal Stimulus Packages across the Baltic Sea Region



Note: Does not include the impact of automatic stabilizers on the budget
Source: EU (2009), EBRD (2009), press reports

State of the Region-Report 2009

Figure 10: Policies to Support the Financial Sector across EU countries

	Change in fiscal balance, 2008-2010	Discretionary Stimulus				
		overall	households	labor market	businesses	investment
	p.p. change	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Finland	-7,1	3,8	2,6	0,0	0,7	0,4
Germany	-5,8	3,6	1,5	0,5	0,8	0,9
Sweden	-6,4	3,2	0,4	1,8	0,4	0,6
Poland	-3,4	2,8	1,2	0,0	0,4	1,2
Denmark	-7,5	1,5	0,0	1,0	0,1	0,4
Latvia	-9,7	0,9	0,6	0,0	0,3	0,1
Estonia	-0,9	0,6	0,0	0,5	0,0	0,1
Lithuania	-4,7	0,0	0,0	0,0	0,0	n.a.
Spain	-6,0	4,0	1,6	0,1	1,4	0,9
Austria	-5,2	3,5	2,6	0,2	0,2	0,5
UK	-8,2	2,6	1,7	0,3	0,4	0,2
Czech Republic	-3,4	2,2	0,1	1,1	0,5	0,5
Slovenia	-5,5	2,2	0,0	0,8	0,2	1,2
Belgium	-4,9	1,8	0,9	0,5	0,1	0,3
Cyprus	-3,5	1,8	0,0	0,0	0,0	1,8
Luxembourg	-5,4	n.a.	n.a.	n.a.	n.a.	1,7
Netherlands	-7,1	1,6	0,4	0,2	0,5	0,5
Ireland	-8,5	1,4	0,8	0,2	0,4	0,0
Portugal	-4,0	1,3	0,4	0,2	0,4	0,3
Italy	-2,1	1,2	0,2	0,4	0,5	0,1
Malta	1,5	1,2	0,4	0,0	0,2	0,6
Slovakia	-3,2	1,2	0,6	0,2	0,2	0,2
France	-3,6	1,0	0,2	0,1	0,4	0,3
Greece	-0,8	0,3	0,3	0,0	0,0	0,0
Romania	-0,2	0,3	0,1	0,0	0,2	n.a.
Bulgaria	-1,9	0,1	0,0	0,0	0,0	0,1
Hungary	-0,5	0,0	0,0	0,0	0,0	n.a.

Source: EU (2009)
Note: The difference between the discretionary stimulus and the change in fiscal balance is due to the effect of automatic stabilizers and any other non -temporary policy changes
State of the Region -Report 2009

suffering as a consequence, resulting in an expected deficit of -0.8% of GDP this year.

The Finnish policy response was mainly focused on battling the dramatic fall in foreign and domestic demand. In response to the crisis, Finland launched the second largest spending plan among European countries, a total stimulus of 3.8% of GDP, coming only behind Spain. According to an EU assessment, the majority of the spending was focused on providing support to households through tax relief and other measures. Fiscal stimulus directed to support investments comprised 0.42% of GDP. The fiscal stimulus associated with business support measures equaled 0.7% of GDP. Other measures undertaken by Finland include raising the retirement age. The total financial package for the stabilization of the generally resilient financial system equaled 1-5% of GDP, all of which were provided as guarantees. As part of the Euro-Zone, Finnish monetary policy is set by the European Central Bank (ECB). The ECB, while initially more cautious in its response to the crisis than the Federal Reserve Bank in the US, has in the meantime cut interest rates repeatedly to 1%. The ECB has also engaged in the quantitative easing practiced in the US and the UK.

The short-term outlook for the Finnish economy is less favorable than for the other Nordic countries, with the exception of Iceland. The IMF expects real GDP to continue to fall in 2010, albeit at a slower rate of -1.2%. The Finnish government sees the possibility of a slightly more positive outcome, which could mean a small positive growth rate. Under the IMF scenario, the current account will register a further reduced surplus of 0.5% of GDP as exports continue to be sluggish. As a consequence, the government deficit will increase, reaching -2.9% of GDP. Finland is thus in danger of hitting the bottom of the crisis slightly later then its peers in the Region.

Iceland, the smallest economy in the Baltic Sea Region, experienced the most dramatic economic decline of all advanced economies in response to the global crisis. Already in 2008 the impact of the implosion of the Icelandic banking system was so severe that growth for the entire year was flat. In fact, after significant growth in the first two quarters, the last quarter saw a dramatic downturn. In 2009, the full extent of the crisis will become visible in the annual statistics as real GDP is projected to drop by -10.6%.

At the start of the crisis, Iceland had a combination of a financial system with assets many times the country's GDP, and a domestic economy that was overheating. The financial sector had financed aggressive expansion abroad through largely wholesale financing on international credit markets. While there is no systematic evidence that their lending behavior on foreign markets was more risky than their peers', recent analysis of Kaupthing Bank indicate that there were large loans given to owners of the bank without adequate safeguards and transparency. Further potential fraud cases are currently under investigation. On the domestic credit markets, banks had increasingly given foreign-currency denominated loans to private households. While this allowed them to take advantage of lower interest rates in the short run, it exposed them to a high currency risk as soon as the international financial markets became highly risk averse and swung heavily against small currencies. As a consequence of the widespread availability of cheap credit, the real estate markets had sky-rocketed and in 2007 the construction sector accounted for almost 9% of GDP, the highest rate of any country in the Baltic Sea Region. In Europe, only Spain and Ireland had larger construction sectors at the time. Unemployment was practically non-existent and inflationary pressure was gathering pace. The government budget registered solid surpluses of about 5% between 2005 and 2007, but this was not enough to slow the economy. The combination of overheating domestic demand and foreign currency

Iceland and the EU – Not a mere formality

By Uffe Ellemann-Jensen (blog in Berlingske, Tuesday 28 July 2009)

The EU's Foreign Ministers have accepted to receive Iceland's application for EU membership. The official decision-making process in the EU has thus now begun. Against the wishes of some, it has been made clear from the outset that there are no shortcuts to Iceland's way into the EU. It is only sensible and appropriate to send such a message because it gives the citizens of Iceland reasons to consider thoroughly what they are embarking on.

I hope it will all end with Icelandic membership of the EU. It would be an old dream come true – and it is certainly the way of getting Norway to join as well. It would strengthen the Nordic community – and the European as well – if all the Nordic countries were to pull their forces jointly in the EU.

Even though my wishes and dreams are strong and sincere, I have my doubts concerning the Icelandic way of approaching the EU. We have only heard economic arguments – and expectations about the Euro and EU membership easing the economic problems of Iceland – but nothing about the overall political visions for Europe. It is worrying because it might indicate that the Icelandic politicians have not made up their minds about what the EU is fundamentally based on: politics! It is the vision about securing peace and liberty in our part of the world by joining forces – including our economic forces. But the economy is only a means, not an end in itself.

I believe that this concern is shared by many people in the present Member States, who did not all receive the Icelandic application with unqualified enthusiasm. The fact that only a small majority of the Icelandic parliament (Alltinget) was behind the membership application was noted in Europe as was the fact that the application was followed by strong Icelandic emphasis on maintaining full sovereignty on a number of areas covered by the EU co-operation. Expecting the accession treaty to be submitted for referendum in Iceland in due cause, many people might think that it is a waste of effort to solve the many problems related to EU accession, since lending, together with the inflows of capital in relation to a number of big aluminum investments, created a huge current account deficit, reaching close to -35% of GDP in 2008. As the financial crisis gathered strength during 2008, the Icelandic krona started to lose value and the real estate market was heading for trouble. The Icelandic stock market, too, had lost value since mid-2007.

When the crisis hit, Iceland was unable to withstand the storm. The banks had already been struggling to refinance their debts as wholesale credit market conditions deteriorated in the run-up to the Lehman Brothers bankruptcy. One of their attempts to raise capital was the more aggressive push into the consumer market by attracting depositors with interest rates above the general market level. This turned out to be insufficient and when the credit markets closed completely in late September/early October 2008, it took only days for the Icelandic banks to collapse. The freezing of Icelandic banking assets by the UK government on October 8th dealt the death blow to the sector. The Icelandic government took over the failed banks and their foreign liabilities. Restrictions were imposed on capital flows; the exchange rates quoted by the Icelandic Central Bank and by the ECB reflected a dramatic drop in the value of the Icelandic krona. Imports collapsed and the current account swung towards balance quickly. GDP dropped dramatically, and unemployment jumped to nearly 9% in early 2009. Private consumption and investment are both expected to drop by around 20% in 2009.

Iceland's policy reaction to the crisis has been dictated by the events. The primary task was to manage the obligations of the defunct financial sector now in public ownership. To be able to cover these liabilities and the government budget deficit resulting from the economic downturn, Iceland turned to the IMF and to individual countries. After complex negotiations, the IMF and the government of Iceland agreed in November 2008 on an economic assistance program focused on currency stabilization, bank restructuring and fiscal consolidation. The program was supported by a US$ 2.1 billion stand-by-agreement, 40% of which was available to Iceland immediately. The 2009 budget presented in mid-December 2008 provided for substantial expenditure cuts on current and capital

eventually there is a high risk of a negative result in a referendum.

Many of the practical problems will be easy to solve due to Iceland's (like Norway's) inclusion in the EEA (European Economic Area) and the Schengen agreements. Up to 80 percent of the acquis is already in place. This being said, accession is not a mere formality. A number of difficult issues remain unsettled.

First and foremost, the common fisheries policy will create huge difficulties, given the Icelandic demands for full sovereignty. Furthermore, the agricultural policy is a very special case in Iceland. Everyone who has visited the Icelandic countryside knows that nowhere in the world are so expensive agricultural machinery used on such poor soils, and nowhere else are crops grown so expensively. That the fragrance of the crops contributes to the best lamb steak in the world is another matter. Icelandic agricultural traditions match badly the common agricultural policy, although there is room for special arrangements for agriculture in difficult areas.

Problems will also appear in trying to make Iceland fit into the EMU-cooperation. Iceland is in huge debt and difficult negotiations are taking place with the IMF on economic reforms and credits that will help carry Iceland through the crisis.

A special problem concerns the servicing of debt that was the result of the bankruptcy of Icelandic banks and of foreign depositors losing their savings. Especially British and Dutch depositors were hit hard by the banking crisis and the total Icelandic debts amount to 30 billion DKK. In line with a repayment scheme that has been agreed upon, the enormous debt should be repaid during a period of 15 years but without installments the first seven years.

In Iceland it is a common view that the huge foreign debt is the result of the actions of banks and foreign creditors and that the individual Icelander carries no responsibility. If this opinion becomes more manifest, Iceland cannot expect wider sympathy from the outside world. This is the hard reality. IMF and other foreign creditors (in particular the Nordic banks) are ready to assist Iceland financially, but only if the Icelandic people recognizes the financial situation and is ready to pay the price for having gambled with high risks. And lost.

spending, as well as an increase of 1 percentage point in personal income tax. Further cuts and tax increases equivalent of 1.6% of GDP were made in June 2009. In the meantime, the first review of the IMF agreement – necessary to unlock additional tranches of the stand-by-loan – was delayed from early 2009 until the summer. There was a perception among the public that this delay was implicitly linked to Iceland reaching an agreement with the UK and the Netherlands regarding the holdings of retail customers of Icelandic banks in these countries. The task fell to a new government formed by a coalition of social democrats and the left-green movement after elections in April 2009. The government negotiated an agreement, but the terms – liabilities assumed by the government accounting for about 50% of the country's GDP – created a backlash in the Icelandic public and parliament. The parliament has now pushed the government to seek some modifications from the UK and the Netherlands, which they have so far been unwilling to make. In early July 2009, Denmark, Finland, Norway, and Sweden provided another €1.8 billion in long-term loans to Iceland. Later that month, the Icelandic parliament voted narrowly in favor of seeking EU membership. This was a significant change of course for the country as well as for parts of the governing coalition. Public opinion remains divided on the issue, and the outrage about the positions of the UK and the Netherlands on Iceland's obligations towards savers from their countries has recently led to a significant drop in support. Negotiations will in any case be difficult, with the treatment of fishing rights in Icelandic waters a key point of contention.

The outlook for the Icelandic economy suggests a slow return to recovery with GDP growth slightly negative in 2010. The current account will be roughly balanced, with trade registering a surplus about as high as in 2009. Private consumption will remain subdued as individuals have to reduce their debt burden and real purchasing power will drop further. Investment is expected to pick up somewhat from the low levels of 2009. The real challenge for the Icelandic economy is the huge long-term debt burden that the country is facing as a consequence of the crisis. This will limit public investments in infrastructure, innovation, and other assets important for the country's competitiveness for years.

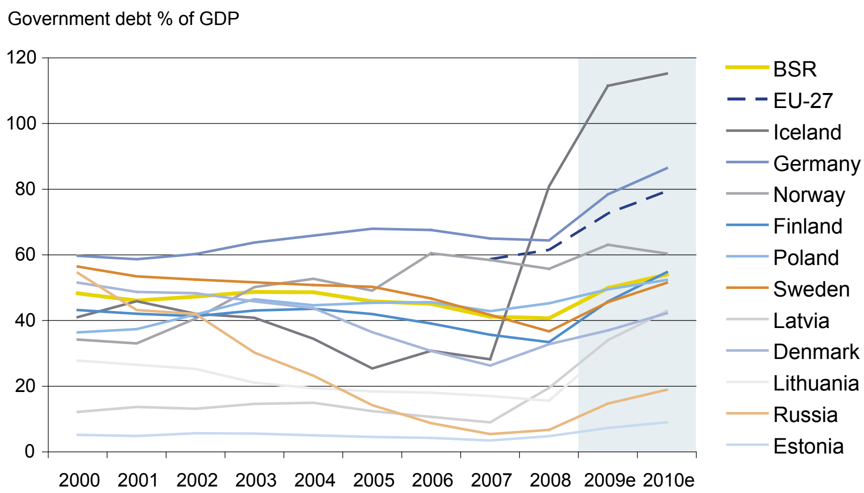
Germany, the largest economy bordering the Baltic Sea Region, had just started to reap the benefits of making some progress in improving its general economic position when the crisis hit. A combination of wage restraint, labor market reforms, a commitment towards fiscal policy consolidation, and significant restructuring in companies had created the foundation for solid growth in 2006 and 2007. A significant contributor had been the large surge in export activity, where Germany stood out as the largest exporter in the world. Exports accounted for about 48% of GDP, huge for a country of Germany's size, and the current account surplus stood at 7.5% of GDP in 2007. The labor market had finally started to improve, with unemployment rates dropping below 8% in early 2008. Private sector debt levels were moderate and real estate prices have stayed relatively stable for some years. The public sector deficit benefited from these developments and was expected to approach zero in 2008. Debt levels had dropped to about 43% of GDP. The three northern states of Hamburg, Schleswig-Holstein, and Mecklenburg-Vorpommern had been affected quite differently from these developments. Hamburg's economy registered huge growth, putting it at the top of German states by real GDP growth rates for the last three years. The city state, also the most prosperous in Germany by GDP per capita, benefited especially from its strong position in global trade. Schleswig-Holstein grew at average rates, with the regions close to Hamburg doing the best. Mecklenburg-Vorpommern remained at the bottom of most rankings of German states, although finally job creation had started in earnest, albeit from a low level and mainly in less well paid jobs.

When the crisis hit the global economy, Germany seemed relatively less affected for a while. But this quickly changed at the end of 2008. First, it became obvious that a number of German banks had become embroiled in the US and international financial crisis, especially publicly-owned Landesbanken and real estate-focused institutions. Access to credit became generally much more complex. Then, export orders dropped at an unprecedented rate, 19% on an annual basis in 2009, when world trade all but collapsed. Business and consumer sentiment deteriorated and investments as well, as production fell by more than 20%. Bankruptcy rates increased, threatening a number of well known companies like Opel and Karstadt. Unemployment rates started to rise, reaching 8.1% in June 2009, but less compared to other countries. The use of publicly subsidized part-time work enabled many companies to hold on to their staff while waiting for the order flow to improve. This has also helped private consumption to remain quite stable with only a small reduction expected in 2009.

The impact on the northern states was again quite diverse. Hamburg suffered significantly due to its dependence on trade and shipping. Hapag-Lloyd, one of the world's leading shipping lines in which the city government and a group of local investors had only recently bought a large stake, is facing severe financial problems. In the first quarter of 2009, for the first time ever, Hamburg received support in the internal transfer scheme among German states because of the huge drop in tax revenues. HSH Nordbank, in which both Hamburg and Schleswig-Holstein hold stakes, was hard hit by speculations in the global markets that turned sour, and then by the downturn in shipping finance, where the bank is among the global leaders. Schleswig-Holstein and Mecklenburg-Vorpommern were somewhat less affected then the German average because of their lower export and industry shares. However, their manufacturing base, especially in shipbuilding, is under strong pressure. Companies in these states also tend to have a lower capital base than their peers in southern Germany, exposing them more to the credit squeeze.

The German government reacted quite strongly. In October 2008, a Fund for Stabilizing the Financial Markets was equipped with €480 billion to bail out failing banks and provide capital support to others. Altogether, the support for the financial sector accounted for more than €550 billion, most of which were guarantees. In February 2009, Hamburg and Schleswig-Holstein rescued HSH Nordbank through a capital injection of €3 billion with an additional €10 billion in credit guarantees. A first package of spending programs with a volume of €50 billion in credits and €20 billion in loan guarantees was launched already in November 2008. An important element of the German crisis response was the funding for publicly subsidized part-time scheme for employees. In early 2009, a second package with another €50 billion was presented. This included a continuation of the subsidy program for retiring old cars and a credit fund (Deutschland-Fond) for companies with viable business plans that were facing liquidity problems as a result of the crisis. The total amount of the fiscal stimulus was evaluated by the EU as 3.6% of GDP. The government deficit is going to reach roughly -3.9% of GDP in 2009, as a consequence of these spending programs, and of the deterioration of public finances which occurs automatically in downturns, As Finland, Germany is subject to the monetary policy set by the

Figure 11: Government debt outlook across the Baltic Sea Region



Source: EIU (2009)

State of the Region-Report 2009

European Central Bank (ECB), which had started to reduce interest rates and directly provide liquidity starting in late 2008.

The Northern German states are able to draw on the funds provided in the two spending programs, which included significant support for public efforts. Hamburg, for example, receives €230 million from the second program and added another €77 million from its own budget. Two-thirds of the funds will be used for investments in education and innovation, the rest for infrastructure spending. Schleswig-Holstein reports roughly €500 million additional or earlier spending between 2009 and 2011 due to the different federal and state programs. Mecklenburg-Vorpommern has launched a ten-point program to stabilize the economy in December 2008.

The outlook for the German economy remains subdued, although there has been some positive data more recently. The IMF continues to see, at best, zero growth in Germany in 2010, following a contraction of -5.6% in 2009. Much hinges on the development of exports and, related to this, employment. Exports are an area where most recently some dynamism is becoming visible, contributing to a positive GDP growth rate in the second quarter of 2009. If the combination of public spending and recovering exports comes early enough to avoid a huge rise in unemployment as short-term work schemes run out, Germany might be able to avoid a more extended downturn. It will, however, be faced with a difficult task of returning public finances back to a sustainable path. For 2010, the deficit is expected to reach -5.9% of GDP and the government debt level will rise above 80% of GDP.

The three Baltic countries shared a number of common features at the start of the crisis. All three experienced a dramatic drop from high growth rates to a contraction of the economy by more than 10% annually. Already prior to the outbreak of the global crisis, all three countries had started to feel the effects of a home-grown recession. Small currencies tied to the euro, a high current account deficit, and quick credit growth in the domestic economy made them especially vulnerable to the impact of the crisis. Also, all three have a banking system with a high presence of foreign-owned banks that were well capitalized and have, at least so far, kept the financial system intact. But while these features were quite similar, there was enough variation in policies for the crisis to have a significant country-specific outcome in terms of depth and timing.

Estonia, the smallest of the three Baltic economies, was the first to experience a slow-down in growth. By 2007, growth had dropped to 6.3% from more than 10% in the previous year. Credit growth had started to come down and the concerns about the real estate bubble were growing. Another important challenge was the fast wage growth that had led Estonia's unit cost position to deteriorate by 10% in 2007. Export growth slowed down and the current account deficit reached -18.1% of GDP. On the positive side, Estonia's government had run solid budget surpluses of between 2% and 4% of GDP since 2003. Estonia also had over the last few years been able to attract significantly more foreign direct investment relative to the size of its economy than its Baltic neighbors. Its currency board arrangement provided for a fixed exchange rate with the Euro and sheltered the currency largely against speculation, as the Central Bank's liabilities, including the entire monetary base, has to be covered by foreign reserves.

When the crisis hit, Estonia suffered from falling exports and the impact of tightening financial market conditions on local demand. Exports suffered from the deteriorating demand in key Estonian markets, especially in Europe, as well as the as the worsening cost position; unit labor costs had risen another 10% relative to the Euro-Zone in 2008. Even more dramatic was the tightening of the financial markets. At the end of 2007, 78% of loans in Estonia had been given in foreign currency. With the global financial crisis hitting the confidence in emerging markets generally, the capital for such loans was no longer available. While there was less pressure on the Estonian kroona compared to the Latvian currency, there were rising concerns about the need to follow a possible devaluation in Latvia to retain Estonia's price competitiveness against its neighbor. The banks giving credits in the region were already being penalized on the equity markets for their exposure to the Baltic economies, further reducing their willingness to extend new credit. As a consequence, manufacturing activity and construction dropped by about a third in annual terms in the first quarter of 2009. Unemployment doubled to 11% and wages dropped by about 10%, both significantly reducing domestic demand

and thus further exacerbating the crisis. Overall, GDP dropped by 15% in the first quarter, with early data from the second quarter suggesting that the reduction in GDP is slowing down.

Estonia had little room to mobilize public resources in response to the crisis. With its goal to reach Euro-membership as quickly as possible, the country is trying its best to stay within the limit of a government deficit not exceeding 3% of GDP. The Estonian government adopted emergency measures and approved spending decreases already in the middle of 2008. In the 2009 budget, spending was set to be decreased by 7% while revenues were expected to decrease by 10%. The parliament voted for tax increases and reduction in unemployment benefits to offset the lack of funds. In particular, the government raised fuel and tobacco excise taxes by 5% (effective July, 1, 2009 and January, 1, 2010 respectively). Unemployment insurance tax will be raised from 3% to 4.2% and previously planned increases in unemployment benefits were frozen until 2013. VAT is set to be raised from 18% to 20%. Under the currency board, the country's monetary base is fully backed by foreign-exchange reserves, which has exposed the Estonian kroon to less pressure than for other currencies in Central and Eastern Europe. Average short-term interest rate went up to 8.6%.

The outlook for Estonia remains difficult. In 2010, the reduction in GDP is expected to slow down to a rate between -1% and -3% of GDP, the best performance of the three Baltic countries. But unemployment is nevertheless projected to rise to more than 14%. The further fall in tax revenues will challenge the government's commitment to staying below the 3% deficit. Cuts made in 2009 have already cost the government its parliamentary majority. More cuts will be necessary to avoid the deficit rising to -3.9% as projected by the EIU.

Lithuania, the largest of the Baltic countries, seemed initially to be in a stronger position than its peers. With slightly lower GDP growth, a smaller current account deficit, and less rapid growth of real estate prices and unit labor costs, the country seemed less vulnerable. Like Estonia, Lithuania had adopted a currency board arrangement that provided some shelter against currency speculation. Lithuanian FDI inflows had been less biased towards real estate and financial institutions than in their neighboring countries. In part, this also reflected the stronger focus on industry in Lithuania, surpassed in the Baltic Sea Region only by Norway (where the oil and gas sector is subsumed under this heading), Russia (the same), and Finland. The state of public finances, however, was less remarkable. Lithuania had the highest debt level of the Baltic countries and had only barely balanced its budget in the years of strong economic growth.

When the crisis hit, Lithuania's slightly better position delayed the impact of the downturn but ultimately could not shelter the country from its consequences. The contraction in the real estate sector had a huge impact on GDP, with the construction sector being as large as in Estonia as a share of GDP and thus only slightly smaller than in Spain, Ireland, and Latvia. As capital inflows came to a halt at the end of 2008, credit growth in foreign currency became increasingly unavailable. In October 2008 a short-lived run on deposits reduced holdings in the banking sector by 6.5%. Export demand dropped by 26%. With economic sentiments quickly dropping, the industrial sector, larger in Lithuania than in most peer countries, slashed production at a dramatic rate. Private consumption, too, fell by more than 20%. Unemployment quickly started to soar and is expected to reach 16% in 2009. With the downturn, the share of non-performing loans is growing fast. After a drop by 10.6% in the first quarter – the smallest deterioration among the Baltic countries – second quarter GDP figures indicated a 22.4% drop in GDP compared to one year earlier.

Lithuania's policy response to the crisis focused on measures to ensure the functioning of the financial system and to manage the impact of the economic downturn on public balances. The Bank of Lithuania reduced banks' reserve requirements to ease liquidity pressures. The deposit insurance limit was raised to €100,000 to avoid further asset runs and the switch to holding foreign currency instead. The regulatory environment was improved through the Financial Stability Law providing additional tools for surveillance and crisis management. On the fiscal policy side, Lithuania had to manage a drop of tax revenues by 28% between May 2008 and May 2009. The current budget implements a fiscal adjustment of more than 7.5% of GDP through a combination of spending cuts and tax increases. Profit tax was raised from 15% to 20% and the VAT from 18% to 21%. Proposal for cutting wages in the public sector by 9.5% and maternity benefits by 50% are being discussed. Instead of applying for IMF assistance, the Lithuanian government raised capital by successfully launching a five-year €500 million Eurobond issue with a 9.375% interest rate.

The outlook for the Lithuanian economy remains challenging. For 2010, GDP growth is expected to remain negative, reducing the size of the economy by another -3% to -4.5%. Unemployment will in this projection rise further to 17%. This will put additional pressure on the government budget leading to rising debt levels; the budget deficit will delay Lithuania's entry into the Euro-Zone.

Latvia, the least prosperous of the Baltic countries, had registered the highest growth rate of all countries in the Baltic Sea Region in the recent past. It then saw its GDP shrink at the highest rate and has been locked into difficult negotiations with the IMF, the EU, and its Nordic neighbors to access international credits and avoid a forced devaluation of its currency.

Latvia had almost doubled prosperity levels since 2000, but in the process had accumulated huge imbalances in its economy. Capital inflows for quickly growing foreign currency loans to Latvian consumers and business financed a massive consumption and investment spree. Real estate prices exploded and the construction sector grew to the largest in any of the Baltic countries. Unemployment dropped to 6%, and much of the remaining unemployed were hard to integrate due to their lack of Latvian language skills. Migration of skilled young workers to other parts of the EU further increased skill shortages. Significant wage growth led to a deterioration of unit labor costs by 30% between 2005 and 2008 relative to the EU-15. With only moderate export growth, Latvia's current account deficit reached 22.4% of GDP in 2007. Government did little to rein in the overheating process. Wage growth in the public sector tended to accelerate rather than moderate wage pressure. Public spending, especially on wages, continued to outpace revenues, even at the time of high economic growth. The Central Bank had pegged the Latvian currency litas to the euro; given the inflation in the country, this led to significant real exchange rate appreciation as in the other Baltic currencies. While there was no legal statute for operating a currency board, the Central Bank kept enough foreign currency to match the monetary base.

When the crisis hit, the Latvian economy was attacked on multiple fronts. The real estate market collapsed in a process which had already been building up in the preceding months. Construction virtually stopped with a dramatic impact on GDP. Parex Bank, the main locally owned bank, ran into serious financial trouble. Exports started to weaken with the slowdown in the major European markets for Latvian goods. The worsening outlook shook the confidence of Latvian consumers and companies, leading to a fast drop in consumption and production. Private consumption declined by 17.4%. Manufacturing contracted by 25.8% in the first quarter of 2009. Construction growth fell by 28.2%. Imports contracted even faster than exports, and the current account deficit quickly started to disappear. Unemployment quickly rose and the government was faced with a dramatic fall in revenues. International financial markets took a generally much more skeptical view of the currencies in Central and Eastern Europe, putting pressure on Latvia to devalue. GDP fell by 4.6% in 2008, largely because of a disastrous fourth quarter, by 18% in the first and 19.6% in the second quarter of 2009.

The Latvian policy response was driven by the need to secure the country's financial system and stabilize the public sector budget. Beyond these immediate tasks, there was little room for maneuvering. In November 2008, the government assumed ownership of Parex Bank and provided more than €200 million in capital to secure the liquidity of the bank. As a consequence, the foreign reserves of the Bank of Latvia dropped below 100% of the monetary base, removing the appearance of a currency board. As tax revenues plunged, the government implemented painful spending cuts, including wage cuts for public employees. In early 2009 demonstrations against these cuts turned violent and ultimately the government left office. A new cabinet supported by the existing coalition assumed office in March 2009. Further spending cuts were negotiated with the EU, the IMF, and the Nordic countries in order to access a €7.5 billion credit package. In June 2009, the Latvian Parliament voted for a revised budget which encompassed further expenditure cuts by US$ 991 million. Public sector wages were first cut by 15% and then by another 20%. Pensions were decreased by 10%. The tax-free minimum monthly income was cut by almost 2.5 times (from LVL 90 (US$ 175) to LVL

35). The minimum wage was decreased from LVL 180 to LVL 140. As of February 2009, excise taxes on beer were raised by 50% and on spirits by 8%. Excise taxes on tobacco were also increased. Agreement with the EU was reached in June, followed by a principal agreement with the IMF a month later. Political pressure is again building against the government. With the IMF/EU/Nordics agreement in place, the chances to sustain the parity of the Latvian lat against the euro, a key pillar of the government's economic policy, have improved. Accession to the Euro-Zone will be delayed as the country has moved significantly beyond the 3% threshold for public sector deficits. With devaluation ruled out, Latvia has pursued a strategy of "internal devaluation", i.e. reduction of wages, to regain cost competitiveness. The public sector has moved ahead and private sector wages have followed as well.

The outlook for the Latvian economy remains precarious. GDP is expected to continue its fall in 2010, even though the drop in the second quarter of 2009 was less severe than analysts had expected. In 2010, unemployment is expected to reach 16%. From 2008 to 2009, private consumption growth will fall by 11%. The European Commission estimates that the Latvian government deficit will increase to 13.6% in 2010.

Over the last few years *Poland* has followed a different economic path than the other central and eastern European countries in the Region. Growth has been solid but lower than in neighboring countries. Polish growth rates peaked in 2007, somewhat later than in the Region overall, and the drop in 2009 is expected to be more modest than the regional average.

At the start of the global crisis, the Polish economy has been more domestically oriented, despite the role played by foreign direct investment. The export share of the economy was, at 42%, lower than in all other Baltic Sea Region countries except Iceland and Russia. Most Polish export went to the German market. Industry played a slightly larger role in the country's economy than in the Baltic Sea Region overall. Compared to other emerging economies in the Region, Poland had largely avoided the macroeconomic imbalances in the economy. The current account registered a deficit, but it had in 2008 only moved beyond -5% of GDP and was well covered by FDI inflows in manufacturing. The banking system was well capitalized and included many foreign-owned banks. Bank credits had started to grow only in 2006 at higher rates above 20% per year. About 26% of credits were denominated in foreign currency, less than half the rate of the neighbor-

The debate about devaluating the Lat

Devaluation is the standard remedy when countries build up huge current account deficits. It increases the ability to export and reduces imports by changing the relevant prices. The downside is the potential for immediate bankruptcies that follow when foreign debt becomes more costly in the local currency. Even in these situations, however, the argument is that the better opportunities for growth after devaluation will improve the ability of debtors to pay back (some) of their debt over time, while at the higher exchange rate their debt burden might be lower but their inability to repay chronic. The "ideal" solution in the eyes of many observers would be the fast adoption of the euro at a devalued exchange rate. But with EU countries unwilling to change the criteria for accepting a country to the Euro-Zone, this is ruled out as a short-term solution.

Given this scenario, the Latvian government decided to stick to the exchange rate. One main concern was that because of the high external debt, the impact on solvency would be much higher than in comparable cases, not only on companies but also on the many individuals that had used foreign currency credits to finance real estate. Politically even more important, devaluation was going to delay Latvia's entry into the Euro-Zone, an external anchor that had been a crucial element of the country's economic strategy. There was a concern that removing this central plank of Latvia's policy would create significant uncertainty about the policy path in other areas as well.

The government's strategy combined the commitment for exchange rate stability with internal austerity measures, including deep wage cuts. These wage cuts were supposed to achieve the increase in cost competitiveness and reduction in purchasing power that otherwise follow from devaluation, but without the immediate solvency effect on external debt. Politically, getting several groups in society to individually agree to wage cuts is much more complex than devaluation.

ing Baltic countries. Unemployment had dropped to 7.1% in 2008; this was still the highest rate in the region, but had been almost halved from two years earlier. Growth had picked up over recent years and with the remaining inflexibilities in the economy, bottlenecks started to appear, driving inflation up and leading to the fall in growth rates since 2007.

When the crisis hit, it exacerbated the domestic cooling that was already under way. The tighter conditions on international financial markets put pressure on the Polish currency and reduced credit growth in the Polish market as banks reassessed the economic outlook for the economy. From November 2008, Poland was among the EU countries suffering the highest reduction in loan growth, together with Sweden and the UK. The export market was affected as soon as the German economy began to lose traction. Exports are expected to drop by 16.8% this year. Economic sentiment held up longer than in other parts of the Region, but ultimately dropped as quickly, especially in the second half of 2008. Industry production contracted between February 2008 and February 2009 by -12.4%. Private sector gross fixed capital formation is expected to be 19% lower in 2009 than in the previous year. Private consumption is projected to fall by 4.7%. Unemployment increased to 8.9% in June 2009, 2%-points higher than a year before. As a result of these changes in the economic climate, the government deficit has been rising to -3.9% of GDP at the end of 2008, with a further deterioration to -6.6% of GDP in 2009 deemed likely. Total GDP is expected to fall by -0.4% in 2009, the lowest reduction in any European country.

The Polish government started to act already in 2008 when the domestic economy commenced its slowdown. The more expansionary fiscal policy stance was then further strengthened in the wake of the global crisis. The EU evaluates the overall discretionary stimulus at 2.8% of GDP, above the level of most other EU countries. The stimulus to support investments equals 1.2% of GDP, with the vast majority of the spending dedicated to physical infrastructure improvements. Support to households was the other main element of the spending plan. The Central Bank started to ease interest rates in November 2008, when a drop in global inflation and easing by the ECB created room to act. Since then, interest rates were cut by a total of 250 basis points between November 2008 and June 2009 to an all-time low of 3.5%. The Polish zloty initially devalued against both the euro and the US dollar but has regained ground in recent months. The Polish government announced its intention to join the Euro-Zone by 2012. Many observers see this target date as optimistic and expect Poland to join instead between 2013 and 2015 at the earliest.

Compared to other countries in the Baltic Sea Region, Poland's economic outlook appears relatively benign. GDP growth is currently expected to reach 0.6% in 2010. Unemployment is predicted to rise to 12% and the government budget deficit might reach -7.3% of GDP. Poland faces stagnation and a difficult task of managing the sustainability of its public finances. But with a public debt still expected to remain below the Euro-Zone entry criteria of 60% of GDP, the country's situation is better than that in many of its neighboring countries.

Finally, *Russia,* which has registered strong growth over the last few years, had experienced an improving macroeconomic policy situation, but had also become increasingly more dependent on oil and gas as the prices for energy sky-rocketed. The combined impact of falling energy prices and a reversal of capital inflows now resulted into a significant drop in GDP.

Russia had experienced a decade of uninterrupted growth since the 1998 crisis, and had seen prosperity levels almost double. The massive inflows from oil and gas exports, driven almost entirely by growing energy prices rather than an increase in production or export volumes, had been used to build up significant foreign exchange reserves. Fiscal policy had been significantly improved, with much of the oil revenues saved in a Stabilization Fund and government debt almost completely paid. The financial system had been significantly improved, but remained still much less developed than in advanced economies. Credit as a share of GDP had gone up from 9% in 2000 to 40% in 2008, with roughly a quarter in foreign currency. Loans were at 160% of deposits, more than double the rate compared to 1998. Government-owned Sberbank dominated retail banking, while otherwise the market was highly fragmented with many banks closely related to companies or industrial groups. The stock market was highly dependent on foreign investors. Main domestic companies had used the easy financial market conditions to raise significant credit and increase their leverage; some had also tapped into equity markets abroad, especially the UK. By the third quarter of 2008, private sector external debt was US$ 500 billion. Against this backdrop the economy started to overheat, with real estate prices exploding, especially in Moscow and St. Petersburg, and unemployment dropping to 6.1% in 2007. Inflation remained high, also as a result of the Russian Central Bank's management of capital inflows. The current account surplus started to drop in 2007 as soaring import demand outpaced exports of energy and other raw materials.

When the crisis hit, Russian policy makers initially saw this as a confirmation of the weaknesses in the US economy compared to their own growth model. Once the oil price started to drop, however, Russia was also drawn into the crisis. Further driven by the political turmoil surrounding the Georgia crisis in the summer of 2008, Russia started to experience significant capital outflows and the stock market lost a huge share of its value. International reserves dropped by a third in the second half of 2008, but have stabilized since then. At the bottom, stock market prices were down by 75% in local currency. The Russian rouble, previously under significant pressure to appreciate, started to slide. This hurt foreign investors but it soon become clear that the radical in global financial market conditions also had a profound impact on Russian companies. Many of them found it difficult to refinance their loans and had to shed assets or ask the government for help. Industrial production fell by 24% in the first quarter of 2009 as both domestic demand and global demand for energy-based industrial products weakened. Real GDP dropped by 7.5% in the fourth quarter of 2008 and 9.8% in the first quarter of 2009. The north-western Russian region with its relatively strong industrial base was hit hard. Unemployment started to grow quickly and reached 10.2% in May 2009. Given the large numbers of one-company towns in Russia, the social impact of companies being unable to pay wages was felt particularly keenly across many Russian regions.

Once the Russian government acknowledged the presence of the crisis, it launched significant actions, drawing on the solid fiscal cushion that it had accumulated during the recent growth period. According to the EBRD, the overall discretionary stimulus package totaled 4.1% of GDP. An initial spending program was launched in the last quarter of 2008 but then there was no additional stimulus in early 2009. As the economy started to deteriorate during this period, a second stimulus package was then launched in April 2009. Stimulus funds accounting for 2% of GDP was directed for social spending programs, 1.3% of GDP for support to individual companies and industries, and 0.8% of GDP for bank recapitalization. In general the government tried to avoid direct bailouts for private companies. They tried to provide support through loan packages and pressured the banking system, including the state-owned banks, to provide financing. Only a few firms received state aid with debt repayments. As a consequence of the spending program, the budget deficit is forecasted to reach 7.4% of GDP. Since March 2009, the Stabilization Fund has been tapped into to finance some of the spending. More recently there were discussions as to whether Russia needed to embark on further aggressive spending plans or start rolling back such efforts to sustain the long-term sustainability of its public finances. So far, the latter view seems to have dominated government action. The Russian Central Bank aimed to avoid large, uncontrolled devaluation, and intervened heavily to manage the rouble's decline between August 2008 and early 2009. In 2009, the focus shifted on easing monetary conditions to fight the recession. The interest rate was cut by a total of 150 basis points since April of this year. The Central Bank and the Ministry of Finance also announced about €100 billion capital support for the financial system through a number of different programs; by July 2009 roughly 60% of this amount had been used. A significant factor for the overall financial health of the Russian economy has been the dramatic rise in the oil price which has come back to about $75 per barrel from a low of $30 in early 2009.

The outlook of the Russian economy remains uncertain. The real economy is likely to bounce back somewhat during 2010. But it remains unclear how the financial system will weather an increase in non-performing loans, which so far remain at a manageable level. A key factor is the future path of the oil price which in turn depends significantly on the pace of recovery in key global markets in the US, Asia, and Europe. The reduction of the fiscal policy stimulus will reduce growth, although some of the spending from the program launched this April is likely to occur only next year.

Assessment

Four main observations stick out from this discussion of the macroeconomic context in the Baltic Sea Region and its different countries. Together they provide a quite challenging context for efforts to deepen regional collaboration.

First, overall the Region has clearly been hit hard and the repercussions of the crisis are keeping governments fully occupied on the national level. And the response has been stronger than in other EU countries, also because of the better initial fiscal position of the Region overall that created room for action. In this situation, regional collaboration among neighbors is pushed lower down the priority list of government leaders. National efforts, as well as macroeconomic coordination and discussions about international regulatory changes, are at the moment the more critical policy arenas. For the mostly small Baltic Sea Region countries, the EU has also gained some traction because it is the main channel through which they can influence international discussion on crisis management. Regional collaboration remains part of the agenda, as seen by the financial support packages of the Nordic countries for Iceland and Latvia. But the reality is that the most effective tools to deal with the current economic challenges do not come from the regional level.

Second, the crisis raises serious questions about the economic development model that the Baltic Sea Region has been following in the past. Countries that had grown the fastest are now contracting the quickest. The Baltic tigers and Iceland, countries the Region liked to showcase as models of its dynamism, are now seen as the symbol of overreach brought down by the crisis. The solid current account surplus of the Region overall and the clear export-orientation of almost all of its economies is characterized by some observers as a model that needs to be reformed to create a more stable and balanced global economy. While some or even all of these questions might have a satisfactory answer that does not require a fundamental change of the Region's direction, it will be important to thoroughly address them.

Third, at the same time the Region, especially the Nordic countries, are again viewed with much interest as economies around the world look for more robust approaches to economic management. Strong fiscal policies, but also the elements of the welfare system that enable economies to deal with a crisis in a way that does not undermine the prospects for long-term prosperity, are seen as important cases for other countries to study. This is an opportunity to have a global impact on the policy debate. But given the clear focus on the Nordic countries rather than the Region as a whole, this interest could internally decrease the push towards integration.

Fourth, and maybe most importantly, the crisis has accentuated the differences across the Region. In terms of outcomes, the Nordics (with the exception of Iceland), Poland, and maybe even Germany will get through the crisis relatively unscathed while the Baltics, Iceland, and to a fair degree also Russia are hard hit. While in the first group the policy agenda could return to normal relatively quickly, the second group will have to deal with the fall-out from the crisis for a much longer time. In terms of policies, the differences in initial conditions left countries with different challenges but also quite different opportunities for a policy response. Most of the Nordic countries, Germany, Poland, and Russia had the resources to engage in a significant stimulus effort, while the Baltics and Iceland struggle to manage the public sector balance, in some cases with the help of foreign institutions. Also in terms of how the public perceives the economic outlook, the role of different policy arenas, and the role of important tools like membership in the Euro-Zone, the differences have widened. The population in the Nordics and Germany sees a lower impact on their personal economic situation and has a higher share of people that believe the worst to be over, while the sentiment in the Baltic countries is exactly the opposite. The citizens of the Nordic countries and Germany see the G8 or the US (and the Finns, also the IMF) as the most important actors in solving the crisis, while the population in Poland and the Baltics sees a more central role for the EU. A relative majority of Germans and Finns feel better protected because of the euro, while a majority of people in countries outside the Euro-Zone (except in Poland) feel better off outside it. All of this will make it harder for the Region to find common ground in developing a joint agenda for deeper regional collaboration and integration.

- **The level of regional collaboration efforts remains high, with no visible impact yet of the economic crisis**
- **Innovation and environment issues are a key concern across many of the activities**
- **The EU Baltic Sea Region Strategy has emerged as an implicit coordination mechanism but there are still no formal structures to align activities**

2. Cross-national cooperation in the Baltic Sea Region

When short-term macroeconomic or political conditions reduce the interest in cross-national collaboration across a region of neighboring countries, established networks and organizations are crucial for retaining the institutional fabric for dialogue and future joint action. Last year's State of the Region-Report discussed how the structures for collaboration in the Baltic Sea Region have developed over time. For some of the main organizations in the Region, it also provided an overview about their activities. This part of the 2009 Report will build on this tradition and give an update on activities that have been pursued by regional organizations over the last 12 months. The EU Baltic Sea Region strategy, a critical element of collaboration in which all of the regional organizations were involved one way or another deserves to be treated in more detail. It will be discussed in Section C of this Report.

The **Council of the Baltic Sea States** (CBSS; www.cbss.org) is the forum for intergovernmental collaboration between the eleven countries of the Baltic Sea Region as well as the European Commission. Its work is organized around the five main areas of the environment, economic development, energy, education and culture, and civil security. From July 2008 to June 2009 Denmark held the Presidency of the CBSS, before handing over to Lithuania for the following twelve months.

A key theme of the CBSS work over the last year has been the reform of the organization in accordance with the Reform Declaration made by the Baltic Sea States Summit in June 2008. Two key elements of the declarations were the decision to discontinue the permanent working structures and to establish expert groups with concrete mandate and timeframe in order to develop a new approach for the more efficient management of projects.

In the area of economic development, the decision was accordingly made to move to time-limited expert groups on specific topics introduced by CBSS member states. The first such group on Maritime Policy, proposed by Germany, was officially instituted in June 2009. Expert groups on labor markets and integration (proposed by Finland), maritime industries (Germany), technology transfer facilitation (Lithuania), small and medium sized family business (Poland), and economic development (Russia) are under discussion. The new expert groups are expected to deliver concrete results, including new projects in the given areas of cooperation.

An example of the new structure for project management was the renewed funding for the CBSS EuroFaculty. Other projects are under way or in preparation. The Baltic Sea Labour Network (BSLN) is a project on interregional labor market policy, where the CBSS works with the social partners, i.e. Trade Unions and employer's organizations in the Region. Creative Across Borders (CAB) is a project on the development of creative industries in cross-border regions.

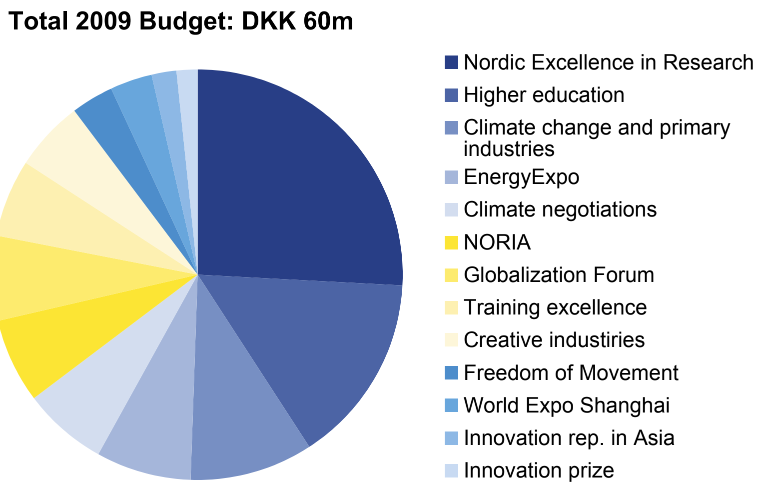
The **Nordic Council of Ministers** (NCM; www.norden.org) is the platform for intergovernmental cooperation between the Nordic countries. NCM has a broad range of activities within 11 different Minsterial Councils. Traditionally, the areas of Education & Research, Culture, and Innovation cover over half of the total budget. Over the last few years, collaboration on competitiveness issues, in particular research and innovation, has become an ever more prominent part of the agenda.

Following a decision by the Nordic Prime Ministers in June 2007, the NCM has launched a new Nordic cooperation effort to meet the challenges and opportunities of globalization. The second *Nordic Globalization Forum*, held in February 2009 in Iceland, discussed these issues, focusing particularly on the impact of the global crisis on small economies and on the challenges of climate change. The *Nordic Globalization Barometer* and a report on *Nordic Innovation Monitor* provided data and analysis on the competitive position of the Nordic countries in the global economy. Fourteen specific initiatives have been launched since 2007 in the context of this work, supported by an annual budget of DKK 60 million.

The largest share of the budget is devoted to joint initiatives in the area of research and innovation. The *Nordic Excellence in Research Initiative* (ERI) Program for the period 2009 – 2013 was launched in October 2008. With total public funding of more than €45 million from national sources as well as the NCM it includes thematic sub-programs on the effects of and adaptation to climate change, the interaction of climate change with ice, snow and glaciers, nanotechnology and energy efficiency, integration of large-scale wind power, sustainable bioenergy and carbon capture and storage (CCS). Policy discussions have been initiated to further develop the Nordic research and innovation area (NORIA) as part of the European Research Area. Efforts are under way to better coordinate the *representation of Nordic innovation in Asia*. There were also plans to launch a new *Nordic Innovation Prize* but parliamentarians in the Nordic Council voted down the proposal, arguing that it would undermine the weight of existing prizes.

Energy, the environment, and climate change are a second key area of the initiative. The conference *Nordic Climate Solutions*, held for the second time in September 2009, provides an opportunity for businesses, researchers, and government representatives to gain insights into the market potential for environmental products and services

Figure 12: Nordic Council of Ministers Globalization Initiatives



Source: NCM (2009)

State of the Region-Report 2009

and provide input to the Copenhagen UN Climate Summit (COP15) in December. The Nordic countries have initiated a *COP15 working group* to coordinate their input for the Climate Summit. Another project aims to document the *impact of climate change on primary industries*, e.g. agriculture and fishing, in the Nordic countries.

Other efforts focus on better collaboration in the area of *higher education*, enhancing the *freedom of movement* in the Nordic region, strengthening the development of *creative industries* in the region (KreaNord), and further harmonizing the *Nordic electricity market*.

While the NCM focuses on collaboration among the Nordic countries, it works very actively with its neighbors in the Baltic Sea Region. New guidelines for the co-operation with the Baltic countries and with North-West Russia identify priority areas for collaboration over the next five years. Education, research, and innovation are one major area for potential collaboration, with environment, climate, and energy issues forming a second one. The NCM has also been very actively engaged in the discussions on the EU Baltic Sea Region strategy. It provided detailed input to the strategy, including a list of specific proposals for activities in all of its areas. Existing Nordic institutions and programs were identified as potential partners for achieving the goals that the EU Baltic Sea Region strategy outlines.

VASAB (www.vasab.org), is a platform for collaboration among the ministries across the Baltic Sea Region involved in spatial planning and development. Lithuania has been chairing VASAB from July 2009. The main priority of VASAB in the recent past has been the consultation process discussing the *Long-Term Perspectives for the Territorial Development of the Baltic Sea Region*. This document has been discussed at a number of meetings and will be the main focus of the conference of BSR ministers responsible for spatial planning and development in Vilnius in October. This meeting will mark the 15th anniversary of the foundation of VASAB and is the 7th Ministerial Conference for spatial planning and development.

Turning to regional and local levels of government, the **Baltic Sea States Subregional Co-operation** (BSSSC; www.bsssc.com) is a political network for decentralized authorities (sub-regions) in the Baltic Sea Region. Acting as a regional partner to the Council of the Baltic Sea States (CBSS), BSSSC promotes and advocates the interests of the sub-regions of the Region to national governments and EU institutions. In early 2009, the Free and Hanseatic City of Hamburg took over the Chairmanship of BSSSC from the Eastern Norway County Network. For the coming two years, BSSSC has prioritized five action areas:

In *maritime policy*, BSSSC will continue its commitment for the implementation of the European maritime policy to make the Baltic Sea Region Europe's maritime best practice region by 2015. The European Commission took up the idea of turning the Baltic Sea into a model region for clean shipping that was developed in the BSSSC Working Group Maritime Policy. BSSSC will support projects of an integrated maritime policy to mitigate the environmental effects of maritime activities in the region. For example, it will initiate the introduction of land-based power supply for ships in ports across the Region and the introduction of environmentally differentiated fair-way and/or harbor dues to promote the use of low-sulphur fuels. BSSSC aims to become a Lead Partner in two flagship projects in the fields of clean shipping and transport.

In the area of *climate change and sustainable development*, BSSSC will focus on how regions can cope with the challenge of climate change at its Annual Conference in October 2009 in Zealand, Denmark. It will develop a special regional input to the UN Summit on Climate Change in Copenhagen (COP 15) in December this year. BSSSC will support the implementation of the HELCOM Baltic Sea Action Plan in collaboration with other partners like Baltic 21.

In the area of *transport and infrastructure*, BSSSC aims to open up the transport potential of linking the Baltic Countries, Kaliningrad Oblast, and Poland with Belarus, Western Russia, and the Northern Ukraine. In cooperation with transport ministries, port and customs authorities, and transportation and logistics providers, the initiative will organize an exchange of best practices. BSSSC will continue to support "TransBaltic – Towards an integrated transport system in the

Baltic Sea Region" as a flagship-project in the framework of the EU Baltic Sea Strategy.

In *youth policy*, a traditional focus area of BSSSC, successful youth conferences were organized in Hamburg in February 2009 (on the EU Baltic Sea Strategy) and in Copenhagen in May (on youth empowerment). A youth conference on youth participation and sustainable lifestyles will follow in Region Zealand, Denmark in October this year.

In *science and education*, BSSSC will support all efforts to strengthen European research within the Region by supporting cross-border co-operation. Academic co-operation, e.g. the exchange of students as well as scientists, will be strengthened by promoting the European instruments for funding. BSSSC will support co-operation in primary and secondary education and – within the EU Comenius Regio program - the exchange of experiences in school management and organization.

Other focal points of BSSSC's work in the next two years will be the promotion of intensified co-operation with Russia, better use of EU programs for projects in the Region, public health and quality of life with a working group on communicable diseases and antibiotic resistance, as well as the continued co-operation in the Baltic Sea Strategy of the EU.

The **Union of Baltic Cities** (UBC; www.ubc.net) is a network of over 100 cities that collaborate on a wide-range of political, economic, social, cultural, and environmental issues. UBC promotes the exchange of know-how and experiences between the cities through seminars, courses, and publications. Its many projects are carried out through 13 different Working Commissions.

The *dialogue with the European Commission* about the EU Baltic Sea Region Strategy has been an important focus of UBC activities over the last 12 months. UBC has provided input both alone and with other partners in the Region on virtually all dimensions of the strategy. The EU Maritime Policy and its policies for Sustainable Development were two of the areas in which UBC contributed specific position papers. The upcoming X.UBC General Conference in Kristiansand in September 2009 will also be dominated by the discussions about the strategy and its implementation.

A policy area of particular relevance to UBC is *city management and planning*. Among the recent and on-going activities in this area was the seminar "Baltic Towers" on the role of high-rise building in city planning. "Citizen 2.0+ is a project that will focus on how social media tools can be used by local and regional administrations in their interaction with citizens. Other efforts included work on an integrated management system for Russian cities and several seminars for civil servants.

Another priority area is *sustainable development* and the management of climate change. CHAMP-Local Response to Climate Change is a three-year project to develop and implement integrated management system (IMS) as tools to respond to the local challenges of climate change effects. UBC is also currently running a competition for The Best Environmental Practice in Baltic Cities. One city will be given the award to showcase successful approaches to sustainable development.

UBC is also engaged in wide range of *cultural activities*. Projects include a Catalogue of Cultural Institutions, "Different History – Common Future!", a project targeted at youth as a resource for a sustainable future in the Baltic Sea Region, sport competitions for the youth and disabled, as well as many art exhibitions and music festivals. The 2009 UBC Cultural Prize is running under the theme of "Creative Use of Information Technology 2009".

The **Baltic Metropoles Network** (BaltMet; www.baltmet.org) represents eleven capitals and large metropolitan cities from around the Baltic Sea Region. Since October 2008, the Chairmanship of the Network rests with the City of Stockholm. The main goal of the network is to promote innovativeness and competitiveness in the Baltic Sea Region by engaging cities, as well as academic and business partners, into close cooperation. BaltMet explicitly welcomed the EU Strategy for the Baltic Sea Region as an important platform for future activities, and wishes to contribute to the policy co-ordination and project implementation with a strong urban dimension.

BaltMet's current project portfolio is supported by a total budget of 10 million euros. Taking into account the various project initiatives in the pipeline, the budget is expected to more than double over time. BaltMet's Action Plan for the 2008 to 2010 period identifies activities in four main areas, with different cities taking responsibility for the implementation of projects.

In the area of *innovation promotion*, three main projects are under way. BaSIC (Innovation network centres) and Josefin (SME Innovation Finance), coordinated by Berlin, focus on policy tools to support cluster development and science-based entrepreneurship. Creative Metropoles, led by Riga, focuses specifically on the development of creative industries in the Region. Another project on the use of public procurement to support innovative products and services is currently developed with coordination from Helsinki.

For *regional identity building and marketing*, a project called BaltMet Promo, an effort to promote the Region from a metropolitan perspective, is currently being developed in coordination of Helsinki. Several BaltMet cities have participated in the Balticness project of the Latvian CBSS Presidency (2007-2008) with the purpose of visualising the Baltic Sea identity.

A number of efforts are under way for *infrastructure and sustainable development*. Helsinki is coordinating project submissions for Rail Baltica corridor development. An initial seminar on sustainable city development was organized by Stockholm in October 2008 with a series of further workshops planned.

Common learning and the exchange of best practices are the focus of the activities for the *integration and capitalization of urban expertise*. BaltMet InfoForums were organized in Oslo, Riga, and Helsinki on the development of information/communication services. A seminar was organized in Riga on private sector involvement in municipal education infrastructure, with future study trips in the Region planned. The proposal for a project on cooperation in urban festivals has been prepared. A project on the management of health care in metropolitan areas is under consideration.

Among private or public-private organizations, **ScanBalt** (www.scanbalt.org) is probably the best example of a bottom-up Baltic Sea Region network of clusters, companies, research institutions, public authorities and other organizations in a specific field. The organization's strategy "Innovation on Top of Europe 2008-2011" focuses on three activity areas to promote the development of ScanBalt BioRegion as a globally competitive meta-region. Under the theme Project Incubator and Excellence, ScanBalt supports research and innovation management, works for coherence of regional policies for research, education and innovation, and aims to improve access to talents in the Region. Within Communication and Marketing, ScanBalt is aiming to strengthen strategic communication, promote the branding of ScanBalt BioRegion, and strengthen the dialogue on ethical and sustainability aspects of biotech. Member Services and Organizational Development are a third priority, with the development and promotion of shared services for clusters and networks, the provision of key benchmarking data, and the further development of network services for all stakeholders.

A key ongoing ScanBalt project is *Bridge-BSR (EU FP 7)*, an effort to strengthen cluster development in life sciences across the Region. The project aims to identify regional bottlenecks in the ScanBalt BioRegion for bringing the benefits of academic research to SMEs, to develop a regional innovation agenda, to promote mentoring, to use best practices and benchmarks, to prepare an innovation agenda to remove bottlenecks, and to initiate pilot activities. In June 2009 the project released a set of recommendations on "Smart Growth: Bridging Academia and SMEs in the Baltic Sea Region". A key recommendation is the establishment of modular shared business and support services between clusters in order to promote the development of high growth SMEs, a recommendation ScanBalt and the members have started to implement. Another key recommendation is the establishment of a Baltic Sea Region Fund for Innovation, Research and Education, which ScanBalt sees as a necessity for an ambitious development of the Region.

A task force was formed between Lithuanian and German public authorities and ScanBalt in August 2009 in order to initiate the EU Flagship project "health region" proposed in the EU Baltic Sea Region strategy. The recommendations from "Smart Growth: Bridging Academia and SMEs in the Baltic Sea Region" will be an important tool box for "health region".

Fostering collaboration across the Region, attracting talent to the Region, and providing integrated education and training are constant themes for ScanBalt. The *ScanBalt Bridge Award*, granted by the ScanBalt Academy and the Royal Physiographic Society in Lund together with Greifswald University and Lund University, will showcase positive examples of research collaboration across the Baltic Sea Region. The *NovoNordisk Scandinavian Return Fellowships* already provides funding for researchers with roots in the Region currently living and working elsewhere in the world to return to the Baltic Sea. The *Nordic-Baltic Expats Forum* continues to be used as a tool to attract talent to the Region. ScanBalt Academy, too, continues to develop summer schools throughout the Region and works to enhance collaborations with Russia based on the Northern Dimension Plan.

The 8th ScanBalt Forum will be held in Kalmar, Sweden, on October 7- 9, 2009. The theme of the ScanBalt Forum *"Restoration of the Baltic Sea; Limitations and possibilities"* will for the first time be in the area of environmental science. ScanBalt Academy is organizing a half-day session on the subject *"Ecology of the Baltic Sea"*.

The **Baltic Chamber of Commerce Association** (BCCA) is an organization of altogether 50 Chambers of Commerce across the Baltic Sea Region. Since 2002 the Presidency and General Secretariat of the BCCA has been with the Chamber of Commerce and Industry of Southern Sweden in Malmö. Its main task is to give the business community of the region a common voice for common concerns.

In 2008 and 2009, BCCA has focused much of its attention on the *EU Baltic Sea Region strategy*. The BCCA believes that trade is a driver of innovation and prosperity and that trade facilitation is a key for success in other areas. Building on the organization's long-held vision to triple trade in ten years (3T), BCCA has put particular focus on seamless cross-border trade within the service sector. It has also encouraged the further promotion of integrated programs for education and research as part of the EU Baltic Sea Region strategy.

In the longer term, BCCA is pushing for policies to leverage a number of key infrastructure investments that are under way. The European Spallation Source research centre will provide the opportunity for the Region to take the lead in green material research. The fixed Fehmarn Belt will rewrite the economic geography in the southwest of the region. For both of these investments to truly pay off, BCCA sees a more integrated market for goods, services, capital, and labor across the Region as a key necessity.

The **Baltic Sea Trade Union Network** (BASTUN; www.bastun.nu) is a network of trade union confederations across the Baltic Sea Region. It provides a platform for joint discussions and projects, and represents the views of its members in regional organizations like the CBSS. Since July 2009 the Lithuanian trade unions are chairing BASTUN for the coming year.

As many for many other organizations in the Region, an important focus over the last twelve months has been the provision of input to the *EU Baltic Sea Region strategy*, where BASTUN submitted its own position paper. A particularly important topic for BASTUN has been labor mobility in the Region. In November 2008, BASTUN organized a conference discussing this topic. Mobility was generally seen as positive but the conference highlighted several challenges that it raises.

The economic crisis has dramatic repercussions on the labor market. Together with employer associations and government bodies, BASTUN is launching a Baltic Sea Labour Network (BSLN) Project under the INTERREG IVB Baltic Sea Region Program. The objective of the project is to enhance knowledge and to promote research on the differences and dynamics across labor markets in the Region. BSLN has been identified as one of the flagship projects under the EU Baltic Sea Region strategy.

BASTUN is currently preparing a Trade Union Baltic Sea Strategy 2020. A high-level meeting will be organized in cooperation with the Council of Nordic Trade Unions (NFS) in late 2009 in Lithuania.

The **Baltic Development Forum** (BDF; www.bdforum.org) is an independent networking organisation for businesses, governments, regional organizations, academia, and media to discuss and collaborate on issues of regional importance.

Baltic Development Forum

sustainable growth · innovation · competitiveness

A key priority of BDF in 2008/2009 has been the provision of input to the *EU Baltic Sea Region strategy* process. The strategy has been a key topic of the BDF Summit in the Öresund region last year and will also be central to this year's Summit in Stockholm. Among many individual meetings and coordination activities focused on the strategy over the last year, BDF co-organized a conference in Warsaw on 3 June 2009 entitled "Building Partnership for Entrepreneurship, Innovation and Competitiveness". The event was held jointly with demosEUROPA - Centre for European Strategy, the Swedish Embassy in Warsaw, the Office of the Committee for European Integration, and the Scandinavian-Polish Chamber of Commerce. Collaborating with the Foreign Ministry of Denmark, the EU Commission in Denmark and Danish regions, BDF co-hosted a seminar on the strategy for interested Danish representatives on 1 September 2009 in Copenhagen. Together with BSSSC, B7 Baltic Sea Islands Network, Euroregion Baltic, CPMR - Baltic Sea Commission, and UBC – Union of Baltic Cities, BDF proposed to the European Commission that the consortium play a leading role in two projects within the strategy related to clean water and green energy. BDF has also offered to make the BDF Summit a yearly venue for stakeholders to review and discuss the progress made in implementing the strategy.

Another priority area of BDF has been *energy cooperation* in the Baltic Sea Region, a topic that was discussed in some detail in last year's State of the Region Report. An important instrument for mobilizing different stakeholders has been an on-going study on enhanced regional energy cooperation that will be presented at the BDF Summit in Stockholm. In February 2009, BDF held a breakfast meeting with the European Commissioner for Energy Andris Piebalgs in connection with the Baltic Sea Region Energy Cooperation (BASREC) Energy Ministers conference. During the Council of the Baltic Sea States (CBSS) Ministerial meeting in Elsinore, Denmark, BDF organized a high-level seminar on energy and climate in June 2009. Also in June BDF co-organized a workshop on energy "Energizing Sustainable Growth" in Kaliningrad to strengthen the dialogue with Russian partners on federal and regional levels as a basis for closer cooperation within the climate and energy agenda in the Baltic Sea Region.

Different questions related to *competitiveness* and *environmental technologies* have always been central for BDF. Together with VINNOVA, the Swedish innovation agency, BDF will assist the preparation of the flagship project on cross-border innovation that is included in the EU strategy. Together with partners, interviews were carried out with representatives of the business community and stakeholders in order to explore the interests and views on the Fifth Freedom and the creation of a Northern European Knowledge Market. BDF has invited concerned members and partners to participate in creating a regional business platform for clean water solutions for the Baltic Sea. An informal round table discussion with the Swedish Minister of the Environment Andreas Carlgren was held in Copenhagen in April 2009.

Together with Russian and Finnish partners, BDF is promoting new initiatives for increasing cooperation and dialogue with *Russia* in the Baltic Sea Region. It is connected to the Northern Dimension Business Council that is being established. BDF has offered to play a role in organizing Forum meetings between regional business representatives and Russian partners.

Assessment

Cross-border collaboration in the Baltic Sea Region continues, pretty much following the broad directions already described in last year's Report. At least so far the dramatic changes in the economic environment have not resulted in any meaningful change in the direction or level of activity. This might change as the pressure on public finances increases and governments will take a new look at the spending and activity priorities of governments across the Region. But so far there is no indication that such a review would result in a radical shift in policies towards regional integration, even though its importance relative to other policy levels might be modified somewhat.

There are a number of reasons of why a dense network of regional collaboration efforts is highly likely to remain an important aspect of the Baltic Sea Region. Looking at the topics being pursued by the different organizations, it is hard not to be struck both by their similarity and by their alignment with what is generally perceived to be central issues for this Region. The broad themes of innovation and environmental sustainability underpin many of the regional activities and are clearly issues generally associated with what this Region stands for. Looking at the way in which activities are being pursued, the trend of the recent past to better coordinate activities and truly collaborate between organizations has continued. All of this has happened without the existence of a central structure with the mandate to set an overarching strategy or coordinate individual activities.

The positive changes in the way regional collaboration is taking place in the Baltic Sea Region occurred without fundamental changes to the existing institutional architecture. This architecture has grown over the last few decades, especially since 1990. It is public sector-heavy and lacks an effective organized voice for the private sector in the Region. This was not so much a concern when many of the cross-regional institutions were founded. At that time, security and institution building was the priority and this could done well by public bodies, sometimes supported by NGOs. It is a serious concern now, when economic development and the interplay between environment and the economy has become much more central.

- **Political conditions in the Region are stable; no new problems have emerged that would fundamentally undermine collaboration in the Region**
- **Existing challenges with regards to the EU integration process and in the relations to Russia are not solved but are less of an immediate concern than last year**

3. Political context

The political context for collaboration in the Baltic Sea Region has changed relatively little over the course of the last twelve months.

The *European Union* remains in the middle of a constitutional debate about the Lisbon treaty. Elections to the European parliament led to a modest shift to the center-right but are unlikely to dramatically change the course of European policies. A second term for EU Commission President Barroso, almost assured after his endorsement by the European Council, will also work towards continuity. The Swedish EU Presidency will naturally increase the focus on the level of regional collaboration achieved in the Baltic Sea Region. But as any other Presidency, Sweden needs to keep a balance between pursuing issues that are of broader interest to the entire EU, and pushing topics in which Sweden itself has a strong interest. The Swedish government has highlighted the reaction to the current economic crisis and the challenges of climate change as the key priorities of its Presidency. The EU Baltic Sea Strategy is then mentioned on the next level of "other prioritized issues", together with the EU's enlargement and global role, the EU's constitution, and further deepening of EU collaboration in the area of justice and home affairs.

Relations between EU members, including those in the Baltic Sea Region, and *Russia* are on a slow recovery path, although the different assessments of last year's events in Georgia remain evident. The renewed Northern Dimension Policy, launched in 2006, provides a framework for collaboration between the EU, Russia, Norway, and Iceland that has been accepted by all four parties; particularly for Russia this is seen as a significant improvement. Project implementation under the umbrella of the Northern Dimension Policy is organized within thematic partnerships. In October 2008, the decision was taken to create a third such partnership in the area of Transport and Logistics. The aim is to make this partnership operational by early 2010.

National political conditions have little visible effect on Baltic Sea Region integration. Governments in Iceland and Latvia became victims of the global economic crisis but in both cases the crisis increased rather than decreased the interest in collaboration with partners in the Region. Elections in Germany (nationally as well as in the state of Schleswig-Holstein) and Norway will dominate the political discourse in these countries, but the issue of Baltic Sea Region cooperation is not high on the agenda of debated topics.

- **The crisis has shifted the focus to policies controlled at the national level and led to a divergence of needs and perceptions across the Region**
- **Regional collaboration has not lost any of its value, but is becoming structurally harder to pursue**

4. Implications for Baltic Sea Region collaboration

The dramatic change in the macroeconomic environment has created a radically new environment for collaboration across the Baltic Sea Region. The traditional objectives for regional collaboration have not disappeared. But the crisis has pushed other policy priorities to the forefront, for which regional collaboration is not the most effective solution. And the different ways in which the crisis has affected countries across the Region might have reduced the common ground necessary for effective collaboration.

The Baltic Sea Region is not at the appropriate policy level to react to the current crisis. Macroeconomic stimulus packages are defined and implemented at the national level and, hopefully, coordinated internationally. Rescue packages and regulatory reforms for the financial sector, too, are a mix of national efforts and international coordination. International collaboration in both cases happens at the global, or at least European, level. There is no particular advantage of pursuing these efforts at the level of the Baltic Sea Region, which is too small to play the role of effective international coordinator. This does not rule out that neighbors within the Baltic Sea Region closely collaborate in the crisis response, as has happened with Iceland and with Latvia. The regional institutions helped by providing a network of well established contacts and the necessary trust for intensive behind-the-scenes dialogue, not only on financial support but on the general course of economic policy. But ultimately these were efforts between national governments in which regional collaboration at best played a very limited role. Importantly, the short-term dominance of macroeconomic policy challenges does not reduce the need to also work on long-term competitiveness in an absolute sense. It just changes the relative weight of this work. And for competitiveness upgrading, the Baltic Sea Region remains a relevant and effective level for collaboration; the same is true for many environmental efforts. The challenge will be to keep Baltic Sea collaboration effective and targeted towards the themes where it can truly make a difference, while the attention of top policymakers is temporarily focused on other issues.

The global economic crisis has played out in different ways across the Baltic Sea Region. The real impact of the crisis has been different and so are the policy responses and the outlook for moving forward. The crisis has amplified the economic differences across the Region because these differences have turned out to have a crucial impact on the trajectory that the individual countries took in response to the global shock. What is more, while different growth rates in the past essentially worked towards reducing the heterogeneity across the Region, i.e. poorer regions growing much faster than more prosperous once, they are now again working towards widening the gap. But the challenge is not only dealing with the actual economic reality of the crisis; it is also dealing with the differences in how the countries in the Region perceive the crisis. This period will be remembered very differently in Stockholm and Hamburg than in Riga and Reykjavík. Already now, the survey data indicates that perceptions are hugely different across the Region and lead people to draw very distinct and divergent conclusions on key policy questions such as the benefits of belonging to the Euro-Zone. This will make it much harder for political leaders to find a common ground and convince their electorates that the Baltic Sea Region is a useful and important area for collaboration. The pressure to provide clear proof of how this collaboration generates real benefits for all participants will only rise.

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. Data is analyzed for individual countries within the Baltic Sea Region and the aggregate of the Region, where comparisons are made to the EU-15 (EU members in 2003), EU-8 (EU members from central Europe that joined the EU in 2004), the Central European Region (Austria, Czech Republic, Hungary, Slovak Republic, Slovenia, south-eastern Germany, and southern Poland), and a number of other broader regions across the world.

Section B: Competitiveness in the Baltic Sea Region

Competitiveness captures the medium-term economic fundamentals that ultimately determine the level of prosperity an economy and its citizens can enjoy. At its core, prosperity is driven by the level of productivity that companies achieve in a location and the ability of an economy to mobilize its resources, especially its human capital, for productive economic activity.

The concept that comes closest in official statistics is the one of potential GDP, which measures how much output the economy can produce at normal levels of capacity utilization. Competitiveness looks beyond potential GDP, providing a framework to understand the factors that drive the level of potential GDP. Traditionally, the growth rate of potential GDP is given by demographics and the "normal" productivity growth in the economy. Again, competitiveness looks beyond essentially projecting a "normal" level of productivity growth from past experience and provides a framework to understand the factors and policy levers that drive productivity growth.

In the short run, countries' levels of prosperity can deviate from its underlying competitiveness and potential GDP. Temporary capital inflows, overheating driven by escalating credit growth or other temporary windfalls can move consumption and growth beyond sustainable levels. Recent academic analysis of countries' growth experience has revealed that many countries have experienced such "growth spurts". But this research has also shown that the vast majority of them have inevitably fallen back into extended periods of much slower growth. In the long run, countries can only achieve sustainable prosperity growth if their fundamental competitiveness, and thus their potential GDP, is increased. The challenge is that short-term growth spurts are relatively easy to engineer. Long-term sustainable growth is much harder to achieve and requires a radically different policy approach.

Competitiveness and the global economic crisis

At first sight, competitiveness seems to be less relevant in the current economic environment. The main challenges today are a demand slump and the apparent structural flaws in some financial markets. Countries face these challenges whether they are competitive or not. And pursuing the traditional elements of a competitiveness agenda with the objective of increasing productivity is not going to address them. Greater productivity counts for little if there are no buyers.

On further scrutiny, however, it turns out that ignoring competitiveness at this time was a huge mistake. The crisis developed as some economies grew much faster than their competitiveness, creating many of the economic imbalances now afflicting the global economy. Ultimately, prosperity will have to fall in line with competitiveness again. And while in the short term this will happen through a decline in prosperity, in the medium term it will be crucial to also raise competitiveness. Even in dealing with the short-term demand slump, competitiveness plays an important role. Government stimulus packages only work, if they unlock spending from consumers and companies that believe these programs will contribute to sustainable growth. If instead they finance a short term spending-spree, the private sector will often even cut spending with the view that the public debt that will have to be covered through taxes or spending cuts in the future. This is why focusing government spending on areas that increase competitiveness is much more likely to be effective than pure consumption support, even when just looking at the short-term impact.

One of the striking features of the current crisis is that it has hit countries almost irrespective of their level of competitiveness. If anything, the impact was more immediate and initially larger for more competitive economies, as manifested by the Baltic Sea Region. As was discussed in Section A of this Report, the size of the immediate impact was largely driven by a combination of countries' openness (which is positively associated with competitiveness) and the extent of macroeconomic imbalances they had developed (which has little systematic correlation with competitiveness).

While higher competitiveness has not sheltered countries from the fall-out of the crisis, it does give them a much better chance for recovery. Again, the outlook for the Baltic Sea Region suggests such a positive scenario. The policy recommendation is to stay the course and avoid policies that might harm competitiveness. For countries at low levels of competitiveness, the outlook is much more complicated. Competitiveness upgrading competes for the same resources as measures to alleviate the immediate impact the crisis has on people and businesses. This dangerous trade-off can only be prevented, if the crisis becomes the rallying point to address deep-seated institutional barriers that have made higher competitiveness unattainable in the past.

The productivity of an economy depends on many factors. The concept of competitiveness applied here, building on the work by Professor Michael E. Porter since 1990, provides a framework to deal with this complexity. A look at the actual prosperity levels achieved has to be part of the analysis. This is the ultimate benchmark to understand whether or not a location is competitive. And the simple decomposition of its drivers can give first insights into the profile of competitive strengths and weaknesses. Intermediate indicators like investment, trade, FDI, and innovation also provide valuable information. They do not measure outcomes that are ultimately valuable in their own right, but they all indicate underlying competitiveness and thus help contribute to current and future prosperity. Finally, the fundamental aspects of competitiveness have to be reviewed. These are the ultimate drivers that policy needs to influence in order to achieve a sustainable impact on the growth trajectory of the economy.

The remainder of this Section follows the broad outline that this analytical framework suggests. The first chapter looks at the outcomes of economic prosperity and intermediate indicators of competitiveness that the Baltic Sea Region has reached. The second chapter then dives into the analysis of underlying competitiveness, both at the level of the Region and for its constituent countries. The third chapter uses a slightly different perspective, creating an aggregate indicator to measure how the Baltic Sea Region is performing relative to the Lisbon Agenda, the plan to increase competitiveness defined by the European Commission almost a decade ago. With the Lisbon Agenda up for renewal, there will also be a discussion of how a new Agenda might look like based on the experience of the Baltic Sea Region

- **The Baltic Sea Region remains one of the most prosperous regions internationally despite a significant drop in prosperity in the wake of the crisis**
- **So far productivity has taken the brunt of the adjustment, while labor participation has held up better; the Region remains overall more balanced on labor productivity and mobilization than its peers**
- **The Region continues to be highly integrated in global trade and investment; while important for prosperity, this integration was in the short term a major contributor to the severity of the crisis**
- **The Region remains more active as an investor and trader abroad than it is attractive as an investment location or market at home**
- **Innovation output is strong but continues a slow downward trend relative to other world regions**

1. The economic performance of the Baltic Sea Region

The ultimate tests for whether or not an economy is competitive are the economic outcomes it achieves. We continue to track the performance of the Baltic Sea Region relative to key peers, as well as of individual countries across the Region. Given the dramatic level of change in the economy, we have this year also incorporated projections for 2009. While the outcome for the current year is still highly uncertain, a discussion of the current crisis based on 2008 data alone is impossible. Last year's outcomes were still largely influenced by buoyant economic growth in the first two or three quarters of the year, followed by a deep contraction in the last quarter.

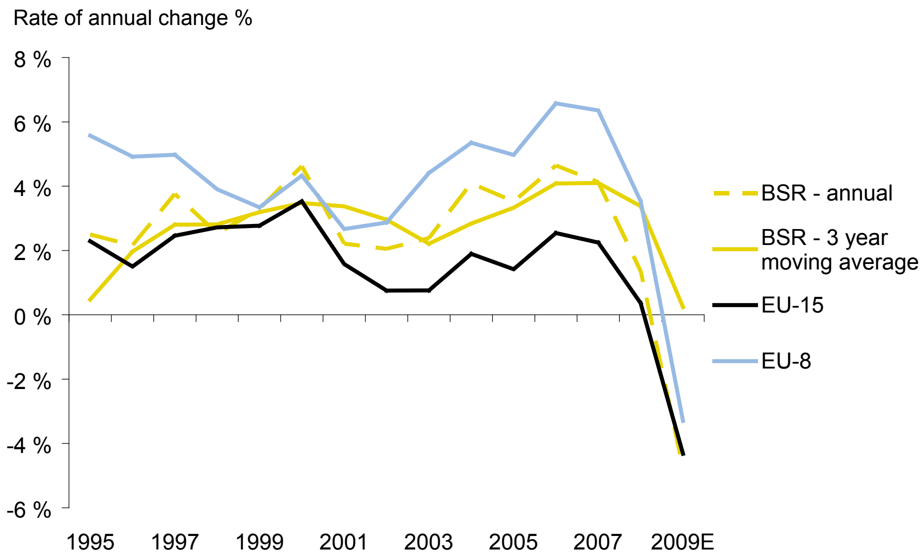
Prosperity

The central measure of prosperity we use is gross domestic product (GDP) per capita, adjusted by purchasing power parity. This measure is comparable across countries and time, and 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 is currently experiencing a significant reduction in prosperity. After prosperity growth ground essentially to a halt in 2008, for 2009 the outlook is for a reduction of GDP per Capita (PPP adjusted) by 4.8%. The Region is registering a sharper contraction in GDP per capita than either the EU-15 or the EU-8. The GDP per capita growth rate has dropped by more than 9.5%-points since 2006, marginally less than in the EU-8 but more severe than in the EU-15 or EU-27. The currently projected contraction will push average prosperity levels for the Region back to where they were in 2006. Between 1999 and 2007, prosperity in the Baltic Sea Region grew at a CAGR growth rate that was 1.6% higher than in the EU-15 countries. This was an extremely high catch-up rate by international standards, reducing the prosperity gap by more than 5% each year. Taking account also of the last two years, the gap since 1999 has been 1.3%. These numbers are high by the international standards reported in the literature. Given the current prosperity gap of roughly 15%, the lower catch-up rate would shift out the date of equal prosperity levels from 2020 to 2024.

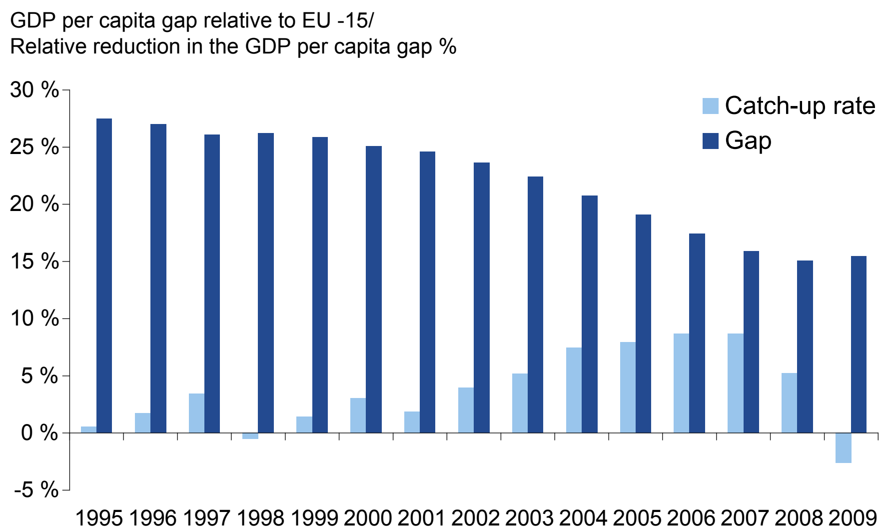
The contraction after the fast growth of the last few years has, of course, not been limited to the Baltic Sea Region. The NAFTA region, suffering for a longer time under the gradually worsening conditions on the U.S. housing market, had started to slow down since 2006. The region has now dropped back to the level of prosperity for that year. Oceania has been the one region among the advanced economies that has done significantly better. While it could not avoid the slowdown and the contraction in GDP this year, the extent of the downturn has been significantly less dramatic, helped by Asian demand for the region's natural resources. Within Europe, the British Isles and the Iberian Peninsula are expecting drops in prosperity in line with the EU-15 this year. For both regions this comes, however, after a year (2008) in which growth had already been zero or negative while the rest of the EU was still growing.

Figure 13: Prosperity Growth over Time in main world regions



Source: Conference Board (2009), EIU (2009) State of the Region Report 2009

Figure 14: Catch-Up Rate: Baltic Sea Region versus EU-15



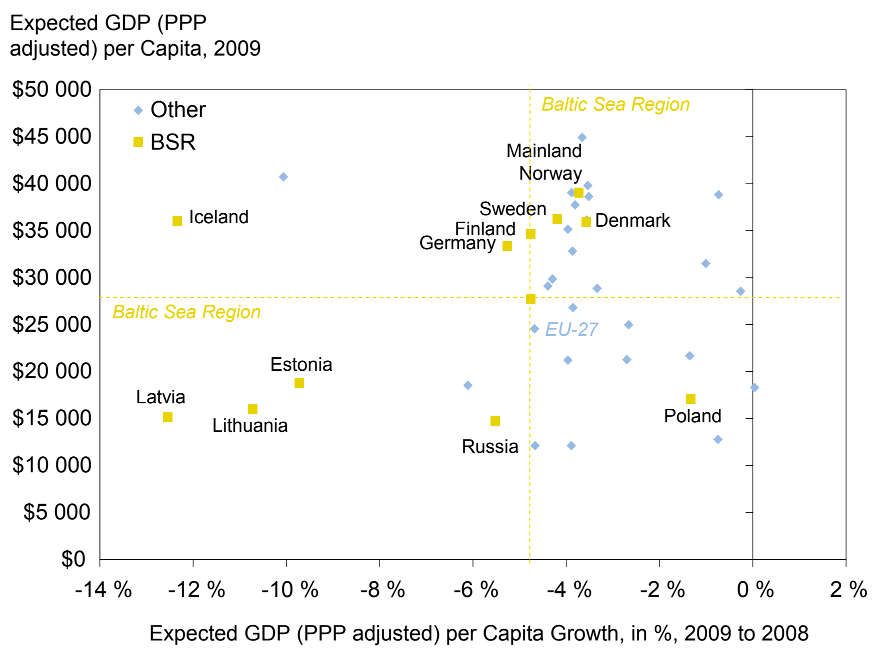
Source: Conference Board (2009), EIU (2009) State of the Region-Report 2009

Within the Baltic Sea Region, there has been a dramatic reversal of fortunes. Countries that used to grow at high rates are now contracting the fastest while those with lower growth rates have tended to be much more stable. This tendency was already visible in 2008 but will become even more pronounced in the current year. Latvia and Iceland are the two countries in the Region that will suffer the most in 2009, although recent data suggests that also Lithuania might join this group. All three Baltic countries are experiencing a dramatic fall in prosperity. Their 2009 GDP per capita (PPP adjusted) level is expected to drop to the levels of 2005/2006. Given the high growth of the last few years, standards of living remain significantly higher than before EU accession. The prosperity drop in Iceland has been dramatic, too, and returned the country to GDP per capita levels last seen in 2003/2004. The other Nordic countries and Germany have moved much more in sync, with rankings among them only moderately changed. Denmark and Sweden had already suffered in 2008 and are now expecting a slightly smaller drop, while instead Germany and Finland have seen a bigger reaction to the crisis this year. Norway's mainland economy has held up relatively well over the entire period. Russia is experiencing a significant drop in prosperity after years of strong growth, and just like Germany and Finland, most of the impact of the crisis on prosperity seems to be happening in 2009. Poland, over the last few years often the laggard on growth and catch-up, has done better recently and is also holding up well this year.

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. Labor productivity is driven by the skills of employees, the available capital stock, but most importantly the so-called Total Factor Productivity (TFP), i.e. the many factors that influence how well these inputs are being used. TFP is one of the single most important signals of the underlying competitiveness of an economy. Labor mobilization captures the combined effect of demographics, employment rates, and actual working hours per employee. While not all of these factors are a reflection of underlying competitiveness, some of them are, Labor productivity and mobilization have an impact on each other – making work unattractive for less productive people raises the former but lowers the

Figure 15: Prosperity Level and Growth over Time by countries



Source: Conference Board (2009) State of the Region-Report 2009

From prosperity to the quality of life

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 UNDP Human Development Index, the most established attempt to provide a broader perspective on the quality of life across countries, has been discussed in previous Reports. The latest rankings released in December 2008 cover data up to 2006 (the next update will become available in October this year). The Baltic Sea Region continues to have a strong position on this ranking, with now Iceland and Norway on top, Sweden ranked 7th, and Finland and Denmark also among the global top 15 countries. Germany ranks 23rd. Poland and the three Baltic countries follow in a group close to rank 40. At 73rd, Russia is near the bottom of the group of countries with high human development. Most countries in the Region are relatively balanced across the different dimensions of development measured. Russia, and to some degree the Baltic countries, suffer from relatively low life expectancy.

Taking the average of prosperity across an economy can easily conceal huge differences of access and participation within the society. The UNDP Gender Development Index and the World Economic Forum Global Gender Report look at the opportunities for women to participate in the economy and society. The Baltic Sea Region is doing even better on these indicators than on general human development or purely economic outcomes per se. The UNU-WIDER World Income Inequality Database (WIID) provides information on income inequality. Collecting comparable data is complex, and the most recent studies covered in the database include data from 2001 and 2002. Overall the data suggest for the Baltic Sea Region relatively wide access to prosperity across society, relative to other groups of countries with similar levels of average prosperity. Inequality is low in the Nordic countries and Germany. In Poland and the Baltic countries inequality tends to be higher but is not remarkable compared to other countries at similar stages of development. Russia sticks out with a much more unequal income distribution.

Quality of life not only depends on economic and social participation, but also the environmental conditions in which people live. Last year's Report discussed the findings of the Environmental Performance Index (EPI). The underlying data has not been updated since then, although some minor improvements have been made. The Baltic Sea Region ranks well on this indicator, with Norway, Sweden, and Finland ranked among the top five. Poland ranks the lowest at 43, and Denmark at 26 is ranked lower on this indicator than on many other dimensions of economic performance and competitiveness.

Overall, these indicators suggest that the Baltic Sea Region is more than just prosperous. It provides its citizens a widely shared quality of life above the level reached by other countries and regions with similar levels of GDP per capita.

latter. Looking only at one of them fails to capture their combined impact on overall prosperity. Price levels are less often used as an indicator when looking at economic performance. But they turn out to have a major impact on prosperity differences across countries and are an important signal of potential problems in local competition or the efficiency of the local economy versus the export sector.

The Baltic Sea Region continues to register solid performance on labor mobilization and to a lesser degree on labor productivity,[1] while it remains a region with relatively high local prices. Most of the short term changes in the rankings of the Region are the consequence of the current crisis. The more dramatic fall in GDP has reduced inflationary pressure and improved the relative price position of the Region. With employment rates holding up better than production, the drop in productivity was more pronounced than in other regions. The weakness of some of the currencies in the Region also contributed to lower productivity measured in US dollar terms.

Within the Baltic Sea Region, the Nordic countries excel on productivity, and have a solid labor mobilization record, but suffer from high local prices. Iceland sticks out with exceptional levels of labor mobilization, still leading the Region on this indicator despite the crisis, but with much

1 This year, purchasing power parity data provided by the IMF has been used to transform labor productivity data in purchasing power terms into labor productivity in real terms. Given that the new real labor productivity measures are expressed in US dollars, changes in the exchange rates between the US dollar and currencies in the Baltic Sea Region have a much more visible effect on the rankings and relative growth rates.

Figure 16: Prosperity decomposition in selected cross-national regions, 2009

GDP per Capita (PPP)	=	Purchasing Power-Factor	x	Employment-Factor	x	Productivity-Factor
OCEANIA (+1)		ASEAN		ASEAN		EU-15
NAFTA (-1)		BRIC		BRIC		B ISLES
B ISLES		EU-8		OCEANIA		NAFTA (+2)
EU-15		CER (+1)		EU-8 (+2)		OCEANIA (-1)
IBERIA		OCEANIA (+3)		Baltic Sea Region		IBERIA +1)
CER		B ISLES (+1)		NAFTA (-2)		Baltic Sea Region (-2)
Baltic Sea Region		NAFTA (-4)		CER		CER
EU-8		IBERIA (-2)		B ISLES (+1)		EU-8
BRIC		Baltic Sea Region (+1)		IBERIA (-1)		BRIC (+1)
ASEAN		EU-15 (-1)		EU-15		ASEAN (-1)

Source: Groningen Growth and Development Centre and The Conference Board (2009), IMF (2009), authors' calculations

State of the Region-Report 2009

Figure 17: Prosperity decomposition in Baltic Sea Region countries, 2009

GDP per Capita (PPP)	=	Purchasing Power-Factor	x	Employment-Factor	x	Productivity-Factor
Norway		Russia		Iceland		Norway
Sweden (+1)		Poland (+1)		Russia		Denmark
Iceland (-1)		Lithuania (-1)		Estonia		Finland (+2)
Denmark		Estonia		Latvia		Germany
Finland		Latvia		Baltic Sea Region		Sweden (-2)
Germany		Iceland (+1)		Denmark		Iceland
Baltic Sea Region		Baltic Sea Region		Poland (+1)		Baltic Sea Region
Estonia		Sweden (+1)		Finland (-1)		Estonia
Poland (+1)		Germany (-2)		Sweden		Lithuania (+1)
Lithuania (-1)		Finland		Norway (+1)		Latvia (+1)
Latvia		Denmark (+1)		Lithuania (-1)		Poland (-2)
Russia		Norway (-1)		Germany		Russia

Source: Groningen Growth and Development Centre and The Conferen ce Board (2009), IMF (2009), authors' calculations

State of the Region-Report 2009

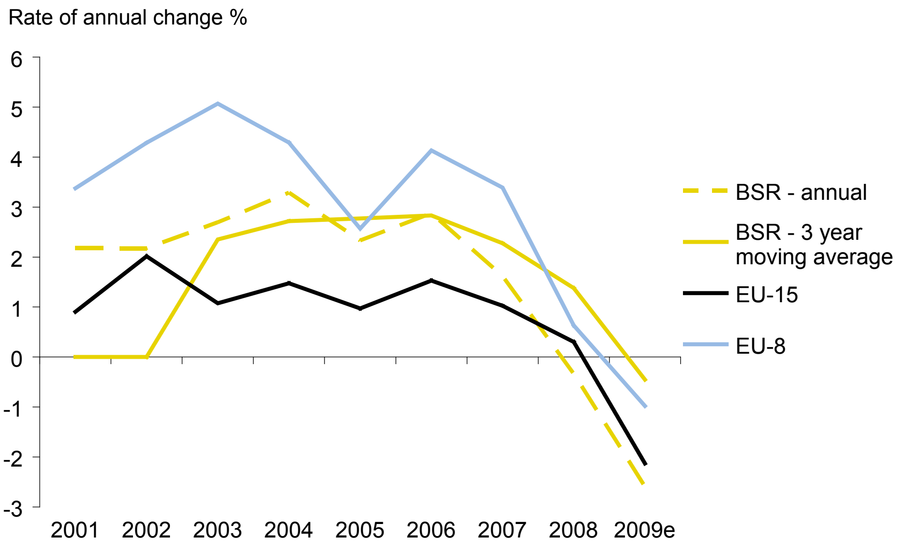
lower labor productivity. Germany is more similar to the other Nordic countries on productivity, but does significantly worse on labor mobilization. The Baltic countries and Russia as the extreme case have low labor productivity but high labor mobilization and low local prices. Here Poland is the slight deviation with a less impressive labor mobilization record. These relative patterns of prosperity drivers are expected to change only moderately in response to the crisis. Changing currency rates are reducing the cost level in the Nordic countries not in the Euro-Zone as well as in Poland. Together with the more dramatic drop in production at so far relatively low employment losses, this leads to a drop in Sweden's productivity position. Poland has experienced less of an output drop but also an even more modest reduction in labor input.

In **labor productivity**, measured by GDP per hour worked,[2] the Baltic Sea Region is expected to see its performance drop by -2.6% after a slight drop in 2008. While the performance this year is not out of line with the EU at large, last year the Baltic Sea Region significantly underperformed relative to its peers. The Central European Region (as well as the EU-8) registered labor productivity growth of 0.5% (0.6%) last year, followed by an expected drop of -2.3% (-1.0%) this year. The level of labor productivity in the Baltic Sea Region has fallen behind both the EU-27 and the Central European Region. Since 2005, the Region had been ahead of them, even though the differences are small. Productivity catch-up to the EU-15 has come to a halt, with the gap now roughly at the level of 2005/2006. NAFTA and the Iberian Peninsula are the only regions covered in the analysis that are expected to register positive labor productivity growth in 2008 and 2009. NAFTA has now more than halved the labor productivity gap it had versus the EU-15 in 2000. Oceania has experienced only a small reduction in labor productivity and continues to slowly reduce its productivity gap towards the most advanced OECD countries.

2 For this part of the analysis PPP-adjusted figures are used. Expressed in real terms and US dollars, labor productivity in the Baltic Sea Region is expected to drop by 20.6% in 2009, following slightly positive growth in 2008. Since these figures are mainly the result of exchange rate changes, they are not discussed in detail.

Within the Baltic Sea Region, Norway (mainland economy) will continue to register the highest level of GDP per hour worked with one of the smallest drops across the Region in both 2008 and 2009. Germany continues to follow in second place, despite a severe drop in labor productivity expected this year. Sweden, Denmark, and Finland follow closely after, with similar changes over the last two years. Denmark has seen more of the fall in labor productivity already in 2008. Iceland has historically been the country among the more advanced economies of the Region with the lowest level of labor productivity. The economic crisis has now further dented this position, with labor productivity expected to drop by close to 9% this year. The Baltic countries and Russia are currently experiencing a significant drop in labor productivity which for now has stopped the fast pace of their productivity catch-up. Measured in purchasing power terms, the level of productivity in these

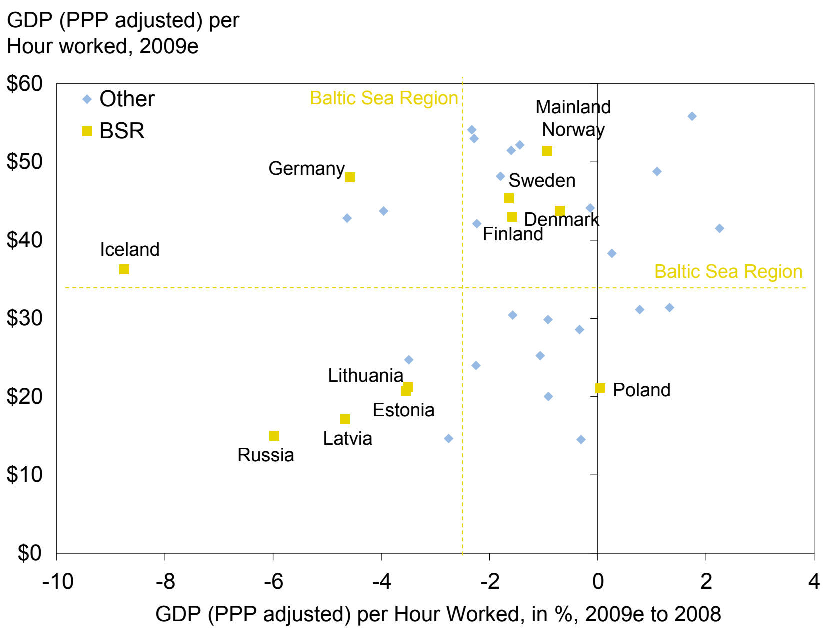
Figure 18: Labor productivity growth over time in selected regions



Source: Groningen Growth and Development Centre and The Conferen ce Board (2009), authors' calculations

State of the Region-Report 2009

Figure 19: Labor productivity level and growth in Baltic Sea Region countries



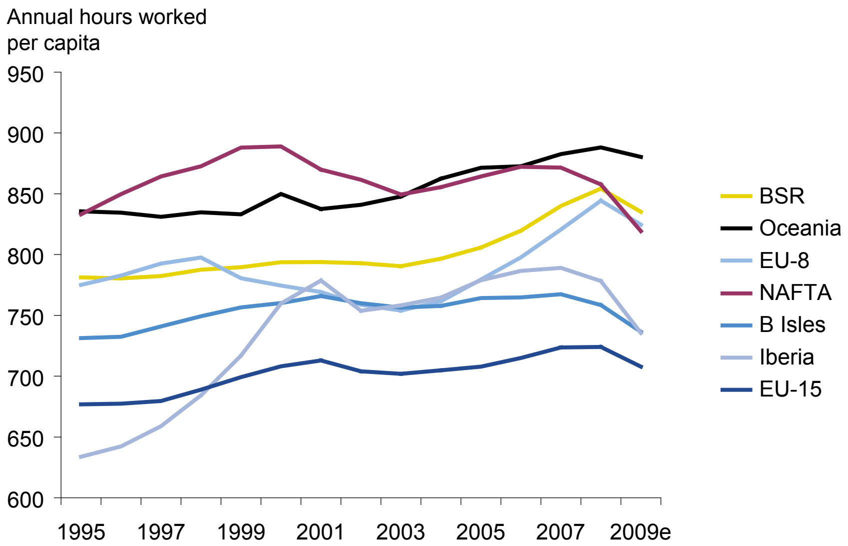
Source: Groningen Growth and Development Centre and The Conference Board (2009), authors' calculations

State of the Region-Report 2009

countries remains between a third (Russia) and close to half (Baltics) of the level in the Nordic countries. Poland is expected to be the one exception this year, being one of the few countries in Europe and the OECD registering positive labor productivity growth. However, its overall level of productivity remains low compared to the EU-15 or the Nordic countries.

In **labor mobilization**, measured by annual hours worked per capita, the Baltic Sea Region continues to register one of the strongest performances among advanced economy regions. Oceania still remains ahead, with 45 hours per capita more work done than in the Baltic Sea Region. NAFTA and the EU-8, both regions with a similar level of labor mobilization as the Baltic Sea Region, are expected to drop more on this measure in 2009, leaving this Region with a small advantage. The largest drop in labor mobilization was registered on the Iberian Peninsula, where at 43 hours more

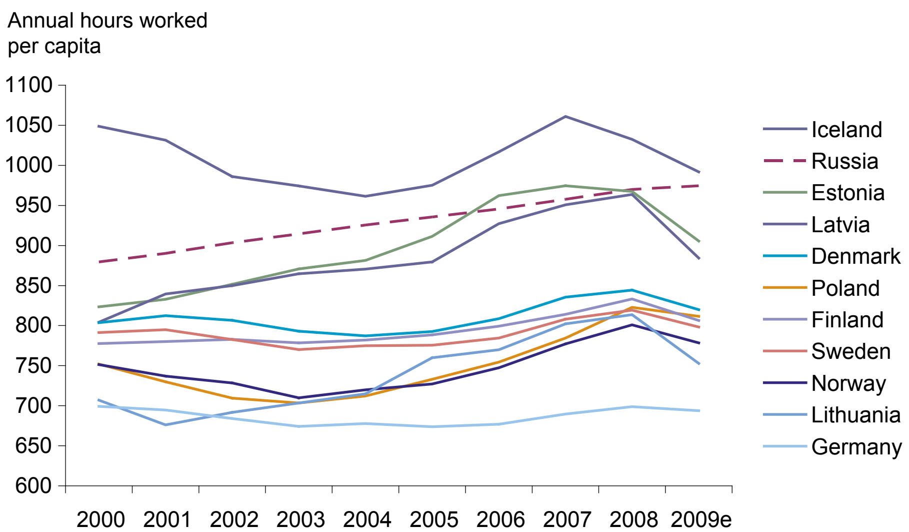
Figure 20: Labor mobilization over time, selected regions



Source: Groningen Growth and Development Centre and The Conference Board (2009), authors' calculations

State of the Region-Report 2009

Figure 21: Labor mobilization over time, Baltic Sea Region countries



Note: Russian data are projections based on peer country data

Source: Groningen Growth and Development Centre and The Conference Board (2009)

State of the Region-Report 2009

than an average working week of production was lost per capita.

Within the Baltic Sea Region, Iceland retained its lead on top of the labor mobilization ranking, despite a massive drop of labor mobilization since 2007. With the Russian data highly uncertain, Estonia and Latvia follow, also with significant reductions in labor mobilization expected for 2009. At some distance, Denmark follows with a moderate drop in 2009. Poland, for a long time one of the laggards in the Region for this aspect of performance, is expected to move ahead of Finland and Sweden in 2009. Finland and Sweden have over time kept a relatively stable level of labor mobilization but are about to lose about half a working week of production per capita in 2009. At a somewhat lower level, Norway had been catching up to its Nordic neighbors to the east but will make no relative gains in 2009. Lithuania is another traditional laggard that had seen mobilization rates improve. For 2009, however, a dramatic drop back to 2004/2005 levels is expected. Germany remains at the bottom of the Region's labor mobilization ranking. Per capita, Germany registers 7.5 weeks less work per capita than Iceland.

For **domestic price levels**, measured by price levels relative to the European average, the Baltic Sea Region has in 2008 continued to perform worse than the EU-27 average. There is no comparable data available yet for 2009. This remains a drag on the actual standard of living that citizens in the Region can enjoy. High local prices are ultimately a sign of insufficient levels of competition, whether or not this is the result of specific policies or natural conditions, like the small market size of most countries in the Region.

Drivers of labor mobilization differences

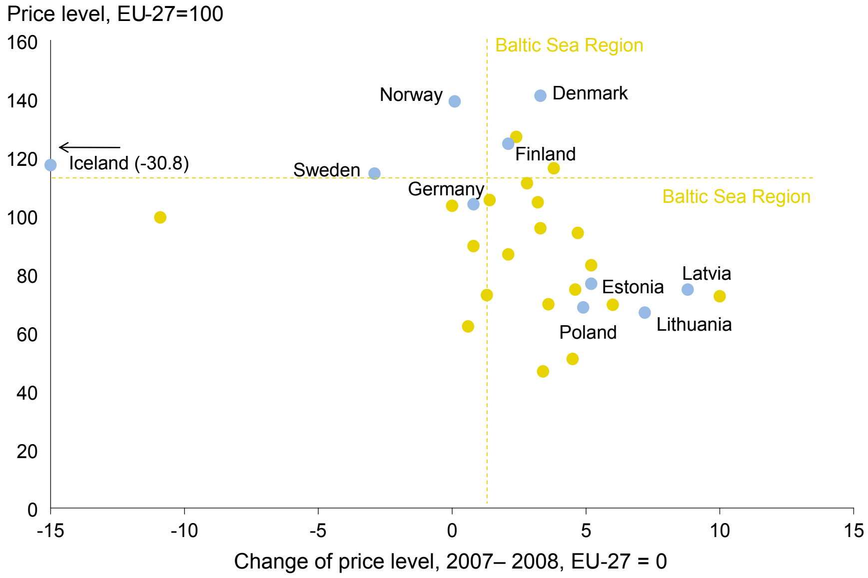
Labor mobilization differences on the aggregated level discussed here are the result of several heterogeneous factors that require their own policy responses.

The *demographic profile* of the population determines the share of people of working age. The Baltic Sea Region virtually matches the EU-27 average, with about two-thirds of the population aged between 15 and 65, the age bracket usually used to track the potentially economically active population. The aging of societies is going to reduce this rate significantly over the coming years and decades. Thanks to relatively high birth rates in most of the Nordic countries, the Baltic Sea Region has a more favorable outlook than many of its European peers. However, individual countries like Russia and the Baltic countries face a significant challenge and the Baltic Sea Region will clearly fall behind non-European regions.

The *labor participation rate* then tracks whether people of working age are actually economically active. With a participation rate of 74% the Baltic Sea Region clearly outperforms its European peers; the EU-27 countries register only 66%. Partly this is the result of lower unemployment rates in the Baltic Sea Region. But it is also driven by higher labor force participation rates of women and older employees aged between 50 and 65 years. Poland is the exception in the Region with one of the lowest rates both overall and for these subgroups. To a significant degree this is the result of higher *unemployment rates*, not because of individual choice to abstain from entering the labor force. Sweden does well on all of these indicators, but registers one of the highest unemployment rates among 15 to 25 year olds. Only Greece, Italy, Latvia and Spain do worse on this measure among European countries.

Working hours per employee are relatively low in the Nordics and Germany, but high in the Baltics, Poland, and Russia. Overall this gives the Baltic Sea Region an advantage relative to the EU-15 and, to a much smaller degree, the Central European Region. The EU-8 countries and outside of Europe, the NAFTA region, register higher working hours than the Baltic Sea Region while Oceania is slightly behind. Part of the reason for the differences within the Region is the huge variation in the rates of absence due to illness, injury, or temporary disability. Sweden and Norway rank highest among all European countries on this measure while the Baltic countries and Iceland rank close to the bottom. Another possible reason is the higher incidence of part-time work among employees. This is the case for Norway, Sweden, Germany, and Denmark, partly also because of the higher share of females, who have generally higher rates of part-time work, in total employment. Overall, however, the Baltic Sea Region does not have a higher share of part-time employment than the EU-15, the EU-27, or Oceania outside of Europe.

Figure 22: Relative price changes, European countries



Source: Eurostat (2009) State of the Region-Report 2009

The trend of higher growth in price levels than elsewhere in Europe has continued in 2008. The high growth and emerging capacity constraints in the Baltic Sea Region in the run up to the crisis have contributed to this outcome. It remains to be seen how different the situation will be in 2009, and whether this could also lead to a structural change in the trend.

Within the Baltic Sea Region, Denmark and Norway are now the most expensive countries in the Region and across Europe. Iceland, the country that had this distinction in previous year, saw a dramatic drop in local prices as consumers' purchasing power disappeared. Sweden is still more expensive than the EU average, but continues its convergence to the average EU price level. The Baltic countries and Poland continue to experience significant price increases, not surprising given their state of economic development.

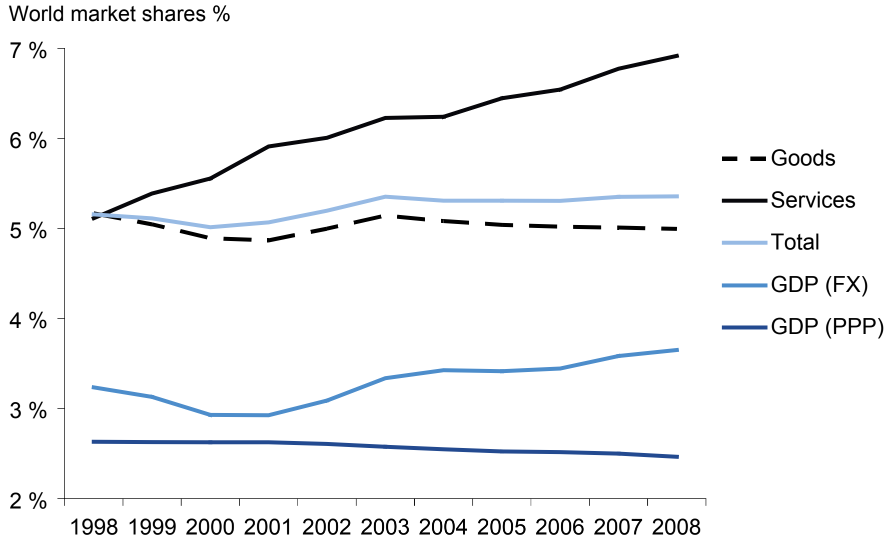
Intermediate indicators and enablers of competitiveness

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. While exports are a sign for how competitiveness underpins current prosperity, investments and innovation indicators can provide some insight into the outlook for prosperity in the future.

***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.*

In world market export shares, the Baltic Sea Region continued to defend its overall world market share, even registering a slight increase. It continues to have a world export market share about twice as high as its share of global GDP. The Region benefits from its growing position in service exports, while it continues to very slowly lose market share in goods exports. Services remain at 16.8% with smaller share of exports for the Baltic Sea Region than for the world economy overall. The difference in shares of overall trade between the Region and the world has, however, halved over the last decade, a trend that continued in 2008.

Figure 23: World export market shares, Baltic Sea Region



Source: WTO (2009), IMF (2009) State of the Region-Report 2009

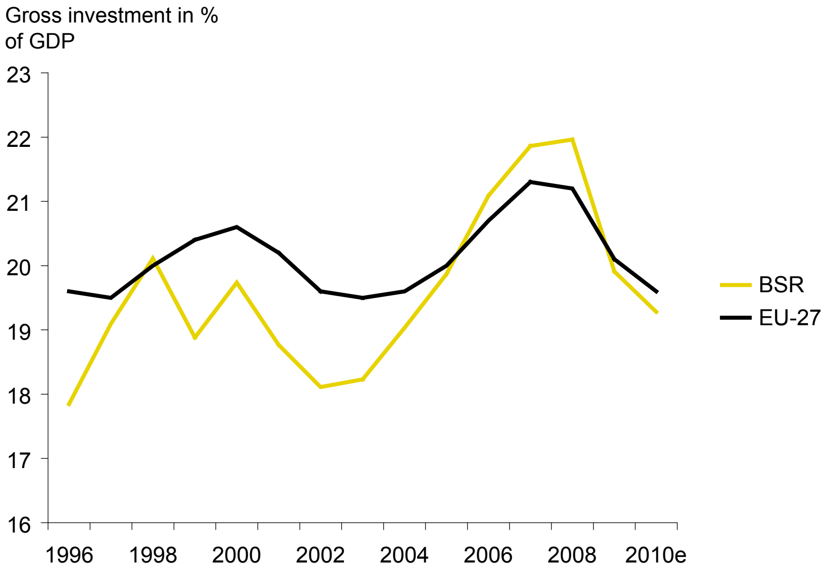
In terms of individual countries across the Baltic Sea Region, Lithuania improved its market share the most, doubling its presence on global markets since 2000. Latvia, Poland, and Russia follow with a similar pattern, but with slightly lower growth rates. Norway, too, registered market share gains in 2008 but has been overall quite stable in the medium term. Denmark and Estonia have seen flat market shares across the entire period, including in 2008. Sweden and Germany lost some ground in 2008, but defended their market position over the medium term. Finland saw the most significant drop in market share in 2008 and reached its weakest position since the beginning of the decade.

The composition of exports differs quite significantly across the Region. Denmark's service share of exports has reached 38%, compared to Russia (10%) and Germany (14%). Over the last decade, Denmark (+14%-points), Sweden (+11%), and Finland (+7%) have become much more service-oriented in their exports. For Poland (-11%-points), Latvia (-7%), and Lithuania (-7%) the opposite has been true. While the more advanced economies in the Region increasingly shift to services and outsource production, the lower cost locations have increasingly attracted export-oriented manufacturing activities.

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.*

Historically the Baltic Sea Region has suffered from a relatively low investment rate. While this is partly the result of the high levels of capital intensity already reached across the Region, it still inhibits the ability to benefit from the technology updating that occurs when new fixed capital is being installed. Since 2002, the Region has experienced a significant rise in the investment rate. This rise is now coming to an abrupt halt and there are signs that investment rates are dropping to the level of the late 1990s. The fall has been as dramatic as for the OECD and North America, despite the presence of a number of countries in the Region which are in a catch-up phase of their economic development. The EU-27 (as well as the EU-15, which reports investment at almost the same level) is more stable in their investment behavior over time. A possible explanation for their higher variability of investment rates in the Region is the higher share of construction in the overall number, much of which might not have made a strong contribution to the productive capacity of the Region.

Figure 24: Domestic investment over time, Baltic Sea Region and EU-27



Source: EIU (2009) State of the Region-Report 2009

Within the Baltic Sea Region, Latvia is at 28% of GDP forecasted to continue to register the highest investment rates in the Region, despite significant drops after 2008. By 2010, Poland and Estonia follow at slightly below 22%; Poland with a stable investment rate over time and Estonia after a significant drop compared to pre-crisis levels. All other Baltic Sea Region countries then follow with investment rates between nearly 18% and 20%. Iceland is forecasted to be at the bottom, both as a result of the imploding housing market and the end of major aluminum investment projects.

Inward foreign direct investment (FDI) *is an important indicator of a location's attractiveness 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 2007, the most recent year for which globally comparable foreign direct investment (FDI) data is available, the Baltic Sea Region saw its share of inward FDI stocks drop slightly as a share of GDP. Over the medium term, however, foreign investors have become a significantly more important part of the Region's economy. This has also been the case for many other regions in the world, including the European Union overall.

Over the last few years the number of countries receiving meaningful amounts of FDI has increased significantly. This is visible in the falling global share of FDI inflows that comes to the Baltic Sea Region. Slowly this process is also eroding the Region's share in the global inward FDI stock. This does not have to be negative for the economies in the Region, as it is primarily reflecting the growth of other parts of the world economy. But it is increasing the challenge to market the Region as an attractive FDI destination in an increasingly crowded global market.

Within the Baltic Sea Region, all countries saw the nominal value of inward foreign investments increase in 2007. Iceland saw the most dramatic increase by 40%, reflecting a higher valuation of the existing FDI stock rather than massive inflows. The crisis in 2008/2009 will undoubtedly show a very different picture. The Baltic countries, where inward FDI stocks increased by between 25% and 30%, saw significant new inflows, especially in Estonia and Latvia. Among the more prosperous economies in the Region, Finland was the one with the largest improvement in FDI inflows and inward stock values. Russia and Denmark experienced the highest absolute year-to-year increase in FDI inflows, although especially for Denmark the high variation of FDI inflows on a year-to-year basis suggests that this was the result of individual transactions rather than a visible trend over time.

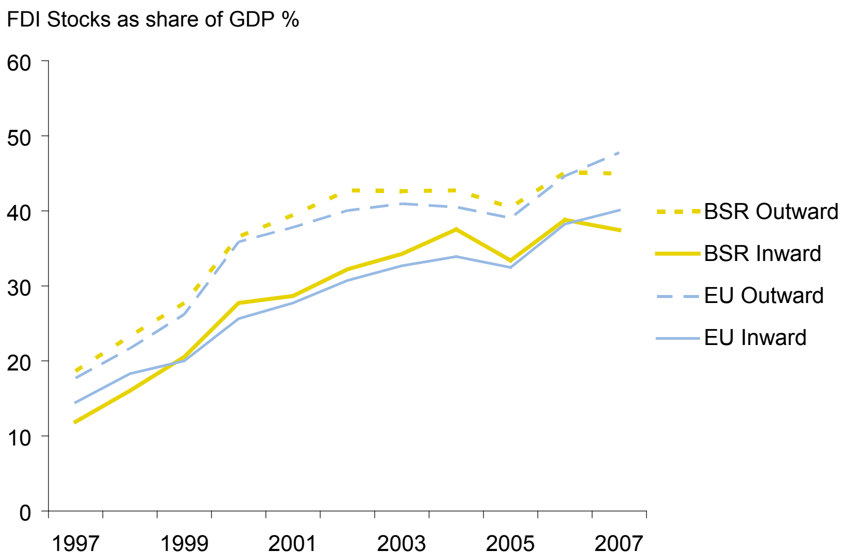
***Outward foreign direct investment** (FDI) is an important indicator for the ability of local companies to transfer their competitive advantages to foreign locations. In many cases, FDI is a substitute for exports that provides companies with control of a larger part of the value chain. Outward FDI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

In outward FDI, companies from the Baltic Sea Region have pretty much kept their position relative to their peers from other parts of the world. After a significant increase in outward FDI relative to GDP until the year 2000, this ratio has remained roughly stable for the last few years. For the first time in the last decade, in 2007 the Baltic Sea Region fell slightly behind the EU-27 on this measure. The Region accounted for 5.4% of global FDI outflows in 2007, below its average rate of 6.1% for the last decade and significantly down from the record 9.6% in 2005. Over the last five years, the share of the Region in the global outward FDI stock has accordingly dropped from 6% to 5.7%.

Within the Region, Sweden remains the most important investor abroad, accounting for about one third of the Region's total outward FDI stock. Like Denmark, the second largest investor from the Region, Sweden reported an increase in outward FDI activity in 2007. Iceland continued to be the most active foreign investor relative to the size of its economy. This overreach culminated in the crisis that unfolded in 2008 and 2009. Among the Baltic countries Estonia retained its leading position as an investor abroad, with much of its holdings in the other Baltic countries. Russia has become a more important investor abroad between 2005 and 2007, although its position remains limited relative to the size of its economy. Outward FDI intensity is one of the indicators where the difference between the more and less prosperous parts of the Baltic Sea Region is the most dramatic. Germany, the country from the former group with the lowest outward FDI intensity, still has an outward FDI world market share 30% above its GDP share. Estonia, the country from the latter group with the highest FDI intensity, is 60% below its GDP share. For many countries in the Region, other countries in the Region are important sources of and destinations for FDI. This is a visible sign of the level of integration between the economies that has been reached over the last two decades.

Overall, the Baltic Sea Region is highly active in the global economy. Iceland, Denmark, and Sweden are the most active relative to their size, both as sources and destinations of cross-border investment. Latvia, Lithuania, and Poland are far behind on outward FDI, Russia also on inward FDI. Despite its overall strong integration in the

Figure 25: FDI Stocks over time, Baltic Sea Region and EU-27

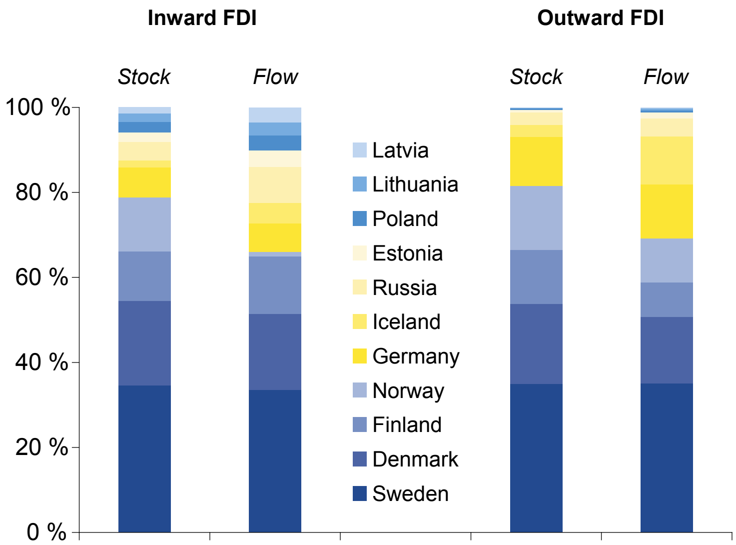


Source: UNCTAD (2008), IMF (2009), author's analysis. State of the Region-Report 2009 global economy, the Region's own attractiveness for investment, both from foreign and domestic sources, is only average.

***Patenting** is an important indicator of a country's innovative capacity, both from companies and research institutions. Patents in the United States are particularly important indicators, because the US is the most attractive market for patent use. 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.*

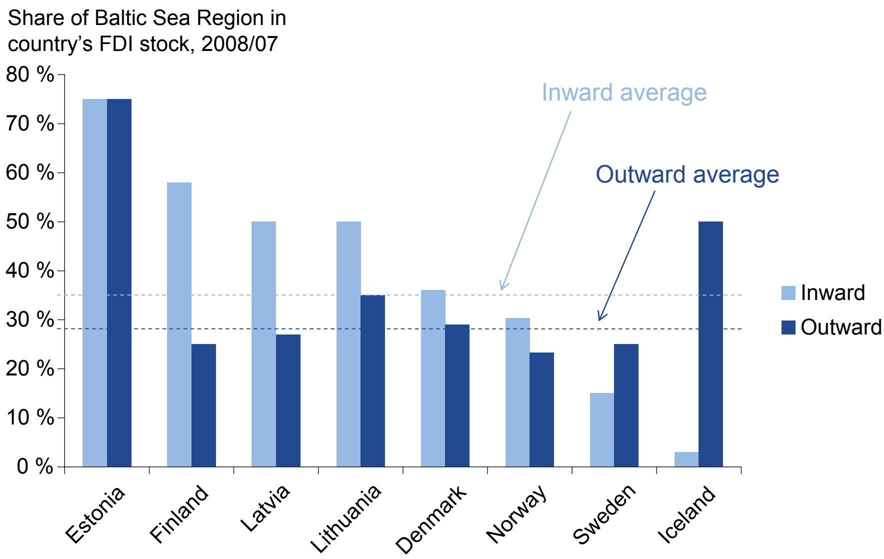
In patenting, the Baltic Sea Region remains one of the most important innovation hubs in the global economy. In 2008, the Baltic Sea Region accounted for 4.2% of patents filed in the US by non-US based institutions. This puts it 5th in the country ranking, behind Japan, Germany, South Korea, Taiwan, and Canada, which has just passed the Region in 2008. On a per capita basis,

Figure 26: Baltic Sea Region FDI by country in 2007



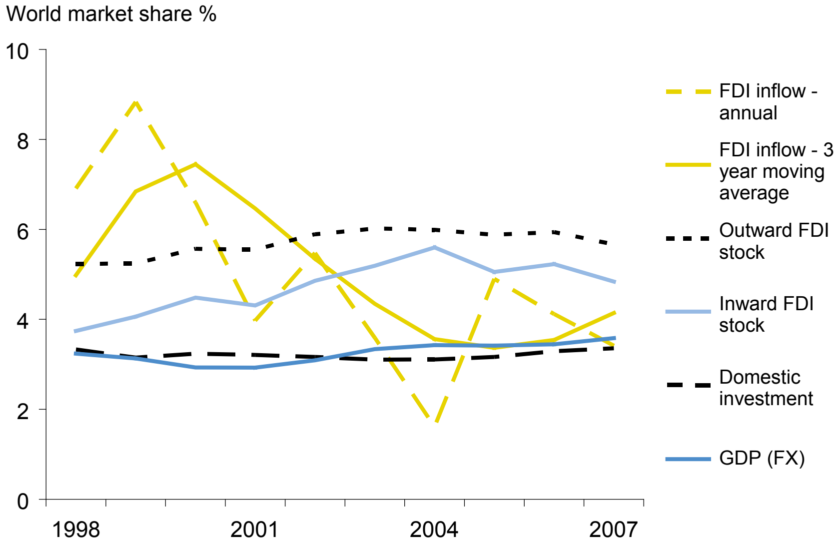
Source: UNCTAD (2008), IMF (2009), author's analysis. State of the Region-Report 2009

Figure 27: FDI Ties within the Baltic Sea Region



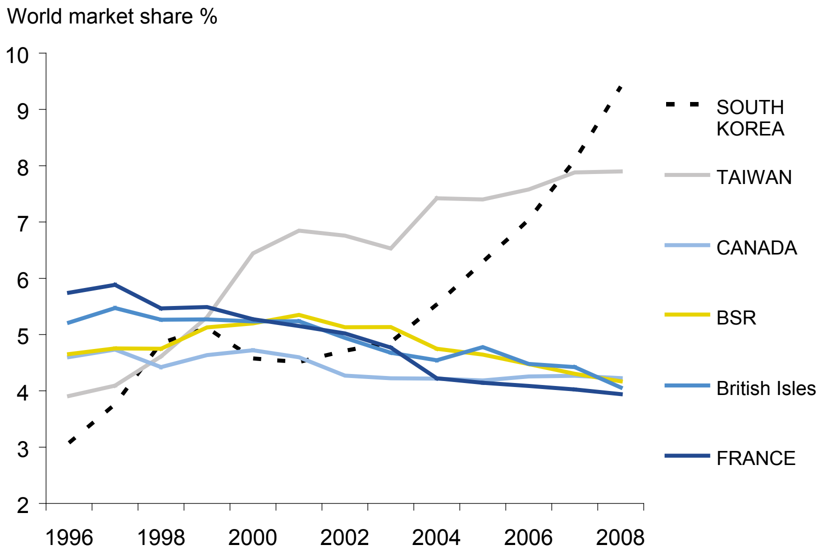
Source: Central Banks in the BSR (2009), authòs analysis. State of the Region-Report 2009

Figure 28: Overview on investment activity in the Baltic Sea Region



Source: UNCTAD (2009), EIU (2009), author's analysis. State of the Region-Report 2009

Figure 29: Patent filings with the USPTO by non-US institutions

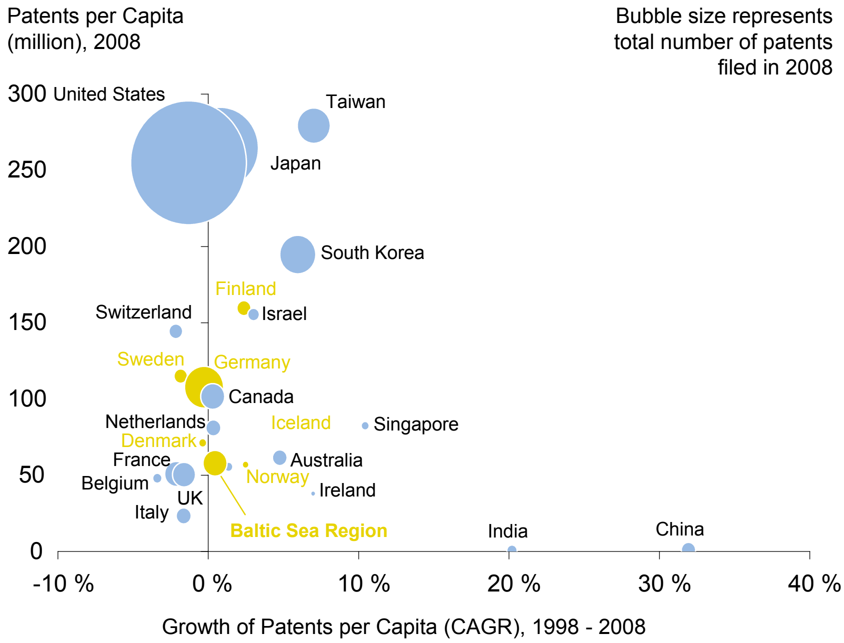


Source: USPTO (2009), author's analysis. State of the Region-Report 2009

Israel, Switzerland, the Netherlands, and Australia join the group of countries ahead of the Baltic Sea Region. Over the last few years, the Baltic Sea Region has fallen behind some of its international peers in terms of patenting in the U.S. This process continued in 2007, albeit at a much lower rate than in 2006. The share of U.S. patents filed by patentors located in the Region dropped by another 0.1% while patenting per capita stayed virtually unchanged.

Within the Baltic Sea Region, Sweden continues to dominate in terms of the absolute number of US patents, ahead of Finland, Germany, and Denmark. On a per capita basis, Finland comes out on top, and Iceland has moved between Germany and Denmark. The other countries in the Region still play virtually no role in terms of patenting, despite some growth over the years. On a per capita basis, Lithuania was the best among these countries in 2008, ranking 32nd globally.

Figure 30: Level and growth rate of patenting in the US



Source: USPTO (2009), author's analysis.

State of the Region-Report 2009

The OECD data covering triadic patents generally supports this analysis. The OECD also provides data on the technology balance of payments, covering royalties and other transactions related to the trade of intellectual property across borders. Overall, the Baltic Sea Region registers a solid surplus on this measure. The size of this surplus is, however, reduced especially by Poland's huge deficit. Russia has a deficit as well, but still trades much less knowledge than Poland. Sweden and Germany have relatively moderate surpluses; for Sweden this is a deterioration relative to its historical position. Norway and Denmark have the highest relative surplus, followed by Finland. For Norway and also Finland, this is a reversal from deficits a decade ago.

Overall assessment

For the Baltic Sea Region, 2008 and 2009 are years of a historic economic slump. The global crisis has affected all indicators. But this does not differentiate the Baltic Sea Region from its competitors around the globe. The more important question will be, whether the crisis initiates or enhances deeper structural changes that could affect the competitive position of the Region. It is still too early to know for sure. But the indicators available so far do suggest that the fundamentals of the Region remain broadly intact and should support a gradual return to a path of solid prosperity and growth.

In terms of prosperity, the Baltic Sea Region has taken a significant hit. This has not happened anytime before in the last few years of strong economic integration across this Region. Looking back, it is becoming clear that the rate of catch-up to the most advanced regions in Europe had been too fast over recent years. The global crisis triggered and deepened the downturn, but the seeds for a slowdown had been clearly planted in the Region before the crisis. Despite this dramatic worsening of the situation, the Region remains very prosperous. And the data also shows that the GDP figures might very well underestimate the true quality of life that large segments of the Baltic Sea Region population can enjoy.

On looking at the elements that directly drive prosperity, the crisis has so far shown its strongest impact on productivity, where the drop has been dramatic. In most countries productivity has taken the hit from lower demand and production, while employment rates were kept relatively stable.

The exceptions are the countries in deep economic crisis, i.e. Iceland and the Baltic countries, where both productivity and employment have suffered. Despite the severity of these developments, there has not been a fundamental change in the profile of the Region's prosperity generation: it is the combination of solid labor productivity and mobilization that continues to distinguish this Region from its European peers.

For most of the intermediate indicators, globally comparable data is only available up to 2008, sometimes even only up to 2007. Only for domestic investment rates are there more reliable forecasts that show a significant drop off in activity. On exports and FDI the Region continues to be deeply integrated into the world economy. This is one of the reasons pointed out already in Section A for why the impact of the global crisis has been so hard. What is somewhat worrying is the increasing imbalance between the Region's very active position abroad and its only average level of attractiveness for inward investment. On innovation the position is similarly mixed: the Region is still doing fine but there is a clear downward trend. This is more as a result of other countries moving ahead more quickly, than of the weakening of this Region. But in the global market place it still translates into a more exposed position.

The economic performance analysis shows a Region that is ailing under the impact of a global crisis and a number of domestic ones. But it also shows a Region that has reached a solid position with a level of prosperity that many other world regions only aspire to. There is reason to be alert and address the weaknesses that exist, including those that the crisis has brutally exposed. But there is no reason for despair. Being at the Top of Europe remains a very realistic goal; it is not a pipe dream that has evaporated in the crisis.

- The Baltic Sea Region remains one of the most competitive regions in the global economy, supporting its high level of prosperity
- Company sophistication and strong institutions remain key strengths; relative to other economies, the biggest gains in 2009 were in the quality of macroeconomic policy
- Tax and welfare systems reducing incentives to work and invest remain a problem; the crisis has led to significant drops in the quality of the capital market infrastructure
- Heterogeneity of competitiveness levels and profile across the Region remains high, in line with the diversity of economic outcomes registered
- Overall the Region does not quite reach its potential prosperity given its competitiveness; this gap has increased during the crisis
- Countries in the Region with prosperity higher than predicted given their competitiveness, are hit harder and at a more fundamental level than the Region at large

2. The foundations of prosperity in the Baltic Sea Region

Prosperity is ultimately driven by the combination of the natural conditions of a country, i.e. its natural resource wealth and location, and the competitiveness that it has created for itself. A country's competitiveness is given by a broad array of factors that determine the level of productivity and innovation that can be reached by companies located there. This complex mix of factors can be organized in two broad categories. Macroeconomic factors set the general context for firms but do not affect productivity and innovation directly. Microeconomic factors have a direct impact on the productivity with which companies can transform inputs into economic value. This section tracks these different determinants of prosperity, especially the dimensions of microeconomic competitiveness, for the Baltic Sea Region relative to key peers, as well as for individual countries across the Baltic Sea.

Competitiveness remains a contested term in the economic policy literature, with different individuals and institutions generating a wide range of definitions and policy advice. For policy makers, this cacophony can be highly confusing. Many of the differences are, however, driven by differences in analytical interests, and are not fundamental disagreements about the underlying economic mechanisms. The set of underlying indicators tends to be quite similar, while there are differences in the weights given to each of them when calculating aggregate measures or rankings of competitiveness.

In this report, competitiveness is understood as the array of factors influencing the level of productivity companies can reach in a location. The motivation is to understand the level of prosperity that the Baltic Sea Region can sustain given the current conditions on these factors, and to provide input on identifying the action priorities in raising the prosperity potential further. While the current economic climate is discussed in section A.1 and the recent economic performance is reviewed in section B.1, this section looks at the medium-term drivers of prosperity.

As in previous years, the data collected for the Global Competitiveness Report (GCR), an annual assessment of competitiveness across more than 120 countries published by the World Economic Forum, is an important source of information for our assessment. 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 data was collected between February and April 2009, i.e. at a period where the extent of the global crisis had become very visible. For the ranking methodology the new approach developed by a team under the leadership of Professor Michael Porter is used.[1] The rankings are therefore not identical to those published by the World Economic Forum in their report. Other sources of data will be used as well. The 2008/09 Global Competitiveness Report has a chapter with more detail on the new index methodology applied for calculating the rankings reported here.

The remainder of this chapter is organized in three parts. First, we provide a short summary of the natural conditions that countries in the Baltic Sea Region face. These factors do not change over time, and have been the topic of previous Reports. Second, we assess the Region's macroeconomic competitiveness. Updated data is available on the institutional capacity of the Region and we also briefly discuss the quality of macroeconomic policy in the Region. Third, we look at indicators of the Region's microeconomic competitiveness. The dimensions covered include different aspects of business environment quality as well as company sophistication.

Natural conditions

Natural conditions include the geographical location, natural resource endowments, and the size and internal geographic profile of countries. A location far away from large markets, with limited access to global trade (often a question of access to sea transport), or in areas with a high propensity for illnesses (for example malaria) or natural disasters, has to achieve higher levels of competitiveness to reach the same level of prosperity as a country with more benignant conditions. Natural resource wealth provides obvious direct benefits to prosperity but it can also hinder development through economic ('Dutch Disease') or institutional (increasing corruption, autocratic political regimes) mechanisms. The size of the economies as well as the degree of urbanization can also play a role, although especially for more prosperous economies, the econometric evidence is inconclusive. These factors do not change over time, although differences in policy, for example in transportation infrastructure or changes in the regulatory environment for extracting natural resources, might affect their impact on prosperity.

The Baltic Sea Region has a *geographic location* that provides a balance of positive and negative influences for prosperity. The Region has a relatively low exposure to natural disasters or illnesses that could threaten to disrupt normal economic transactions or reduce incentives for long term investments. But these advantages are generally shared with other advanced or transition economies. The climate conditions in the north of the Baltic Sea Region generate some additional costs but affect only a small share of the Region's overall population. The Region has ample access to sea trade, although it is not located near any of the major global transit routes for sea transport. It is located at the periphery of the European market, still one of the largest markets in the global economy. But it is geographically less well-placed to serve the markets of Asia, which will inevitably increase in economic importance in the future.

The Baltic Sea Region is home to a number of valuable *natural resources*. IPS provides a simple ranking of energy resources per capita based on production. Among the 65 countries covered the Region (no data for Iceland and the Baltic countries) ranks 12th with Norway and Russia in the top five. Not included in this assessment is the access to hydro power, an important asset for Iceland, Norway, and Sweden. Sweden and Russia, in particular, also have significant access to metals and other minerals.

The Baltic Sea Region has a moderate *overall size*. At 13% of the EU-27 economy, it is comparable to the economy of the Iberian Peninsula and slightly smaller than the Italian economy. The economy of the Region is divided into eleven countries (or parts of countries) with the largest, Sweden, accounting for about 21% of the Region's aggregate GDP. The Region has a relatively low *population density*, with few metropolitan centers of European, let alone global, reach. The overall share of the population living in metropolitan regions is comparable to the rest of Europe. But most of the metropolitan regions around the Baltic Sea are relatively small.

1 Apart from Michael Porter (HBS), the team consists, of Scott Stern (Northwestern), Mercedes Delgado (Temple), and Christian Ketels (HBS/SSE) with Antonio Ciccone (Pompeu Fabra) as special advisor.

Geography and competitiveness: Implications for the Baltic Sea Region

Over the last few years, the role of geographic factors has become an increasingly important factor in the academic debate. The recent Nobel Prize in Economics for Paul Krugman, in part for his work on economic geography, and the current World Development Report, dedicated to a discussion of the role of differences in the level and profile of economic activity across space, are recent visible examples of a much broader trend.

The traditional economic models suggest a strong trend for economic activity to be dispersed across space: if there is already a lot of something in one location, that increases competition, drives down the costs for outputs/raises the costs for inputs, and thus makes moving elsewhere more profitable. While this is clearly an important factor, the empirical evidence suggests that this cannot be the whole story: much economic activity is, in fact, highly concentrated in a few places. The new models and approaches developed in the last two decades provided two mechanisms that are at work to explain the economics behind this trend for agglomeration. The central feature of these models is that more companies not only lead to more competition, they also attract more suppliers, employees, and consumers, and create a pool for knowledge and other positive spillovers. Given the right conditions, these forces can be stronger than the competition effect and lead to a self-reinforcing process of agglomeration by making it more attractive to be close to one's competitors rather than far away from them.

The *new economic geography literature*, strongly associated with Krugman's name, focuses on economy-wide agglomeration affects. If the benefits of proximity work across all economic activities, this leads to so-called core-periphery (or urban-rural) outcomes. Some regions will grow and prosper while others fall behind, even if they are initially identical. Initial differences will only speed up this process and determine the larger region as the 'winner' from the outset. This is what motivated the EU Commission to invest significant resources in structural funds, which were supposed to reduce initial differences and work against the agglomeration effects unleashed through the 1992 Common Market program. It is also the main concern of this year's World Development Report, which essentially discusses the policies to ensure a more balanced economic development that also includes peripheral regions at the national and global level.

The *cluster literature*, associated with Michael Porter's name, focuses instead on industry-specific agglomeration effects. If the benefits of proximity work largely within a narrow set of related economic activities, this leads to specialization. Regions become more different in terms of the specific economic activities they host, but not (necessarily) in the overall amount of economic activity or prosperity. There are many roads to prosperity and the main task for policy is to enable economic specialization and upgrade competitiveness, region by region, in a way that is aligned with the different economic activity profiles.

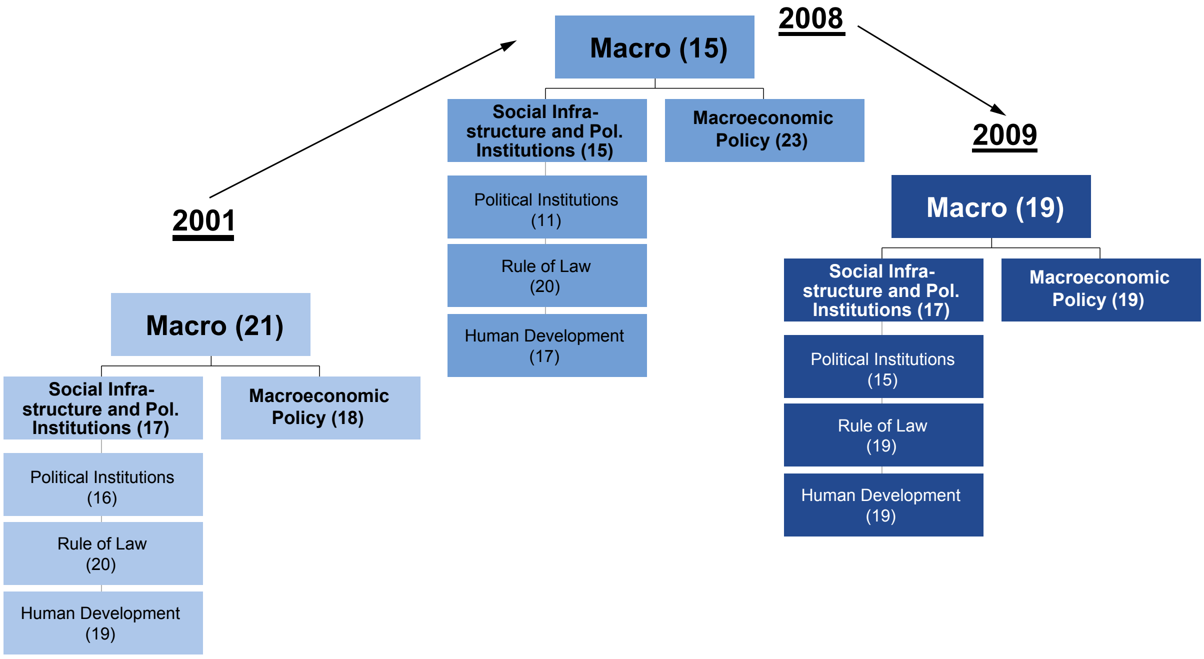
Which one of these effects is dominant in a given situation is an empirical issue. Both are conceptually well established. Their relative importance might differ between different types of economic activities and over the course of countries' economic development. The World Development Report argues that for the developing world the economy-wide agglomeration effects dominate and create difficult challenges in terms of unlivable mega-cities and rural poverty. Krugman himself hinted in his Nobel Prize speech that for advanced economies the economy-wide agglomeration effects might have become much less important. Instead, there is significant evidence that cluster-wide agglomeration effects are highly important, especially as the knowledge-intensity of economic activities increases. This creates opportunities for all regions but requires each of them to develop their own profile and economic strategy.

For the Baltic Sea Region, these issues have enormous practical importance. In a world where economy-wide agglomeration effects rule, a small region of eleven individual markets at the periphery of Europe is in a tight spot indeed. If instead cluster-specific agglomeration is more important, there is hope in specialization. Which one of these scenarios will better describe the path of the Baltic Sea Region also depends on the policy choices that are made. Higher internal integration can overcome some of the disadvantages of small size. A focus on more knowledge-intensity can shift the balance towards activities with stronger cluster effects. And cluster efforts themselves can reinforce the benefits from proximity at the level of related industries.

Macroeconomic competitiveness

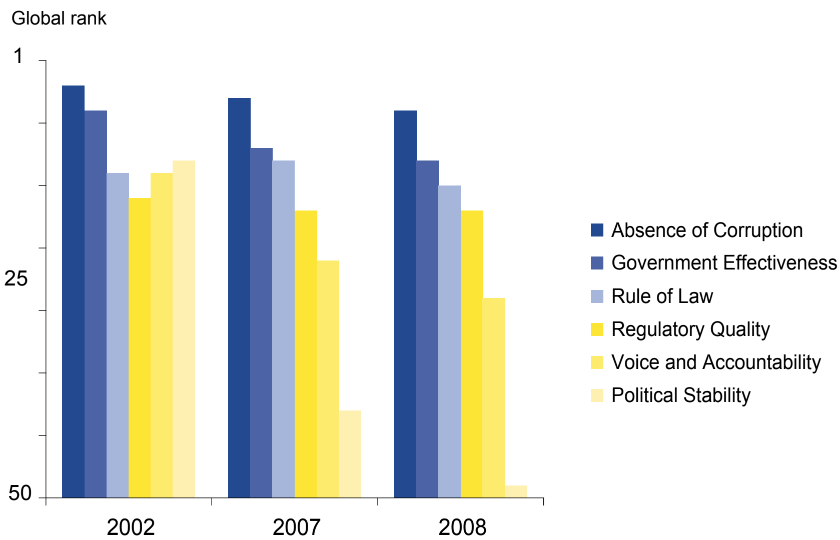
Macroeconomic factors set the overall context in which companies operate but they do not directly influence the productivity and innovativeness of firms. The social and political infrastructure provides the basic condition that enables citizens and companies to engage in economic activity. Basic human development, like basic levels of health care and education, are necessary so that individuals can go beyond pure subsistence activities. The rule of law provides the necessary stability in the incentive structure. And sound political institutions ensure that the laws put into place remain legitimate. Macroeconomic policy keeps the economy

Figure 31: Macroeconomic competitiveness over time, Baltic Sea Region



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis. State of the Region-Report 2009

Figure 32: Governance in the Baltic Sea Region



Source: World Bank (2009), author's analysis. State of the Region-Report 2009 *at an aggregate level in balance. Fiscal policy largely has to ensure that the balance of public revenues and spending remain within what economist call the intertemporal budget constraint, i.e. government does not build up unsustainable levels of debt. Monetary policy has to ensure that inflation remains in check. And macroeconomic management needs to avoid the emergence of overall imbalances in the economy.*

Social infrastructure and political institutions in the Baltic Sea Region continues to be solid, with the Region ranked globally among the top twenty countries (in these and all following rankings, countries in the Region remain counted). However, according to the data collected for the Global Competitiveness Report there has been some slippage in 2008. Especially in the quality of political institutions, traditionally one of the key strengths of the Region, there has been a drop. Overall the Region is now almost back to the level it had in 2001.

The World Bank's governance data, updated since last year, generally supports this assessment. On all six dimensions tracked, the Baltic Sea Region lost slightly in position during 2008. Compared to five years ago, the drop is even more visible. Most of the deterioration came in the category of political stability, where Iceland, Latvia, and surprisingly also Sweden, registered significant drops in 2008. The more dramatic changes since 2002 had, however, occurred early in Russia on both political stability and voice and accountability. Despite the slight overall drop in 2008, the Region still ranks between 20 and 35 for most indicators. The absence of corruption (the global corruption perception index has not been updated since last year's Report), the effectiveness of government, the rule of law, and the quality of regulation remain key advantages for the Region. The Korean IPS provides survey data on the perceived quality of politicians and bureaucrats. The Baltic Sea Region (Baltic countries and Iceland are not covered) ranks 15th and 17th respectively on these categories.

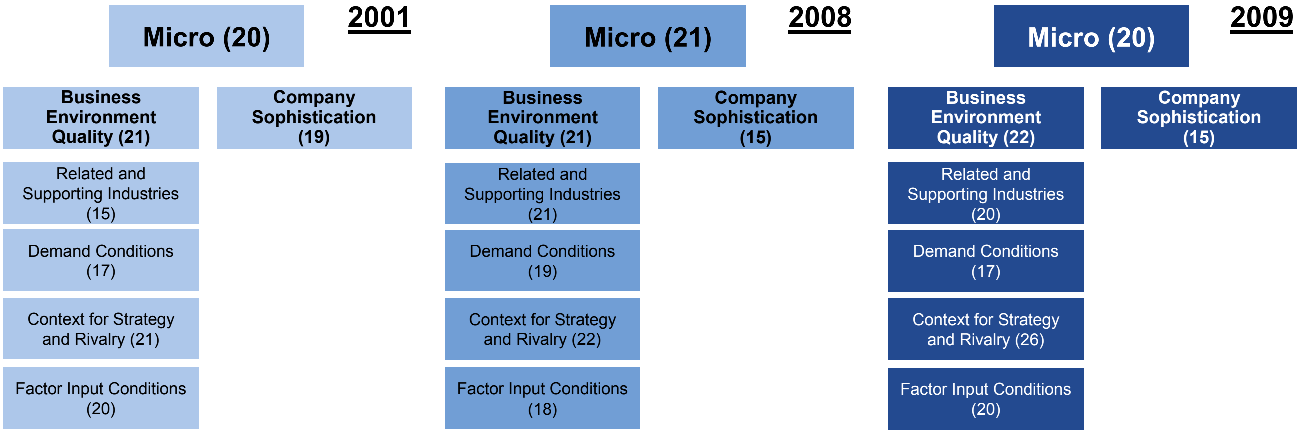
Macroeconomic policy, too, remained overall a strength of the Baltic Sea Region. In fact, in 2008 the Region's position slightly improved. With inflationary pressure rising in other countries as well, the Region gained relative position on monetary policy. IMD has a survey question on whether or not the Central Bank policy has a positive impact on economic development. The Baltic Sea Region ranks relatively poorly on this indicator, coming in 29th out of 55 countries. But Central Bank policy is not a popularity contest and it is questionable whether good Central Bankers would do well on this question. On fiscal policy, the Region remains strong. Section A of the Report already discussed in detail how the solid macroeconomic policy in the Region overall has provided it with a huge advantage during the crisis. Especially the solid government surplus over the last few years is now providing the cushion to finance a more expansionary policy.

The Region overall is strong on macroeconomic competitiveness. Differences across the Region are significant but overall still smaller than in other dimensions of competitiveness. However, in terms of Regional cohesion there is a huge difference between social infrastructure and political institutions on the one hand and macroeconomic policy on the other. Macroeconomic policy tends to be more comparable across the Region. Institutional quality, however, is hugely heterogeneous. And these changes have not decreased over time, not since last year and surprisingly, also not compared to 2002, a year when the Baltic countries and Poland were still outside the European Union.

Microeconomic competitiveness

Microeconomic factors have a direct influence on the productivity and innovativeness of firms. The quality of the general business environment shapes the productivity of the assets that companies can access as well as the opportunities for their productive use. The strength of local clusters determines the level of positive externalities that companies can nurture. And the sophistication of company strategies and operations directly sets the economic value that they are able to generate from factor inputs for their customers. The quality of these three dimensions of microeconomic competitiveness is not controlled by any individual institution; it is the outcome of decisions taken independently by many different players in companies, government agencies, universities, and many other institutions. And the challenge is for coalitions of policy makers to mobilize joint activities on action agendas that target the particular needs of a given location, not some generic set of activities that can be easily benchmarked.

Figure 33: Microeconomic competitiveness over time, Baltic Sea Region



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis. State of the Region-Report 2009

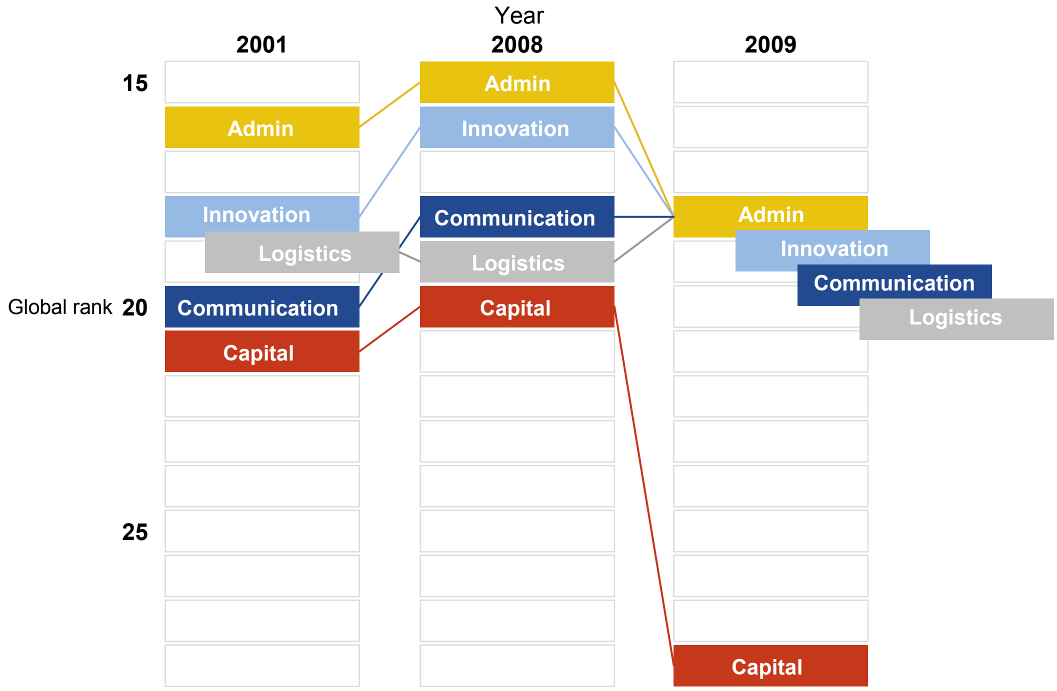
The *quality of the business environment* in the Baltic Sea Region remains high. The Region lost one rank relative to last year, but still ranks 22nd overall. While the Region continues to have relatively balanced positions across the different broad areas of business environment quality, differences increased in 2009. Factor conditions and in particular, the context for strategy and rivalry, were downgraded quite significantly, while demand conditions and the presence of supporting and related industries were seen more positively. The changes are not dramatic but the Region has not reported such significant differences in the past. Imbalances tend to devalue the benefits derived from competitive advantages. And the Region has in the past benefited from its balanced portfolio of strengths and weaknesses.

On *factor input conditions*, the Region has lost significant position in the assessment of its *capital market infrastructure*. The loss in position in this area is driven by a radically more skeptical assessment of the soundness of banks (the Region now ranks 83 on this indicator, a fall of 26 ranks relative to last year) and the ability to get financing through the local equity markets (rank 64, down 11). On all other dimensions of capital market infrastructure, the Region's ranking is much higher and has generally also stayed relatively stable compared to last year. Companies report larger barriers to getting loans, however; this is an area where the Region now ranks 36th after a fall of seven ranks. There is no new data from the other financial market-oriented sources discussed last year (WEF Financial Development Index, Milken Institute Capital Access Index) which had ranked the Region about 20th globally, comparable to its rank last year on the indicators that now have seen a significant fall.

In the four other dimensions of factor input conditions broken out in the analysis of the GCR data, the Region performs at an equal ranking towards the bottom of the global top 20 (note that four to seven countries from the Region are included among the countries ranked higher).

The Region's *logistical infrastructure* has been ranked very constantly over the years. Railroads and ports get particularly high grades, even improving slightly this year. The Region also does well on the logistical network that companies can access. The quality of this network is not only a function of the available infrastructure but also of the logistical companies providing their services. Concerns are the highest about the quality of the road network, where the Region dropped another five ranks to now come out 42nd among the more than hundred countries covered in the analysis. The heterogeneity of transportation infrastructure is high and has not decreased over time.

Figure 34: Factor input conditions over time, Baltic Sea Region



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis. State of the Region-Report 2009

Figure 35: WEF Enabling Trade index, Baltic Sea Region

Note: ranks and change in ranks reported
Source: World Economic Forum (2009), author's analysis. State of the Region-Report 2009

Other studies, like the Korean IPS ranking that uses statistical information on the transportation network physically in place, come to a broadly similar result. The WEF Enabling Trade index covers data on general business environment conditions including the policy-induced barriers to trade as well as on the infrastructure and the available services. In the last assessment,

Figure 36: WEF IT Readiness index, Baltic Sea Region

Note: ranks and change in ranks reported
Source: World Economic Forum (2009), author's analysis. State of the Region-Report 2009

published after the release of the 2008 State of the Region Report but using the survey data available at that time, the Region improved its ranking and entered the global top twenty. The World Bank Logistical Performance index, discussed last year, has not been updated since then; it showed the Region as ranked 22nd globally.

Communication infrastructure is another area in which the Region has kept its position globally over the years. The survey data collected in early 2009 suggest a weaker assessment of the quality of the phone system relative to other countries. But the statistical information on penetration rates for information and telecommunication technology remained stable, keeping the Region's overall position unchanged. This is an area in which the differences between the strongest and weakest parts of the Region are more limited than for other dimensions of competitiveness. The WEF IT Readiness index, updated after the publication of the 2008 State of the Region Report but using the survey data available at that time, shows an improved ranking for the Region.

Innovation infrastructure is a crucial element for the Region to achieve its ambition to be one of the global innovation leaders. The Region has lost position somewhat on this indicator but still ranks among the global top twenty. As for communication infrastructure, this is an area in which the differences across the Region are less strong. While the Baltics, Poland, and Russia are much weaker in management education and university-company linkages than their peers in the Region, they provided a well-skilled labor force and a large science system.

There are many studies available that provide overall assessment of the innovative capacity of countries. The Baltic Sea Region, especially the Nordic countries, tends to perform well on these rankings. And in the available data there is no indication that the Region's position should have deteriorated in a meaningful sense in the last year. However, the EU's European Innovation Scoreboard highlights a challenge that continues to affect the Region: it ranks well on most enablers of innovation, essentially the input factors to the innovation system. It also does well on linkages between the science system and companies, and the Region is home to a significant number of companies that invest in and compete on innovation. But nevertheless the outcomes in terms of economic value and market impact created are not quite up to the level of inputs and

Figure 37: Innovation in the Baltic Sea Region

Enablers

Human resources	
S&E and SSH doctorate graduates per 1000 population aged 25-34	6
Participation in life-long learning per 100 population aged 25-64	8
S&E and SSH graduates per 1000 population aged 20-29	13
Population with tertiary education per 100 population aged 25-64	13
Youth education attainment level	15
Finance and support	
Public R&D expenditures (% of GDP)	5
Venture capital (% of GDP)	8
Private credit (relative to GDP)	16
Broadband access by firms (% of firms)	24

Firm Activities

Firm investments	
Business R&D expenditures (% of GDP)	7
IT expenditures (% of GDP)	10
Non-R&D innovation expenditures (% of turnover)	18
Linkages	
SMEs innovating in-house (% of SMEs)	8
Innovative SMEs collaborating with others (% of SMEs)	9
Public-private co-publications per million population	10
Throughputs	
Technology Balance of Payments flows (% of GDP)	9
EPO patents per million population	11
Community designs per million population	13
Community trademarks per million population	17

Outputs

Innovators	
SMEs introducing product or process innovations (% of SMEs)	11
Reduced labor costs (% of firms)	21
Reduced use of materials and energy (% of firms)	26
Economic effects	
Knowledge-intensive services exports (% of total services exports)	10
Employment in medium-high & high-tech manufacturing (% of workforce)	13
Employment in knowledge-intensive services (% of workforce)	16
New-to-market sales (% of turnover)	17
Medium-tech and high-tech exports (% of total exports)	21
New-to-firm sales (% of turnover)	22

Note: Coloring indicates relative strengths and weaknesses

Source: European Innovation Scoreboard (2009), author's analysis.

State of the Region-Report 2008

firm activities. While the individual indicators used in the EU-sponsored study can be discussed, this is an assessment that comes up quite often in similar types of studies.

Finally, the Region continues to do respectably on the quality of the *administrative infrastructure*, despite a small loss of position in 2009. Given the large size of government, this is no small feat. And it is consistent with the World Bank data on government effectiveness reported earlier. However, this is an area where the differences across the Region, both from West to East but also from North to South, are significant. Even within countries these differences can be significant. In an assessment of the government bureaucracy across German states, Hamburg was ranked best while both Schleswig-Holstein and Mecklenburg-Vorpommern were at the bottom. This suggest a strong role for policy in shaping appropriate government processes, quite independent of the overall role the public sector is playing.

On the *context for strategy and competition*, the picture in the Baltic Sea Region remains mixed. Overall the Region has lost some position in this area. Especially for FDI and capital flows the business executives see now a less benevolent environment in the Region. The Region continues to do well in areas like the efficacy of corporate boards and the presence of equal market opportunities for all companies. In some of these areas the Region has even gained position as the conditions in peer countries have deteriorated. The key challenges that still remain are the weak incentives and other distortions created through the taxation system.

The relative weakening of the context for strategy and rivalry is consistent with the Region's lower rank on economic freedom. This assessment tends to rank the Baltic Sea Region generally lower because it has a strong bias against large government. But while this bias is a constant, the data collected for this analysis suggests a clear deterioration over the last year, which has increased the gap between areas in which the Region is ranked high relative to those in which it is ranked low. The economic crisis as

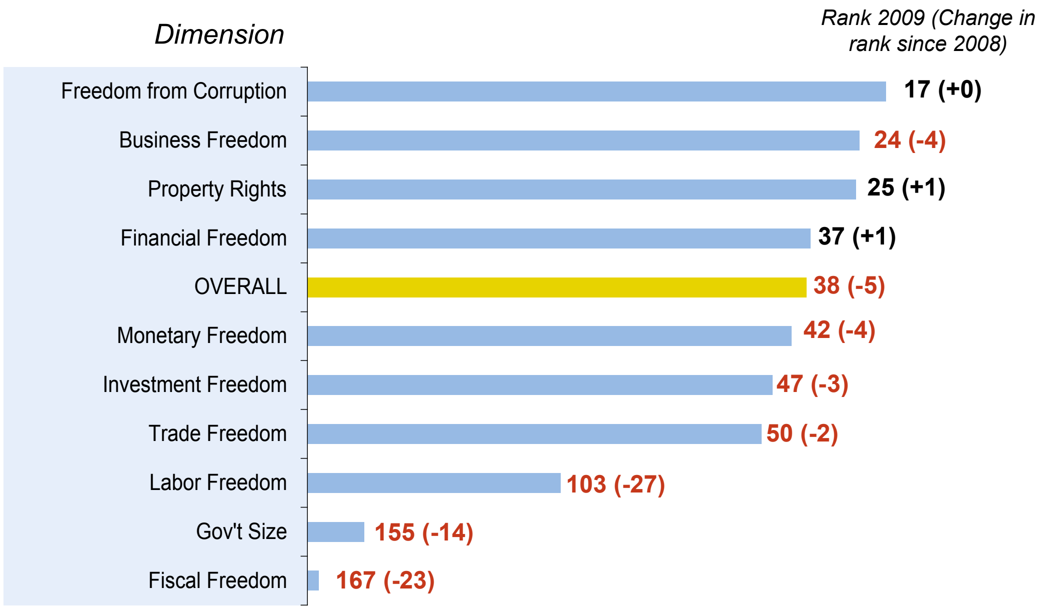
Figure 38: Context for Strategy and Rivalry in the Baltic Sea Region

Indicator	Rank	vs. 2008	vs. 2001
Efficacy of corporate boards	16	-1	-1
Low market disruption from state-owned enterprises	16	+3	+3
Cooperation in labor-employer relations	18	+2	+1
Quality of competition in the ISP sector	18	-1	+9
Intellectual property protection	20	+3	+5
Effectiveness of antitrust policy	20	+3	+2
Strength of auditing and reporting standards	22	+10	+11
(Low) Extent of market dominance (by business groups)	28	+1	-1
Intensity of local competition	30	+1	-5
Restrictions on capital flows	36	-7	+13
Prevalence of trade barriers	40	-2	-1
Prevalence of foreign ownership	40	+5	-2
(Low) Distortive effect of taxes and subsidies on competition	43	+1	-9
Pay and productivity	51	-1	-9
Business impact of rules on FDI	77	-9	-13
FDI and technology transfer	78	-8	-1
(Low) Impact of taxation on incentives to work and invest	96	+3	-13

Note: Changes in rank are calculated for a stable sample of countries
Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

State of the Region-Report 2009

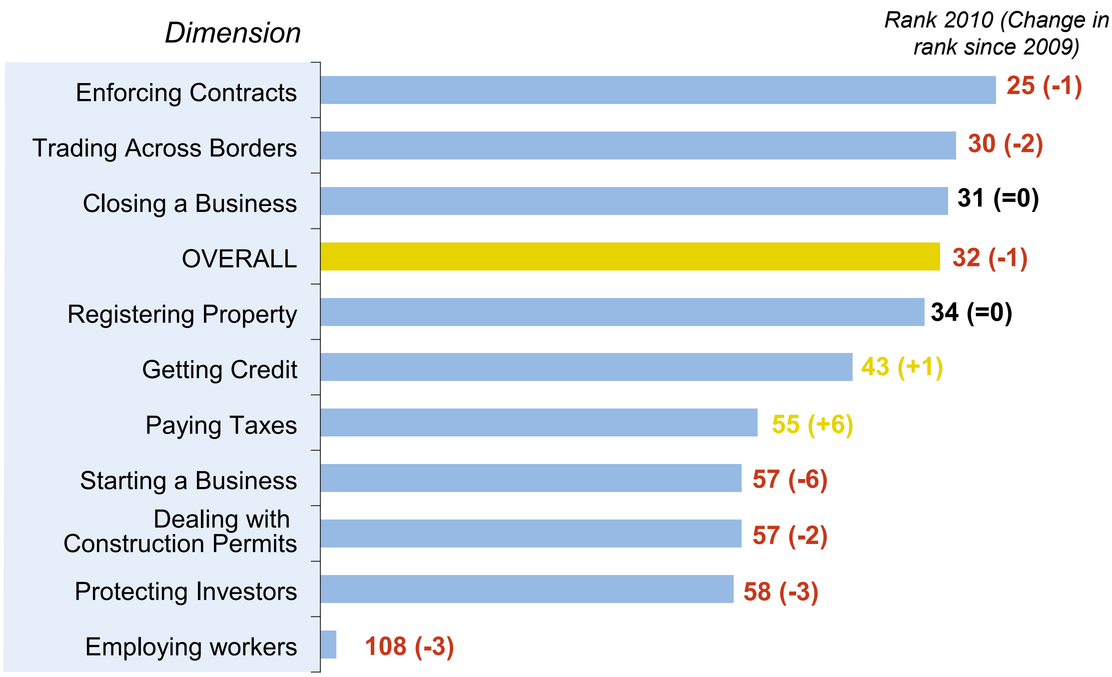
Figure 39: Economic Freedom in the Baltic Sea Region



Source: Heritage Foundation (2009), author's analysis.

State of the Region-Report 2009

Figure 40: World Bank Doing Business Index, Baltic Sea Region



Source: World Bank – Doing Business (2009), author's analysis. State of the Region-Report 2009

Figure 41: World Bank Doing Business Index, Baltic Sea Region countries

	Overall	Enforcing contracts	Trading Across Borders	Closing a Business	Registering Property	Getting Credit	Paying Taxes	Starting a Business	Dealing with Construction Permits	Protecting Investors	Employing Workers
Denmark	**6 (-1)**	28	6	7	47	15	13	28 (-10)	10	27	9
Norway	**10 (=0)**	4	9	3	8	43	17	35 (-10)	65	20	114
Iceland	**14 (-3)**	2	73 (-38)	16	13	30	31	33 (-14)	31	73	56
Finland	**16 (-2)**	8	4	5	27 (-6)	30	71 (+18)	30 (-10)	47 (-6)	57	132
Sweden	**18 (-1)**	51	7	18	20	71	42	43 (-11)	19	57	117 (-5)
Estonia	**24 (-2)**	49 (-20)	3	61	13 (+11)	43	38	37 (-14)	20	57	161
Germany	**25 (+2)**	7	14	35	57	15	71	84 (+17)	18	93 (-5)	158
Lithuania	**26 (-1)**	17	28	36	4	43	51 (+8)	99 (-22)	64	93 (-5)	119
Latvia	**27 (+2)**	15	22	88	58 (+21)	4 (+8)	45 (-8)	51 (-16)	78	57	128
Poland	**72 (=0)**	75	42	85	88	15 (+12)	151	117 (+28)	164 (-7)	41	76 (-7)
Russia	**120 (-2)**	19	162	92	45	87 (+22)	103	106 (-18)	182	93 (-5)	109

Note: number in brackets indicates changes in rank since last year; only rank changes larger than +/- 5 reported State of the Region-Report 2009
Source: World Bank – Doing Business (2009), author's analysis.

a driver of some of these changes has accentuate the differences of the dominant economic policy model in the Region versus the benchmark used for the Heritage Foundation's Economic Freedom index.

On the 2010 Doing Business ranking just published, a World Bank assessment of the rules and regulations affecting business, the Region ranked 32nd overall, a continuation of the slight negative trend of the recent past. The Region's strengths remain in enforcing contracts, trading across border, and closing a business. Its weaknesses are labor market regulations, tax regulations, and a number of other rules and regulations affecting companies, especially SMEs. Worryingly, the Region continues to slip at a significant rate – another six ranks this year – on the ease of starting a business. While other countries reduce, sometimes aggressively, regulatory barriers for new companies, the Baltic Sea Region stands still on an area that is widely perceived as a key challenge it has to address.

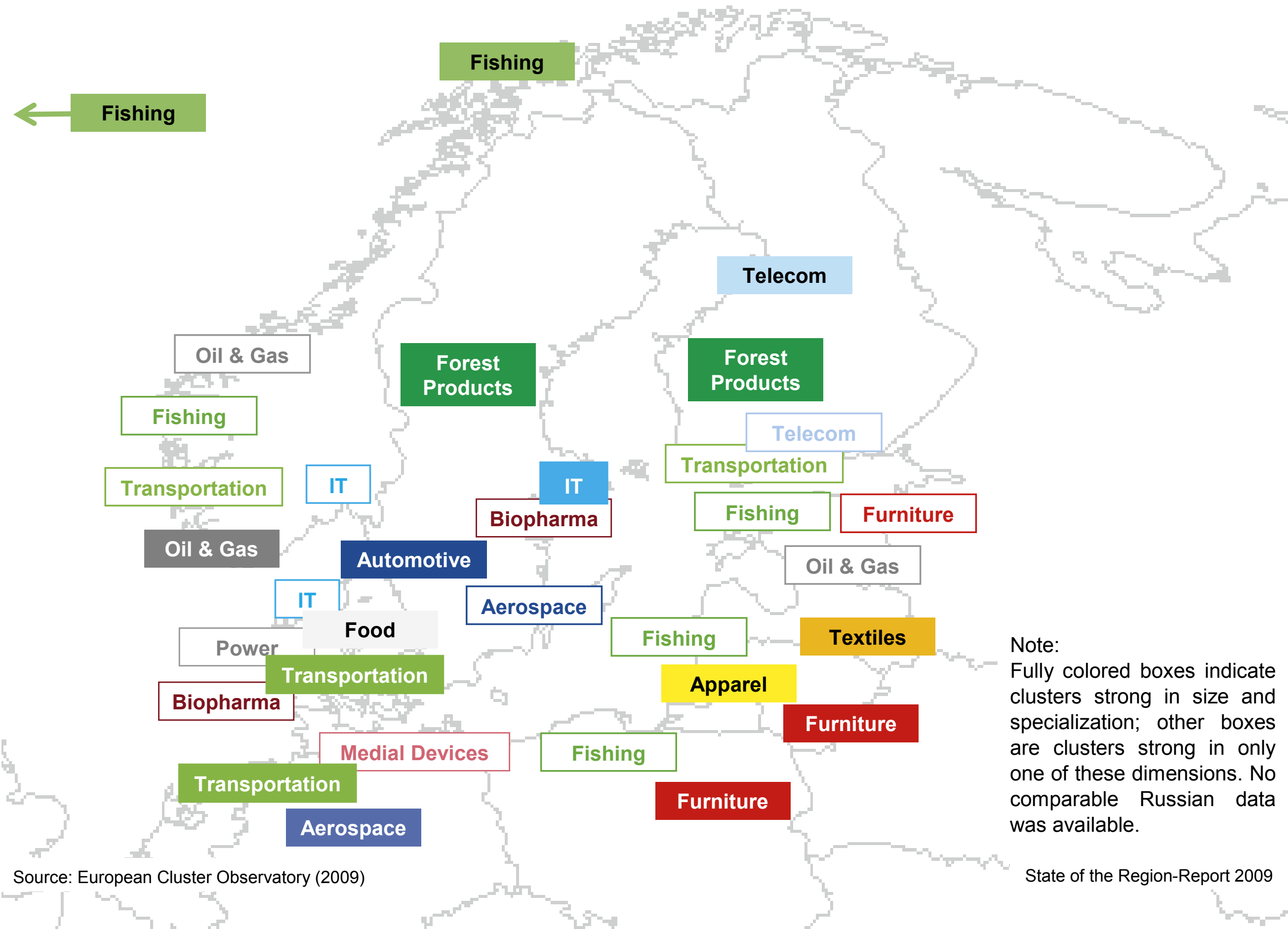
Figure 42: Supporting and related industries in the Baltic Sea Region

Indicator	Rank	vs. 2008	vs. 2001
Local availability of process machinery	13	4	5
Local availability of specialized research and training services	14	3	-1
Local supplier quality	21	-2	-1
Extent of collaboration in clusters	24	0	-11
Availability of latest technologies	27	-3	-2
State of cluster development	27	-2	-11
Extent of cluster policy	29	6	6
Local supplier quantity	40	-12	-19

Note: Changes in rank are calculated for a stable sample of countries
Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

State of the Region-Report 2009

Figure 43: Clusters in the Baltic Sea Region



Note:
Fully colored boxes indicate clusters strong in size and specialization; other boxes are clusters strong in only one of these dimensions. No comparable Russian data was available.

Source: European Cluster Observatory (2009)

State of the Region-Report 2009

Cluster policy: the state of the debate

The Baltic Sea Region has over the last few years seen a huge rise in cluster efforts, mostly as the result of government progress to strengthen and develop clusters. While policy makers have spoken with their budgets, there remains a significant level of skepticism as to whether these efforts will work.

The traditional concern about cluster policies has been focused on the possible distortions they might introduce. For most countries in the Region this argument has lost considerable weight in the last few years. If there were distortionary effects, they tended to be much smaller than for most other policies that would have been used instead. Cluster efforts turned out to be a way to engage in sector-specific policies in a way that was much less distortive then the traditional industrial policies. One reason is the difference in scope: while traditional policies focused on individual companies or narrow industries, cluster efforts encompass a broader set of related industries and companies. This leads to much less distortion among companies that are in narrow competition for customers or input. The other reason is the nature of the policy tools employed: cluster support tends to come in the form of subsidies for collaboration, investment, or demand, while traditional industrial support used targeted credit or temporary shelter from competition. But while cluster efforts have been less distortive than initially feared, it remains the case that in countries with weaker institutional structures they can open a pandora's box of intervention. This is a key concern in Russia, where robust program structures are necessary to avoid cluster programs falling into this trap.

The key concern about cluster policies now is on their actual impact. One line of argument focuses on the nature of cluster policy itself. Despite a number of years of experience with cluster policy, there remains a huge degree of vagueness about what it actually entails. Researchers from the new economic geography school have tended to see cluster policy as attempts to artificially "create agglomerations" to jump-start a process of then self-supporting cluster growth. The problem in this approach is that it is very hard for the government to determine where such jump-starting might work. And that is why most researchers are highly skeptical of such an approach. Researchers from the cluster school understand cluster policy very differently. They see it as ways to improve the competitiveness of naturally developing agglomeration by improving their internal collaboration, and by making public investments in business environment upgrading in intense dialogue with them. Agglomeration thus becomes a tool to make economic policy more effective, not an outcome that is directly targeted or created through government intervention. Seen this way, cluster policy is much less contentious, even though differences in opinion about its potential remain.

The other argument concerns whether cluster policy is sufficiently scalable. Looking at the experience with the impact of cluster efforts so far, most individual assessments of cluster programs come to quite positive conclusions. These efforts seem to generate beneficial results for the companies and regions involved. Much work still needs to be done on exactly tracking and quantifying the impact of cluster initiatives and programs, but that is the emerging consensus of program evaluations done so far. The problem for policy makers, however, is that success for the participants in a cluster initiative tends to be quantitatively small or even miniscule relative to the economic trajectory of a region or entire country. Can cluster policy be scaled up so that it starts having a meaningful impact at this higher level? There are a number of ideas on how to do this, but so far this remains one of the clear challenges cluster policy has to address over the coming years.

See: "Clusters, cluster policy, and Swedish competitiveness", study done for the Swedish Globalization Council (2009); http://www.sweden.gov.se/sb/d/9150/a/121799

Figure 44: Demand sophistication in the Baltic Sea Region

Indicator	Rank	vs. 2008	vs. 2001
Stringency of environmental regulations	13	0	3
Presence of demanding regulatory standards	18	0	-5
Buyer sophistication	19	-1	-4
Laws relating to ICT	26	6	4
Government procurement of advanced technology products	29	0	2
Government success in ICT promotion	32	3	7

Note: Changes in rank are calculated for a stable sample of countries
Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

State of the Region-Report 2009

Figure 45: Demand sophistication in selected Baltic Sea Region countries

Consumers are …

	OVERALL	quality sensitive	health and environment conscious	design oriented	well informed	open to new products	respectful of IPR	brand sensitive	price sensitive
Denmark	2	6	4	1	12	6	9	11	22
Sweden	3	3	1	4	2	3	3	16	24
Finland	18	27	20	32	7	22	11	21	36
Germany	19	19	18	14	16	30	16	30	53
Norway	20	14	13	5	23	27	19	4	46
Russia	26	9	29	46	39	42	53	46	2
Poland	32	22	30	31	35	18	47	31	26

Source: IPS National Competitiveness Research (2009)

State of the Region-Report 2009

On *related and supporting industries (clusters)*, an area discussed in detail in previous reports, the Region has slightly improved its position. Interestingly, the differences between strong rankings for the access to specialized suppliers of process machinery and weak rankings for the overall quantity of suppliers is increasing further. This is consistent with an increasing level of specialization in the economies of the Region. About 30 clusters across the Region have already developed to significant employment size and specialization at the European level. Many more hold meaningful positions in more narrow market segments.

On *demand conditions*, often critical for innovation, the Region does well and has improved its position over the last year. Stringent government regulations on consumer protection and environmental qualities are one driver. While they impose short-term costs, such regulations can enable companies to gain a lead in product features or production processes that competitors elsewhere have to adopt later on. But consumer behavior is another driver: markets in the Baltic Sea Region are open to new technologies and trends, and often highly 'fashion'-driven with a significant premium for brands and short-term innovation.

The Korean IPS study provides survey evidence for more detailed aspects of consumer behavior. For the seven Baltic Sea Region countries, it shows in particular a focus on quality, health and environmental features, and design. If products and services score high on these dimensions, consumers in many parts of the Region are not particular price sensitive. This supports innovation and makes the Baltic Sea Region an interesting test market.

The *sophistication of companies* in the Baltic Sea Region continues to be a distinct advantage of the Region. It retains its position as the 15th ranked region on this dimension globally. Of the countries ranked higher, five are from the Baltic Sea Region with three of them among the top five.

The indicators of company sophistication can be organized in three groups, capturing different aspects of company organization and strategy.

Figure 46: Company sophistication in selected Baltic Sea Region countries

Indicator	Rank	vs. 2008	vs. 2001
Strategy and operational effectiveness			
Capacity for innovation	10	1	2
Company spending on R&D	13	2	2
Value chain breadth	18	0	-1
Production process sophistication	18	-1	2
Extent of marketing	20	9	9
Nature of competitive advantage	21	-1	-1
Firm level technology absorption	24	-4	-3
Degree of customer orientation	25	-2	1
Organizational practices			
Willingness to delegate authority	9	3	4
Extent of staff training	12	2	7
Reliance on professional management	16	-1	2
Extent of incentive compensation	29	1	-2
Internationalization of firms			
Control of international distribution	14	7	5
Breadth of international markets	20	0	1
Extent of regional sales	21	0	3
Prevalence of foreign technology licensing	32	1	22

Note: Changes in rank are calculated for a stable sample of countries
Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

State of the Region-Report 2009

As in the past, the Region does best on measures of organizational practices. Companies in the Region generally employ modern structures well aligned with high levels of innovation. On measures of strategy and operational effectiveness the Region does also well. Significant is the strong innovation-focus of companies which has even increased slightly over time. Internationalization of firms has improved over time and is now also an area where the Region ranks among the top twenty globally.

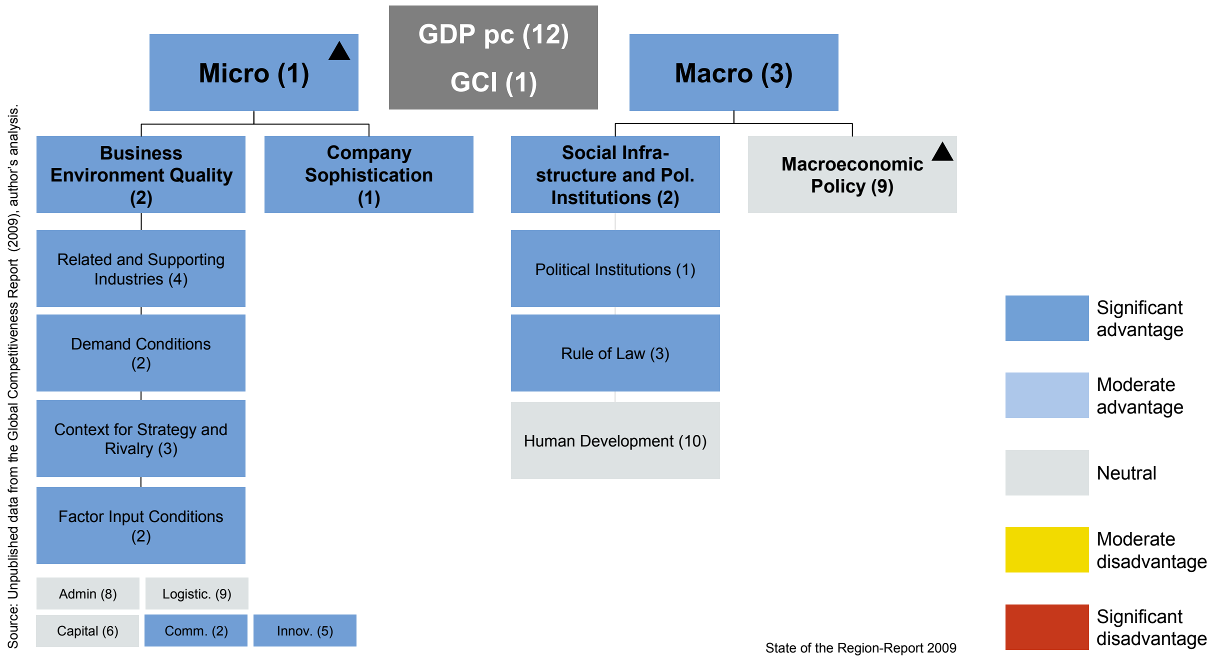
National competitiveness across the countries of the Baltic Sea Region

*Within the Baltic Sea Region, **individual countries** face different challenges for upgrading their competitiveness. This heterogeneity exists not only between the Nordic countries and Germany on the one hand and the Baltic countries, Poland, and Russia on the other hand, but also between countries within these two groups. A country-specific analysis of competitiveness is thus crucial to identify appropriate action priorities. The following section provides a brief discussion of individual Baltic Sea Region countries.*

Sweden ranks 1st on the new aggregate indicator of competitiveness calculated from the Global Competitiveness Report (GCR) data. This is a jump by four ranks since last year, putting Sweden back in the leading position it had in 2007. Given the small margins that separate the leading countries on the index, these changes in rank do not reflect fundamental changes in their position.

Sweden made particular gains in microeconomic competitiveness. The high level of company sophistication, most visible in the significant number of globally active Swedish multinational companies, is at the heart of the country's prosperity. Already strong in many dimensions of company sophistication, this year saw a further improvement in the assessment of factors related to companies' internationalization. In business environment quality,

Figure 47: Competitiveness profile: Sweden

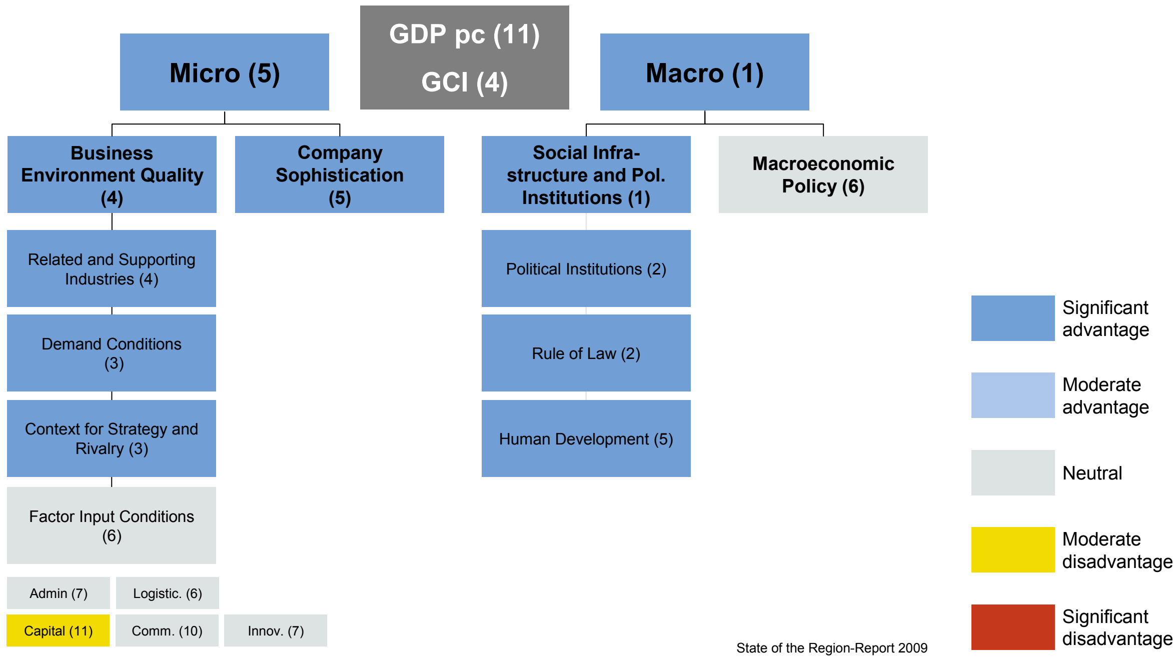


the overall patterns of strengths and weaknesses remained virtually unchanged. Sweden has very balanced strengths, although factor input conditions, here in particular the innovation system and the communication infrastructure, and demand sophistication are particularly highly ranked. In the area of related and supporting industries, cluster policy has become much more visible in the eyes of the Swedish business executives that responded to the survey. Sweden has traditionally been strong on institutional quality and retained this position in 2009. On macroeconomic policy, it also improved further. While the country is ranked a bit lower on this indicator than on other dimensions of competitiveness, the gaps among leading countries in this area are particularly small and do not reflect fundamental differences in competitive position.

Denmark ranks fourth overall on competitiveness, a loss of two ranks compared to last year. Since 2002 Denmark has been among the top five countries in the world on overall competitiveness.

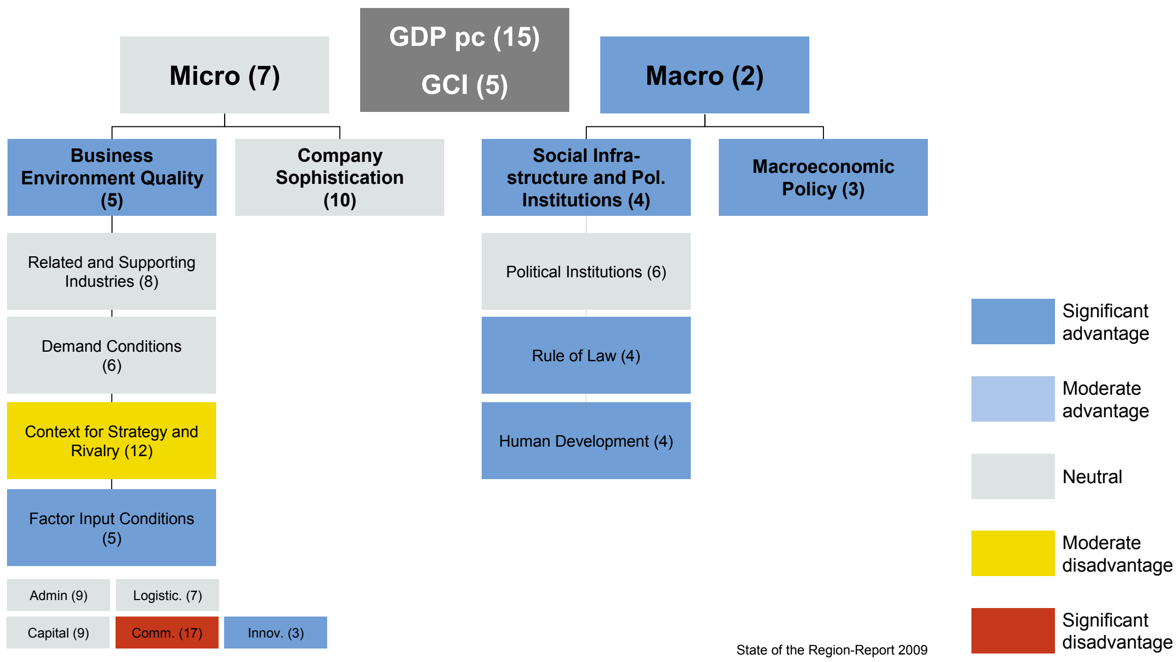
The country's competitiveness profile has remained virtually unchanged since 2008. It ranks top in the world on macroeconomic competitiveness for the first time. Especially on social infrastructure and political institutions Denmark is the global benchmark. On macroeconomic policy, an area where the differences among the leading countries are particularly small and have little impact on overall outcomes, the country's position remained similar to last year but has improved somewhat over the medium term. On microeconomic competitiveness there has been a small loss of position. In company sophistication, the internationalization of firms, especially their control of foreign distribution and their regional sales, has fallen somewhat behind. The position on different aspects of business environment quality remains quite balanced, with strong demand conditions and solid dynamics of related and supporting industries. However, over the last year there has been a drop in the perceived level of collaboration within clusters. Also, the view of cluster policies in the country has become slightly more skeptical. Not surprisingly, the view of capital market infrastructure has deteriorated, especially on access to equity finance and on the soundness of banks. The overall stable rank on innovation infrastructure obscures not only improvements in the perceived quality of the innovation system, but also growing bottlenecks in finding the needed highly-skilled employees.

Figure 48: Competitiveness profile: Denmark



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

Figure 49: Competitiveness profile: Finland



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

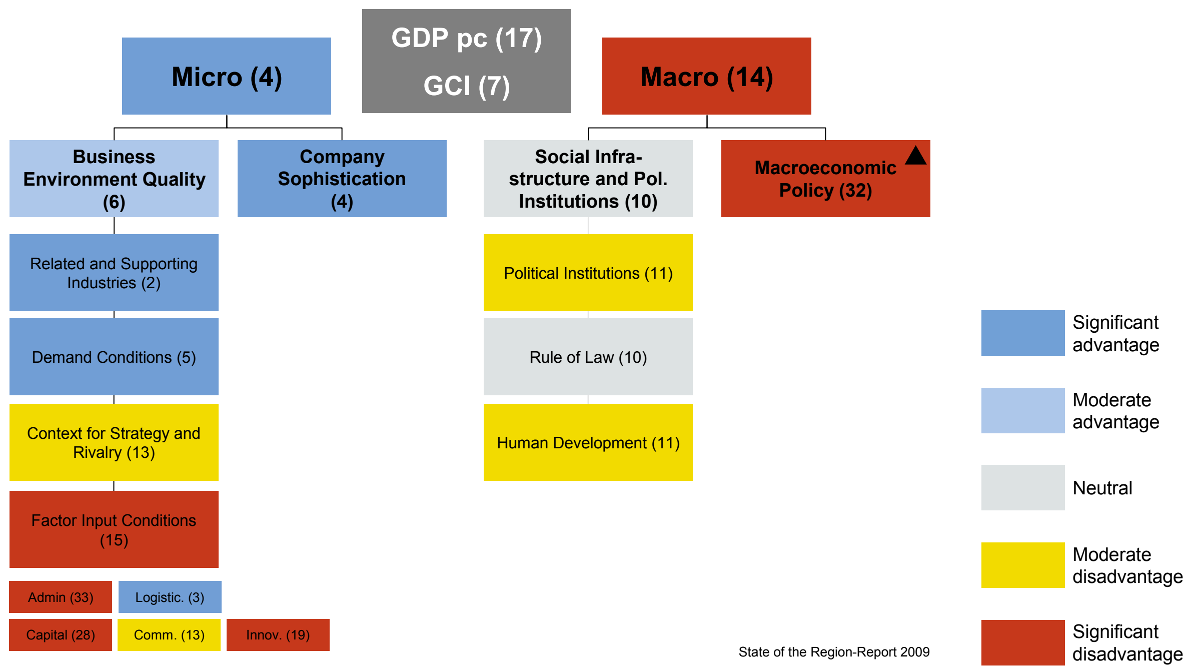
Finland drops to fifth place, losing the leading position it had on overall competitiveness last year and for most of the period after 2000. While this is the lowest rank the country has held since comparable data has been available, it still ranks firmly within the most competitive locations in the global economy.

High macroeconomic competitiveness remains Finland's distinctive asset, even though it had to cede the first rank to Denmark. There is some drop in public trust of politicians and the perceived transparency of policy making, possibly related to issues of party funding discussed over recent months. Finland continues to rank among the global top ten on these indicators even after this slight deterioration. In the area of microeconomic competitiveness, company sophistication, traditionally slightly weaker in Finland, has seen some drop on the internationalization of companies. Business environment quality has remained overall more stable, especially on factor input conditions. Capital markets remained solid and their ranking even improved as other countries saw a more significant drop. Innovation infrastructure continues to be a significant advantage, although the assessment of quality has fallen for both scientific research institutions and management education. The position on related and supporting industries has dropped somewhat, mainly because of a significant fall in the quantity of suppliers that executives report. Collaboration within clusters and, despite some slippage, cluster policy continue to gain high marks. The context for strategy and rivalry also suffers somewhat, especially because measures of the openness and intensity of domestic competition are at a markedly lower level than in the past.

Germany is up four ranks and now comes seventh on overall competitiveness, roughly the same rank as it had between 2005 and 2007. Germany is now the only large economy among the ten most competitive countries in the world, after the US dropped from seventh place to seventeenth.

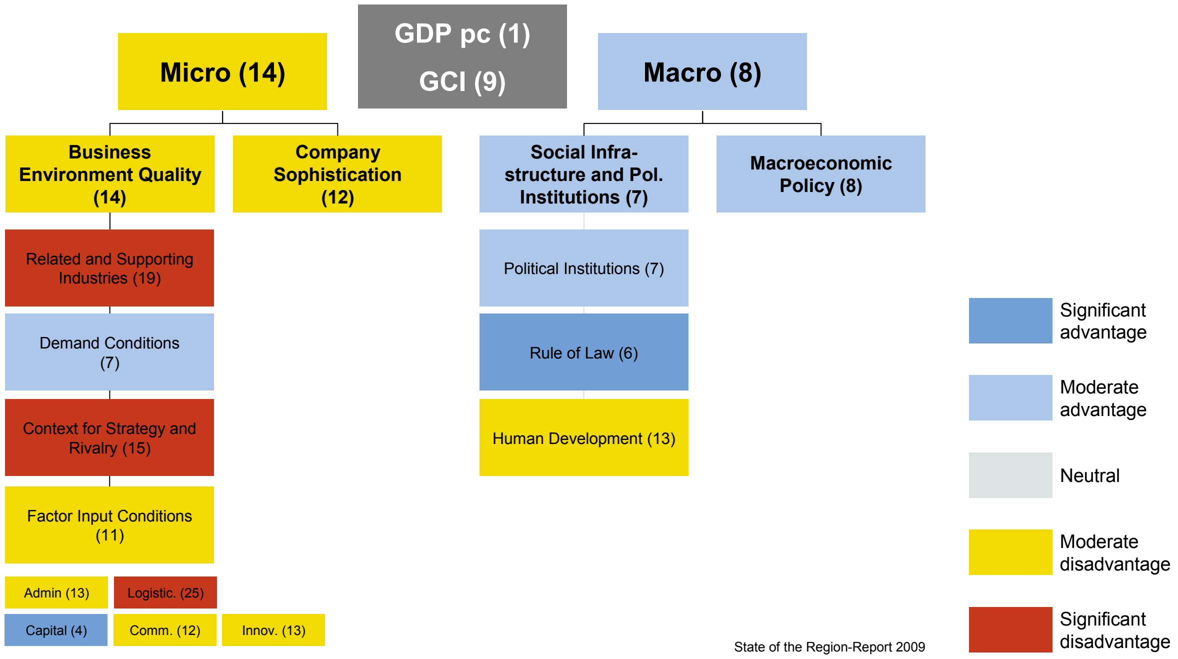
Germany's key strength is its solid microeconomic competitiveness, especially a leading position on company sophistication. There have been slight improvements in organizational practices, the area of company sophistication in which the country ranks somewhat weaker. Business environment quality has remained virtually unchanged overall, with capital markets and administrative infrastructure being areas of the most obvious relative weakness. Demand conditions, a key driver of innovation, have improved and are now back to their long-term average position after a surprising dip last year. Cluster policy has been more strongly recognized by business executives, possibly in reaction to the Spitzencluster competition in which the Hamburg Aerospace cluster from Northern Germany was one of the six first winners. Macroeconomic competitiveness remains somewhat weaker but especially macroeconomic policy has improved relative to the recent past. Despite these im-

Figure 50: Competitiveness profile: Germany



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

Figure 51: Competitiveness profile: Norway



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

provements, the country's position on monetary and fiscal policy remains below the levels reached at the beginning of the decade.

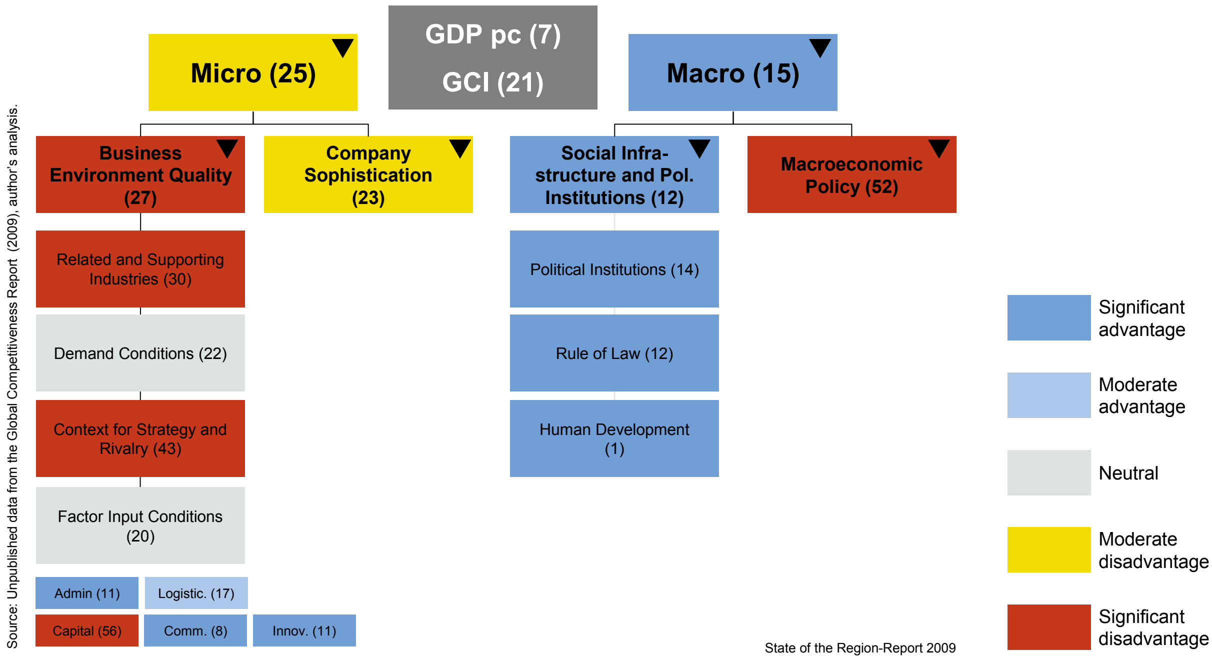
Norway now ranks ninth on overall competitiveness, virtually unchanged from its eighth place last year. The last two years have been the first instances in which the country was ranked among the global top ten, after a history of being positioned at around rank 15.

Norway continues to excel on macroeconomic competitiveness, despite a slight drop relative to last year. Traditionally the weak point in this overall area has been the lack of decentralization of economic policy. Relative to last year, however, Norway saw significant improvements in this dimension. In microeconomic competitiveness, the country's position dropped one rank despite a better performance on company sophistication. Especially organizational practices, traditionally a relative strength, were up. Demand conditions remained beneficial, and factor conditions kept their overall position. However, there was a drop in all aspects of transportation infrastructure, especially the perceived quality of the road system. The assessment of capital market infrastructure was up relative to peer countries, despite weaker access to equity financing. Local supplier quantity, collaboration within clusters, and the extent to which government was seen as pursuing a strong cluster policy have all visibly dropped.

Iceland dropped twelve ranks to place 21st on overall competitiveness. Historically ranked the lowest of the Nordic countries, the gap to its peers has increased significantly. This is the first time the country dropped out of the top twenty since comparable data has been available.

The most dramatic drop has been in macroeconomic policy, the country's main weakness even before the onslaught of the crisis. Despite this, Iceland still ranks higher on macroeconomic than on microeconomic competitiveness. This is a testament to its strong institutions, but also an indication of the work that needs to be done on upgrading microeconomic competitiveness, besides dealing with the macroeconomic fallout of the crisis. Even in institutional quality, however, the crisis has shown its impact in markedly lower rankings for politicians, the parliament, and the ethical behavior of companies. Company sophistication has gone down by eleven ranks and has never before been assessed as so weak; there has been a dramatic fall, especially on organizational practices. There is a troubling drop in staff training, R&D focus, value chain presence, and the overall nature of companies'

Figure 52: Competitiveness profile: Iceland



competitive advantages. On business environment quality, there have been deep falls in some areas while in many others Iceland's position has remained stable. Business executives looking at Iceland's position are clearly more worried across the board, but they make clear distinctions among different dimensions of the country's competitiveness fundamentals. Not surprisingly, the assessment of capital market infrastructure is dramatically down, especially the view of the soundness of banks but also the access to equity and loan capital. Demand conditions have suffered, especially with the government now perceived as not being in a position to procure advanced products and services. The context for strategy and rivalry also suffered significantly. Restrictions to capital flows and the greater skepticism on the efficacy of boards, the quality of auditing standards, and the quality of regulation, have taken their toll.

Estonia now ranks 26th, not much changed from last year's rank of 22nd. This is very much in line with its position over the last decade and continues to put the country on top of its Baltic peers and, now following Slovenia, among the best performers in Central and Eastern Europe.

Estonia remains especially strong on macroeconomic competitiveness. This is the case despite the significant drop on macroeconomic policy compared to last year, and even more so when comparing to its position at the time of its EU accession. Microeconomic competitiveness has suffered even more than overall macroeconomic competitiveness. In the past the country had a balanced position across both dimension. Estonia is historically weaker on company sophistication than on business environment quality. It ranks low especially on the internationalization of companies, but it has also weaknesses in marketing, the nature of companies' competitive advantages, and, after a fall this year, in the R&D focus of firms. Business environment quality has remained relatively stable. On factor conditions, capital markets have lost some strength, but the drop has been less pronounced than in some peer countries. The context for strategy and rivalry remains the highest ranked among the four business environment dimensions, despite growing concerns about an erosion in the presence of foreign companies. Demand conditions have dropped as the government's willingness to buy sophisticated products and services, seen as an advantage in the past, is now seen with more skepticism. Cluster dynamism, traditionally low, has suffered from a fall in the perceived level of collaboration among companies.

Poland, now ranked 33rd overall, registered the largest ranked gain of all countries in the Baltic Sea

Region, gaining nine ranks since last year. This is the best rank the country has achieved since comparative data has been available, and the first time it is among the global top forty countries.

Poland benefits from its overall very balanced positions on microeconomic and macroeconomic competitiveness. The country gained especially on microeconomic competitiveness but also institu-

Figure 53: Competitiveness profile: Estonia

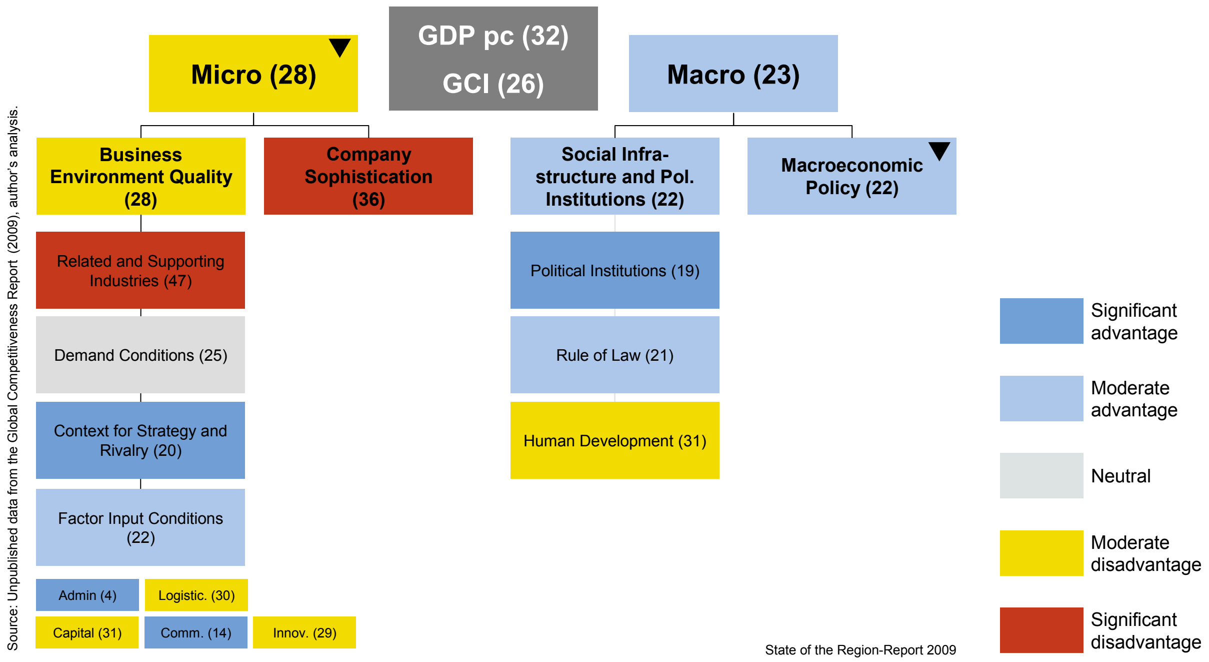
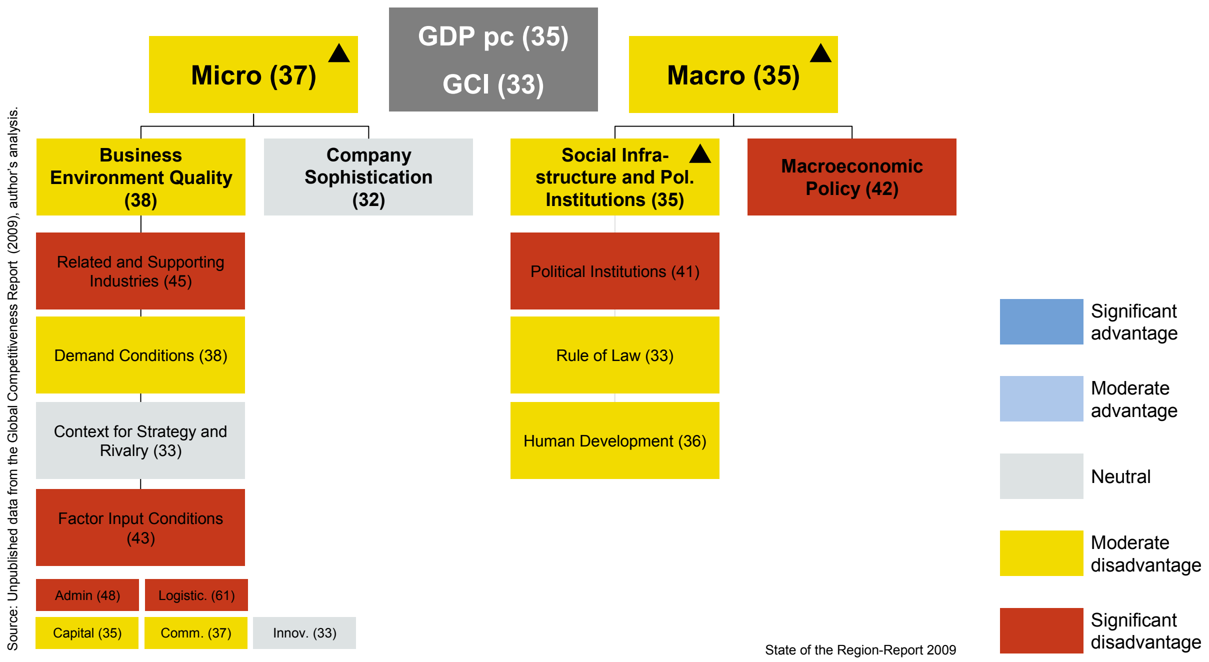


Figure 54: Competitiveness profile: Poland

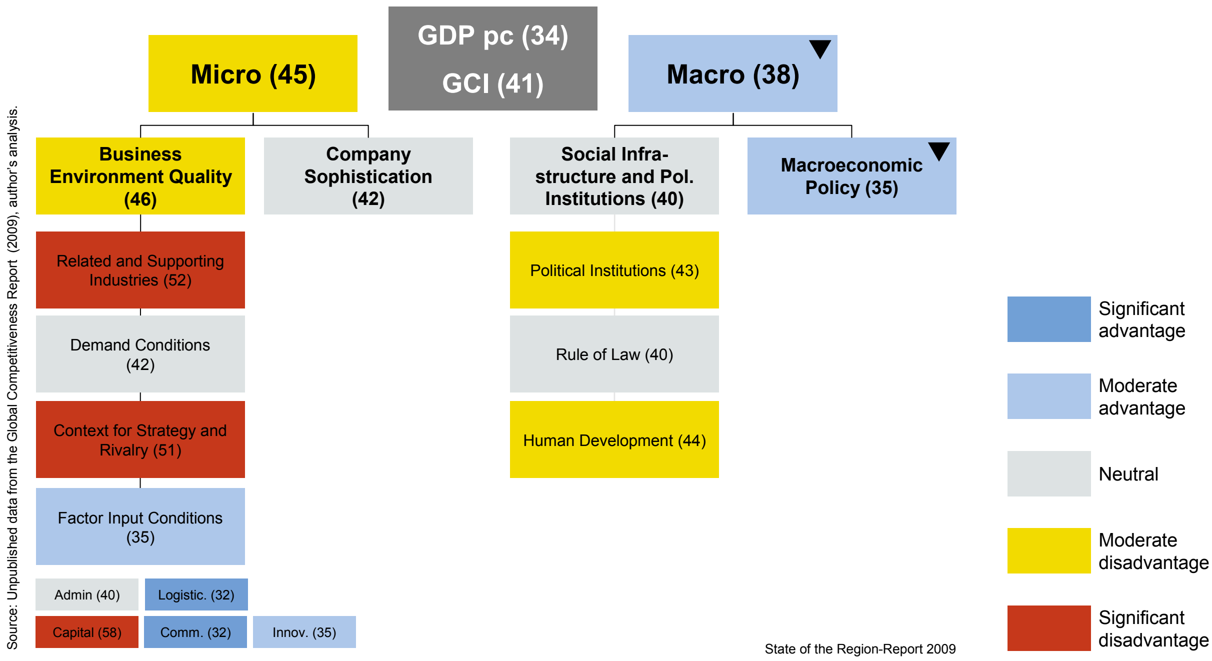


tional quality. Company sophistication remains the key weakness, but it registered huge improvements, especially in organizational practices, and now ranks 28th versus 54th last year. In business environment quality, demand conditions and the context for strategy and rivalry improved the most. Demand conditions benefited from more sophisticated and stringent regulation. The context conditions improved almost across the board, both in terms of domestic sophistication and international openness. Among factor conditions, administrative procedures and capital market infrastructure, after the significant drops in peer countries, are both up. Indicators of the innovation system also continue to improve, although at 33rd Poland is now only back at the position it held at the beginning of the decade. The physical infrastructure, especially roads, continues to be weak. Cluster development remains another key weakness, despite an improvement in the quantity of suppliers. On macroeconomic competitiveness, the view of institutions has become significantly more favorable. There is more trust in politicians and parliament, and less perceived favoritism. However, the low level of efficiency of the judicial system is now even more glaring and remains a key concern.

Lithuania is now ranked 41st on overall competitiveness. This constitutes a drop of six ranks compared to 2008, and of eleven ranks compared to two years ago.

Lithuania remains stronger on macroeconomic competitiveness, especially macroeconomic policy. But this advantage is now eroding fast with fiscal policy already showing signs of an impending crisis. Given the forecasts, a further deterioration in the coming year is all but certain. The country has also lost position on microeconomic competitiveness. On company sophistication its ranking remained stable and well balanced. Business environment quality, however, dropped back to pre-EU accession levels. Capital market infrastructure suffered the most. But there was also a clear deterioration in the assessment of physical infrastructure, where the position on air transport and on electricity supply is down; the latter is likely to be a consequence of the uncertainties created by the closure of the Ignalina nuclear power plant. Innovation infrastructure is the one area with shows more meaningful improvements, but the country is still behind its position during the middle of the decade. Demand conditions and cluster presence are stable but the context for competition and

Figure 55: Competitiveness profile: Lithuania



strategy is down. Higher taxation as a consequence of the government's crisis measures are one concern, and a significantly less positive view of competition policy and a strong drop in the perceived intensity of local competition are another.

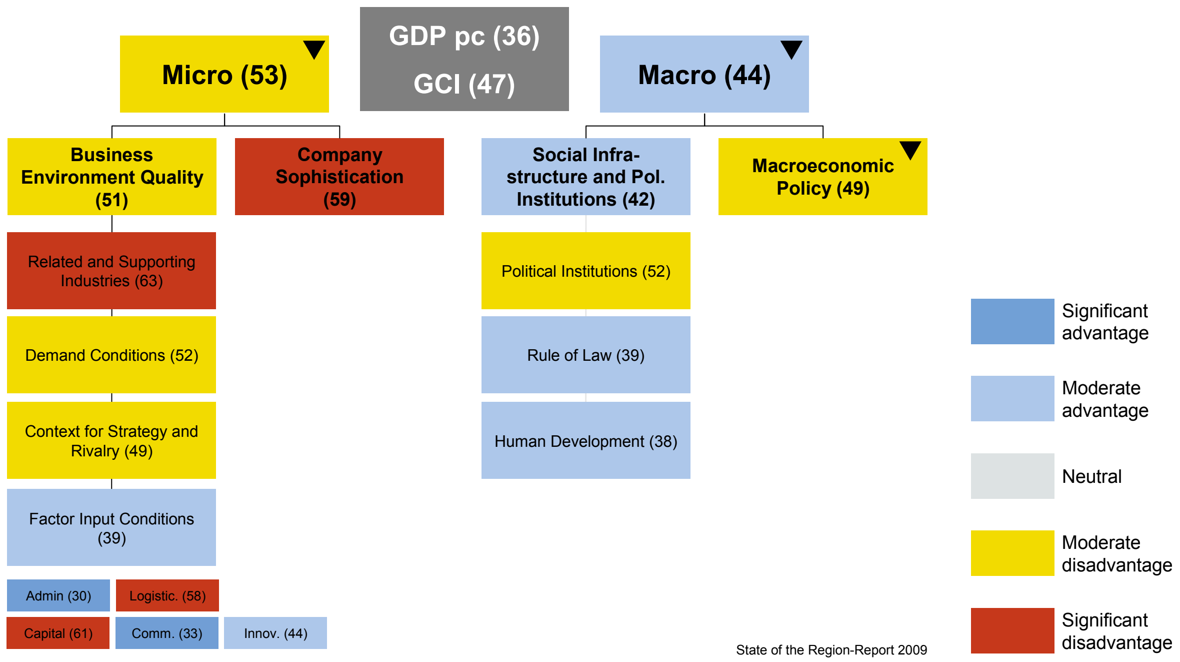
Latvia dropped to 47th rank, down nine ranks from last year. The country remains the weakest ranked of the Baltic countries, with the gap to its peers rising and Poland passing it by. Its current rank is the weakest recorded since comparable data has been available. There has been a constant decline since 2003, the year prior to EU accession.

Like its Baltic neighbors, Latvia is stronger on macroeconomic than microeconomic competitiveness. With the dramatic deterioration of macroeconomic policy in the wake of the crisis, the gap has been shrinking somewhat and is now back at the level seen at the beginning of the decade. Institutional quality has also dropped but by much less than the country's overall competitiveness. There is a lower level of trust in politicians and the parliament, and rising concerns about favoritism. But interestingly there is also a much higher sense of transparency of policy making. Microeconomic competitiveness is assessed lower in both company sophistication and business environment quality. For companies, internationalization remains the clearest weakness but this has been holding up better than other aspects. In the business environment, especially the context for strategy and rivalry has deteriorated. The crisis has led to more concerns about the ease of capital flows, rising tax levels, and an eroding presence of foreign companies. Capital market conditions have quite obviously deteriorated as well. Many other aspects of the business environment are, however, seen as more stable or even improved. While business leaders in Latvia clearly are concerned, there is no across-the-board downgrading in their views about the conditions for doing business in the country.

Russia is now ranked 53rd, still at the bottom of the Baltic Sea Region. After losing six ranks compared to last year, the gains made since 2004 have completely evaporated. But the country continues to rank significantly better than after the previous crisis.

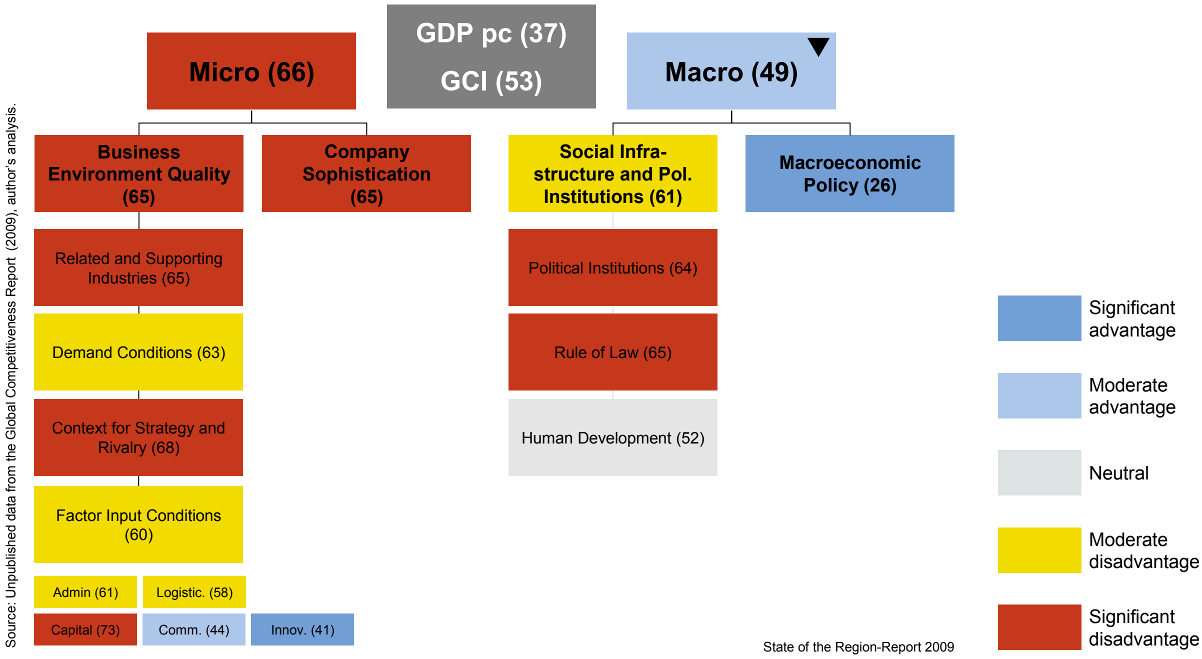
Russia remains much stronger on macroeconomic than on microeconomic competitiveness. This is almost entirely the result of its relatively solid macroeconomic policy. This is also the area in which the country has lost most ground over

Figure 56: Competitiveness profile: Latvia



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

Figure 57: Competitiveness profile: Russia



the last year, but the size of the drop has so far not been dramatic. Institutional quality remains far weaker and has lost slightly in position over the last year. Microeconomic competitiveness remains the Achilles heel of the Russian economy. There were small gains between 2002 and 2004 but since then, the country has slowly lost position, especially after 2006. The perceptions on company sophistication, an area which had registered some gains last year, dropped dramatically by 13 ranks. The drop affects almost all areas of company operations and strategies and has, worryingly, hit staff training particularly hard. Factor input conditions have also dropped significantly, while most other dimensions of business environment quality remained relatively stable. However, in demand conditions there are increasing concerns about the role played by government as a buyer of advanced products and services. The most dramatic deterioration has surprisingly been registered in the assessment of the innovation system. Traditionally seen as an area of relative strength, the education system is now seen much more skeptical. Physical infrastructure and capital markets have also suffered, although the drop in the latter has been not as dramatic as in some other countries.

Overall assessment

The Baltic Sea Region continues to be among the most competitive economies in the world, and there has been no change in the Region's overall position since last year's Report. The Region's key strengths continue to lie in its sophisticated companies and, despite a slight deterioration this year, its solid public institutions. Macroeconomic policy is the area in which the Region has gained the most relative to its global peers. The negative incentive effects of the tax system continues to be a strong relative weakness. The Region also does not rank too well on policies affecting FDI attraction. While this will come as a surprise to many, it is consistent with the gradually eroding track record on FDI inflows presented in this Report. The strongest drop has been registered in capital market infrastructure, which has historically been the lowest ranked element among factor conditions. The crisis has fully exposed existing weaknesses.

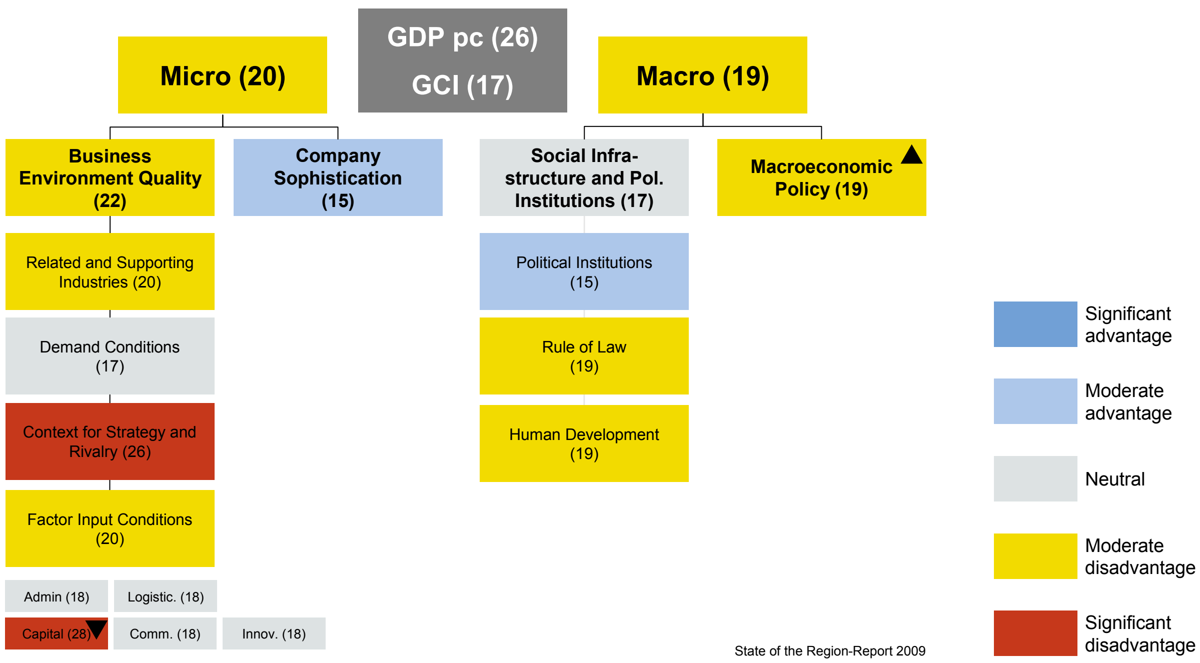
As was discussed already in past Reports, these aggregate rankings obscure the huge differences that exist across the Region, not just in level but also in the profile of strengths and weaknesses. A number of countries deviate from the overall patterns characterizing the Region: Germany ranks significantly higher on micro- than on macroeconomic competitiveness. Lithuania, Poland, and Russia are stronger on macroeconomic policy than on social infrastructure and political institutions. Finland, Estonia, and Latvia perform better on business environment quality than on company sophistication. And Estonia is much stronger on the context for strategy and rivalry than on business environment quality overall.

The economic crisis has a visible impact on the Region's competitiveness, despite the overall stability in rankings. The repercussions are not surprisingly most visible in capital markets, where access to equity and, to a smaller degree, loan capital has been severely curtailed and the soundness of banks is viewed with greater skepticism. But there are a number of other areas that have been affected quite strongly in a number of countries, even though at the level of the Region the impact has been less visible. Cuts in staff training have been widespread in the countries most affected by the economic downturn. Government spending on sophisticated products and services, an important driver of innovation, is seen dropping where budgets have come under severe stress. And companies located in economies with sharp falls in market demand have cut down on their collaboration in clusters.

The crisis is exposing the differences across the Region. Even more worryingly, it is likely to increase those differences. The developments outlined above will further increase the gap between the capacity for innovation and high productivity in the advanced versus the emerging economies of the Region. The size and nature of the spending programs discussed in Section A will further reinforce this trend, with advanced economies investing more in their innovation capacities while emerging economies either lack the resources for any investment or focus on infrastructure upgrading.

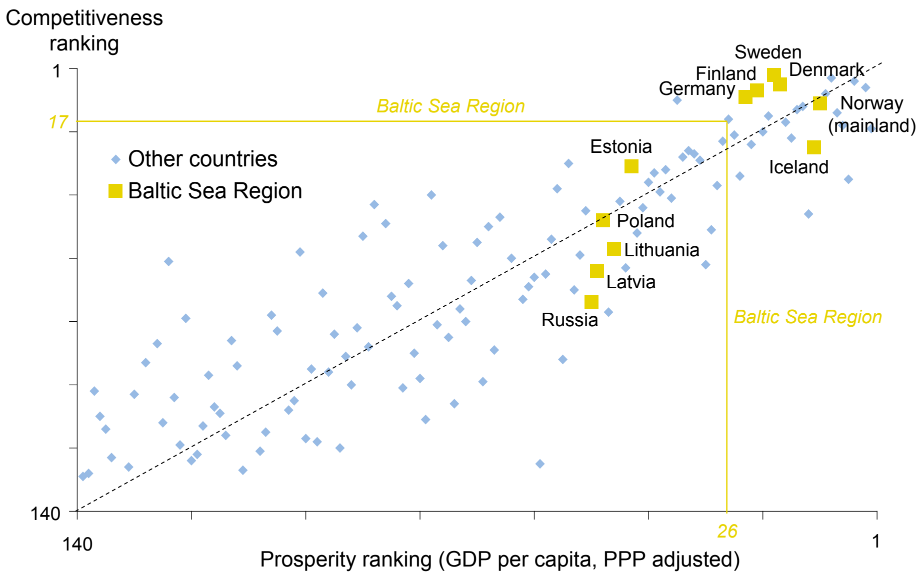
Does competitiveness have any impact on the way the Region and its individual countries are affected by the crisis? In terms of the initial impact of the crisis such a relationship is hard to detect. High openness, an element of high competitiveness, is one key factor that increases the exposure to the global shock. Economic imbalances are the other. Such imbalances are not directly associated with the level of competitiveness but they are revealed in gaps between the level of competitiveness and the level of prosperity. Countries that register much higher prosperity than is supported by their competitiveness are often driven by unsustainable macroeconomic imbalances.

Figure 58: Competitiveness profile: Baltic Sea Region



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis.

Figure 59: Competitiveness and prosperity



Source: Unpublished data from the Global Competitiveness Report (2009), author's analysis. State of the Region-Report 2009

The Baltic Sea Region registers an aggregate level of prosperity that is well supported by its competitiveness. In fact, the bigger puzzle is that the Region seems unable to fully translate its competitiveness into better economic outcomes for its citizens. While this continues to be a concern, in the current crisis situation it provides a cushion of strong economic fundamentals. Countries with prosperity levels well supported by their competitiveness stand a good chance of recovering quickly as the global economic climate improves. For some countries in the Region, however, there are dangerous imbalances between prosperity and competitiveness: Russia, Iceland, Latvia, and Lithuania all report prosperity levels above what their competitiveness suggests. In Iceland and the two Baltic countries the painful adjustment process to lower prosperity levels is already in full swing. In Russia, where the huge natural resources explain part but not all of the gap, the same is happening at an even lower level of initial prosperity.

This analysis suggests that the policy priorities across the Region are different depending on the initial relationship between competitiveness and prosperity. Where prosperity significantly outperforms competitiveness, the challenge is to stay the policy course even if there is growing political pressure to intervene. Where the opposite is true, the pressure is higher, but there is also the opportunity to use the crisis as a tool to enable the reforms for upgrading competitiveness that have not been feasible in the past.

- The Baltic Sea Region remains the Top of Europe on the goals of the Lisbon Agenda
- A cross Europe, a number of structural weaknesses have led to overall disappointing outcomes of the Lisbon Agenda process, despite the improvements after 2005
- The post-2010 Lisbon Agenda needs to address these weaknesses; the current debate is more focused on pushing national policy models to become European benchmarks
- The Baltic Sea Region has, because of its relative success on the current Lisbon Agenda and out of self interest, an important contribution to make to the post-2010 Lisbon Agenda

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. With the original end date of the strategy, 2010, coming into view, the discussion about a new Lisbon Agenda is currently starting to take shape. This section first provides an update on the performance of the Baltic Sea Region and its EEA member countries against the Lisbon Agenda. It then discusses some of the learnings from the Lisbon strategy process and the proposals currently on the table.

The European Commission provides a detailed set of indicators covering six different policy areas to track countries' progress on the Lisbon Agenda. We selected the broader categories for these indicators for our calculations. The only indicator we dropped is the regional dispersion of unemployment rates, because it is not avail-

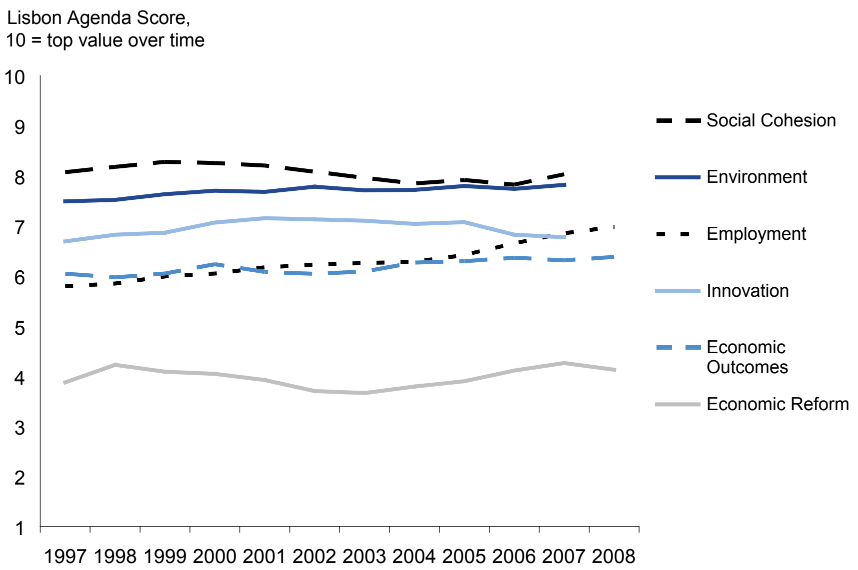
Figure 60: Lisbon Agenda categories

	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

able for the many countries in the Baltic Sea Region that are equivalent to NUTS-2 regions.

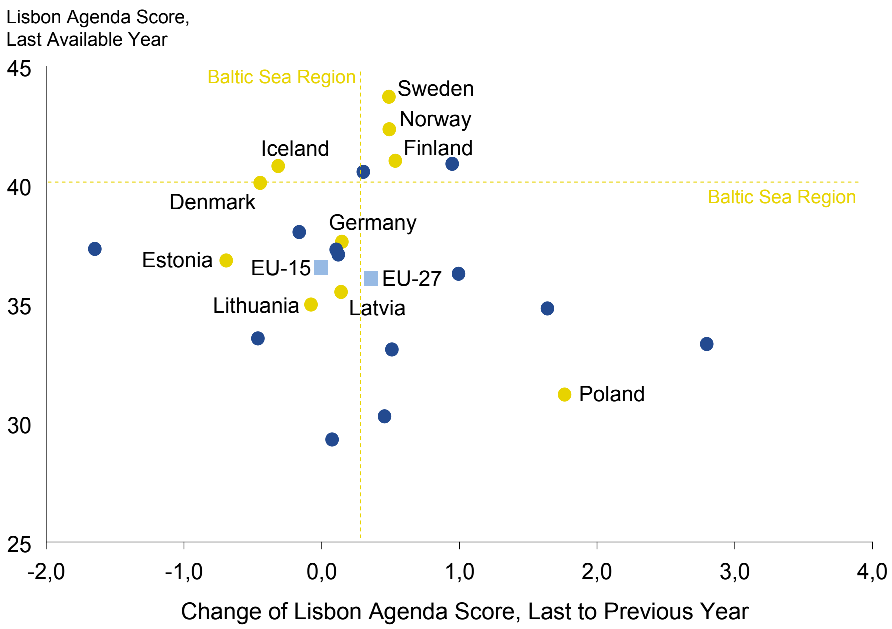
To aggregate the data, we first normalized the raw data. For each indicator, the best value reached by any country between 1997 and 2008 is normalized to 10 and the worst value reached by any country during this period to 1. All other values become values between 1 and 10 using a linear transformation. This normalization does allow tracking of overall improvements over time. The normalized values are then averaged within each of the six categories. The values for the six categories are then summed up to create a Lisbon score for each country and year. Finally, GDP (PPP

Figure 61: Lisbon Agenda performance over time, Baltic Sea Region



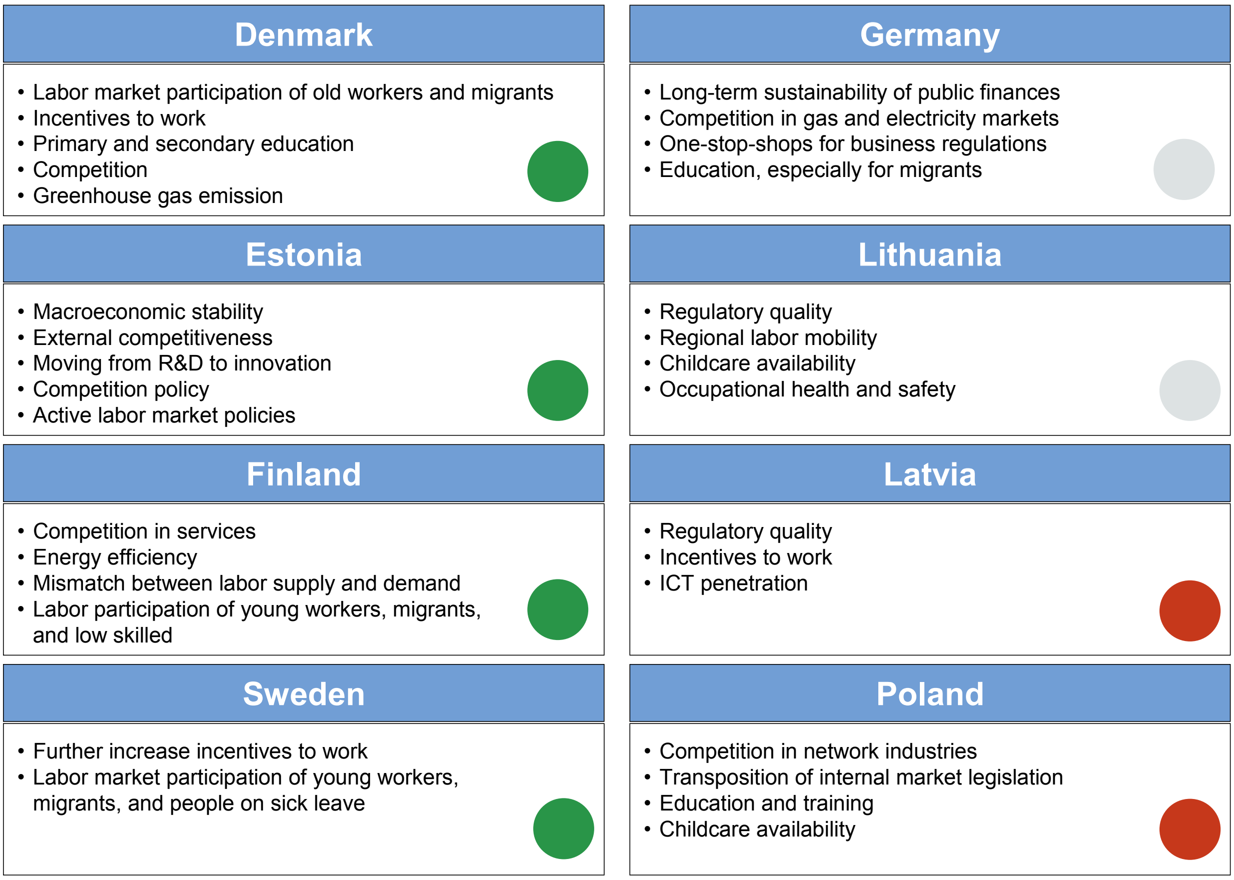
Source: EU Structural Indicators (2009), author's analysis. State of the Region-Report 2009

Figure 62: Lisbon Agenda performance, European countries



Source: EU Structural Indicators (2009), author's calculations State of the Region-Report 2009

Figure 63: Lisbon Agenda challenges for selected Baltic Sea Region countries



Note: Coloring of bubbles indicates overall quality of NPR process and content with green/high, grey/medium, and red/low
Source: EU (2009), author's analysis
State of the Region-Report 2009

adjusted) weights are used to create a weighted average for the Baltic Sea Region over time.

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 2008 (2007 for data on the environment, social cohesion and innovation) would put the Region at rank 5 of all EU member countries, unchanged from the previous year. It retains an aggregate score significantly above the EU-15 countries. The Region also improved faster than the EU-15 during the last year for which data is available, increasing the gap between them. The Baltic Sea Region continues to perform best on social cohesion and the environment. Innovation has just been surpassed by the performance on the employment measure, with the two having had opposing trajectories for the last two to three years. Economic outcomes follow, having improved slightly over time. Measures of economic reform continue to lag and have dropped in 2008, largely as a consequence of rising price levels.

The countries from the Baltic Sea Region continue to dominate the top positions of the Lisbon Agenda ranking. Sweden, Norway, and Finland lead the overall ranking. Iceland has dropped behind the Netherlands. Denmark then follows after Austria. Germany is now ranked 11th, after leaving Ireland and Estonia behind. Latvia and Lithuania remain relatively unchanged as 15th and 16th. Poland gains two more ranks after similar improvements last year, but is at 24th place, still the weakest among the Baltic Sea Region countries.

Last year's Report provided some discussion of the profile of strengths and weaknesses across the countries from the Region; these positions have not changed significantly since then. Overall, the analysis of the Baltic Sea Region's position on the Lisbon Agenda is consistent with the results of the competitiveness analysis in the previous section.

Using this type of information, the European Commission provides regular assessments of the national reform programs (NPRs) that countries put forward to achieve the Lisbon goals. These assessments discuss the adequacy of the plans and objectives put forward, evaluate their role within the country's policy process, and identify key challenges that have to be addressed. Most EU countries get average grades for the quality of their reform programs and the way they use the NPRs as strategic tools to organize economic policy. Smaller countries tend to take the NPR process more seriously and the more advanced economies generally have higher-quality action plans. EU members from the Baltic Sea Region, especially the Nordic countries and Estonia, get generally good remarks about their NPRs. For Poland and Latvia the assessment is less positive with significant areas for improvement in both the NPR content and process identified by the Commission. In terms of the key challenges identified at the country level, they are broadly consistent with the data shown in this Report.

The Lisbon Agenda: 2000, 2010, and beyond

The Lisbon Agenda was launched in 2000 with the ambitious goal to make the European Union "the world's most dynamic knowledge-based economy by 2010." At the time, Europe's failure to keep up with the strong productivity growth in the United States, a process often described as the New Economy, was a key motivation for policy makers to act. The European Commission was charged with leading the effort. Since weak competitiveness was a problem of high importance that seemed to affect all of Europe, there was a sense that action to address it also had to be taken at this level. Apart from a strong focus on innovation, action areas included labor market policy, cohesion/regional policy, and the internal market. Soon after, a stronger focus on environmental issues was also added.

In 2005, the Kok-review provided a depressing view of the progress that had been made over the first five years of the Lisbon Agenda. The initial goals, which were mostly qualitative, but explicitly in numbers for R&D spending and labor force participation, were out of reach. The global economic climate had not helped; the IT bubble burst only weeks after the signing of the Lisbon Agenda. But most of the blame was put on an inadequate policy approach. A relaunch of the agenda provided a significant change in scope and process, in particular by shifting much more of the political 'ownership' of the Agenda to the member countries. Key elements of the new approach are:

- Refocus on job and growth as the key objectives
- Coach and evaluate member countries on national reform programs (NRP) in which they had to define their key policy priorities
- Use the open model of coordination (OMC)
- Earmark parts of structural funds for Lisbon Agenda objectives

By 2009, there has been some progress on outcomes, but the ambitions set in 2000 will clearly not be fulfilled by next year. The relaunch is generally viewed as a success, with both the Commission and the member countries seeing increasing value in the NRP process. When EU leaders met last year to set priorities (innovation, better regulation, modern labor market policies, energy and climate change) for the final years of the current Lisbon agenda process, they also instructed the Commission to launch a process of discussion about what to do after 2010.

This process is currently under way and the Swedish EU Presidency has made the post-2010 Lisbon Agenda an important part of its work plan. The input provided so far by a number of countries including Denmark and Sweden, has been focused on revising the policy priorities for the Agenda in light of the new challenges that exist. Globalization and climate change have to be taken into account through a stronger focus on macroeconomic sustainability, the external relations of the EU to other world regions, and environmental sustainability. But existing priorities in terms of supporting innovation, further deepening of the internal market, and modernizing the labor market also continue to be seen as important. Not surprisingly, the countries' recommendations often have a strong resemblance to their domestic policy priorities. There are also suggestions concerning the policy process, but overall, only more modest changes are seen as necessary in this area. The discussion will continue until mid-2010, when an EU Summit will have to make a decision.

Markedly absent from the discussions so far has been the question of what went wrong with the old Lisbon Agenda, even in its revised form after 2005. Without an answer to this question, it is unclear as to whether a new version will perform much better. The competitiveness framework applied in the State of the Region Report series suggests five key issues among the potential reasons for failure:

- *Policy coordination between different levels of government.* The Lisbon Agenda was motivated by the hope that by elevating a number of policy areas to the European level, more progress could be made. In its first incarnation of 2000, the Agenda led to a heavily EU Commission-driven process. Once that failed, in 2005 the responsibility was shifted back to the EU member countries, with the Commission playing an OECD-like role of advisor and judge that could name and shame, but not sanction.

  From a competitiveness perspective, neither approach seems particularly appropriate. All levels of government, from the EU to the national and down to the regional and local levels, have a role to play in improving competitiveness. The key question is not which level should be put in charge, but how the responsibility for the different aspects of the competitiveness agenda should be allocated to the level of government with the best capabilities to address them.
- *Integration of policies across different functional areas.* The Lisbon Agenda started by addressing an economic problem of disappointing performance. Quickly social issues of the labor market and environmental issues of sustainability where added. As this seemed to erode the focus and effectiveness of the Agenda, the 2005 relaunch narrowed the target to a more manageable jobs and growth-agenda.
  From a competitiveness perspective, both approaches have serious flaws. The initial agenda created a multitude of goals with no clarity about how they related to other. The new agenda narrowed down the goals, but at the same time also risked excluding many policy areas that are relevant for competitiveness. Competitiveness is deeply cross-cutting, depending on education, infrastructure, labor markets, environmental regulations, taxes, and much more. The key question is how to ensure that policy choices across these areas are made in a consistent way, reflecting the overall objectives set on competitiveness but also on social, environmental and other dimensions.
- *Benchmarking versus strategy.* The Lisbon Agenda was launched after the success of the Internal Market program, which had essentially equalized regulatory environments across Europe. It followed this example in setting benchmarks for policies and outcomes that were to be applied equally across Europe. Once that turned out to be ineffective in reducing the differences across the Union, the relaunch in 2005 allowed individual member countries to define their own action agendas (NRPs). This acknowledged the need for context-specific adjustments in priorities, but the end goal and benchmarks for good policies remained the same across Europe.

  From a competitiveness perspective, the new approach is clearly a step in the right direction. However, it does not do enough to encourage countries in defining a clear economic strategy with resulting priorities in terms of competitiveness upgrading. Different priorities are not only the result of differences in initial conditions (as the current Lisbon Agenda implicitly assumes). They are also the result of differences in the types of competitive advantages countries aim to create. The key question is how to create a policy structure at the EU level that provides sufficient pressure on countries to upgrade to benchmarks relevant everywhere, that also encourages them to push further along a specific set of targets they themselves have defined.
- *Dealing with policy differences.* Europe never had one united philosophy guiding its eco-

nomic policy choices. The Internal Market was for some countries (Germany, UK) a way to increase insufficient competitive pressure on European markets, while for others (France) it was a way to match the economies of scale companies could reach in the US. For the Lisbon Agenda, the focus on innovation was something that everyone could agree upon. Liberalizing the labor markets or the market for cross-border services, however, has been quite a different matter. Progress was made where there has been political consensus, not where action has been most critical to achieve the objectives of the Lisbon Agenda.

The competitiveness perspective can do little to overcome the differences in opinion that do exist. But it can help to reveal how this led to the disappointing lack of progress on reaching some of the overall objectives of the Agenda, even when many successful policies, programs, and projects were launched in individual areas.

- *Aligning policy goals with spending priorities.* In most policy areas, rules and regulations have been more important tools of the European Union than spending programs; the EU budget accounts for roughly 1% of European GDP. Nevertheless the failure to assign meaningful resources to the Lisbon Agenda in 2000 was clearly problematic. The relaunch of the Agenda went some way towards addressing this, by allocating about 10% of total EU spending to competitiveness and allowing member states to "earmark" a share of their structural funds (in total 35% of the EU budget) to Lisbon goals. Despite these improvements, EU spending on agriculture still outstrips the spending on upgrading Europe's competitiveness.

  The competitiveness perspective can do little to change the political decisions behind the current budget allocations. But with discussions about new five-year budget guidelines on the horizon, it will be crucial to evaluate whether the future spending plans reflect the political will expressed in a post-2010 Lisbon Agenda. An important priority should be a thorough revision of the structural and cohesion funds. They are currently stuck between two objectives: reducing regional disparities and supporting growth. The first objective was driven by the fear that the removal of internal barriers to trade would foster increasing disparities across the regions, the core-periphery result of Krugman's new economic geography (see the box **Geography and Competitiveness: Implications for the Baltic Sea Region** on page 69 above). But with significant evidence that for many regions the alternative cluster view gives a more accurate reflection of economic realities, regional funds should be distributed differently to maximize growth. Trying to mix both objectives only ensures that neither will be reached.

What can the Baltic Sea Region contribute to this debate? The Baltic Sea Region is, as this Report reconfirms, the part of Europe that has been most successful in moving towards the objectives of the Lisbon Agenda. To a large degree, this is testament to the national policy choices made in the EU member countries within the Region. But the Baltic Sea Region is quite possibly also the part of Europe that has gone furthest in cross-border cooperation as a means to support and strengthen these national efforts. Being squeezed between the national and the EU level, the Baltic Sea Region has been forced to be very specific about why and where it provides a useful platform for policy action. The Region's track record on competitiveness and its experience with regional collaboration provide a number of insights for the discussions at the EU level.

- Countries in the Region have followed a particular set of *policies* that have helped them achieve high levels of global competitiveness. These policies, often a combination of strong government with open markets, are useful examples for other European countries as well. They are also good examples of how competitiveness policy interplays with efforts to address climate change and achieve environmental sustainability. The Baltic Sea Region is not the gold standard in economic policy, and many of its approaches do not easily translate to countries with other conditions. But the Region's success makes it a good example to analyze when designing the post-2010 Lisbon Agenda.
- In the implementation of policies, the Region has made use of *government across all*

geographic levels, from the local and regional, the national, the Baltic Sea, and finally to the EU. Instead of shifting responsibilities from one level to another, the philosophy has been to develop integrated efforts that leverage the respective capabilities of each of the geographic levels of government in one strategy. While this has not always been successful, it clearly is a direction in which Europe needs to go. The EU Baltic Sea Region Strategy itself is an indication that a new level between the EU and its member states could provide an additional, useful mechanism. None of the Baltic Sea Region countries that have made submissions in the debate about the post-2010 Lisbon Agenda has mentioned the EU Baltic Sea Region Strategy.

- At the national level, some of the most successful countries in the Region have also found new ways to *co-ordinate policies across individual ministries or agencies*. The Danish Globalization Council was a particular noticeable one. At the EU, the Lisbon Agenda has so far not enabled the necessary coordination between the many parts of the Commission that affect competitiveness through their work. The Competitiveness Council at the EU brings some of the relevant Ministers together. But the EU clearly needs to go much further in designing integrated policies if it wants to stand a chance of addressing the complex economic and environmental challenges ahead.

The Baltic Sea Region can provide valuable input to the post-2010 Lisbon Agenda. But it will also be deeply affected by whatever choices are being made. A European economy that makes no progress on competitiveness and environmental sustainability will hurt the Baltic Sea Region, even if this Region as a whole continues to do better. And a European policy process that has no room for deeper collaboration between neighboring countries will make Baltic Sea Region integration much harder, instead of providing a perspective for it to reinforce European actions. Commission President Barroso said in 2005 that "the Baltic Sea Region can act as a beacon to the rest of Europe." The discussion about the post-2010 Lisbon Agenda is an important opportunity to forcefully play that role, in the interests of Europe as much as in the interests of this Region.

- **Deepening regional integration within the Baltic Sea Region remains a crucially important goal, and will go some way to addressing key weaknesses challenging the Region**
- **Moving towards an innovation-driven economy remains the right strategic direction for the Region; there is progress to build on and no viable alternative in sight**
- **The Region has to become better prepared to deal with external economic shocks, both in individual countries and across borders; this is one of the key lessons from the crisis**

4. Implications for the Baltic Sea Region

The analysis of economic outcomes and competitiveness fundamentals leads to a number of action recommendations. Some of them have been on the Region's agenda for some time and there are significant efforts under way to address them. Others have been pushed to the forefront by the crisis and are not yet as visible in the collaborative activities across the Region.

- *Further pursue deeper regional integration.*

  This might seem more than obvious and a boring repetition from previous years. But there are two reasons to continue to keep this issue on top of the list. First, it remains crucial for the Region and is an area where regional collaboration is the central tool for progress. As small economies, the countries in the Region suffer in multiple ways from the market separation that exists: consumers pay higher prices, foreign investors are kept away, companies remain less productive than they could be, and innovators face more barriers to provide a profitable product or service. And the EU Internal Market process alone is clearly insufficient to tackle the underlying barriers stopping further market integration.

  Second, the crisis has made regional collaboration both more important and more difficult. It has become more important, because there is the danger of negative contagion effects from the economies that are in the most serious trouble, on the rest of the Region. But it has also become more difficult. Partly this is because the crisis has, as discussed above, put more focus on national policy responses. But it is also because the crisis has created repercussions that have led to much anger, related to the multiple linkages that exist across the Region. In the Baltic countries the Swedish banks are blamed for reckless lending growth in recent years. In Sweden the mismanagement of boom and bust in the Baltic countries is seen as dragging down the Swedish banks and impacting the country's currency. In Iceland there is a mixture of gratitude and disappointment towards the Nordic partners which have helped the country financially, but were slow to do so, and which have not pushed harder on the UK and the Netherlands to be more flexible in their demands. The reality is that the Region and all of its countries individually will get out of this crisis faster, if there is collaboration. This is not a zero-sum game, and it is hard to see what any of the countries of the Region could gain by going it alone.

- *Continue the path towards a sustainable innovation economy.*

  For a number of years the Baltic Sea Region has been on its way to compete on innovation and on its environmental capabilities. Progress has been made, but as this Report shows again, there is still work ahead. Much of this work will need to be done on the national level, where the necessary political debate has to take place. But the collaboration in the Region can continue to help, both by providing better information and by supporting the implementation of actions.

The EU Baltic Sea Region strategy provides a framework to better integrate these efforts. A discussion of the progress made in the strategy and action program proposed is in Section C of this Report. Such integration could help rationalize activities and strengthen their strategic direction. A Baltic Sea Region Lisbon strategy could become a key pillar of the EU Baltic Sea Region Strategy implementation and complement the existing efforts on the national level.

- *Prepare the Region for a changing economic environment*

The global economic crisis has been a rude wake-up call for the economies, which need to ready themselves for the realities of a changing global economic context. One aspect is the need to put mechanisms in place that can prevent a repeat of the current crisis. For the Baltic Sea Region, there is limited ability to influence the global architecture that needs to be put into place. Yet because of its high level of integration in the world economy and its reliance on functioning institutions to deal with crisis, the Region has to be one of the voices which must speak up on these matters via the EU. Having said that, the Region also has to do work at home. With hindsight, some of the overheating at the national level could have been stopped earlier, and at least in the Baltic countries the banks from the other parts of the Region could have played a more conducive role. Closer cooperation on macroeconomic surveillance could help. And while this is a policy area largely under national control, advice from close neighbors with a stake in a positive outcome might be easier to accept than that from a distant international organization. This is already happening through multiple formal and informal channels; it could be further elevated at the Baltic Sea Region level.

However, improved global institutions and surveillance will not be able to prevent all future global shocks. And given their nature, the economies in the Baltic Sea Region will continue to be highly exposed. A domestic policy structure, covering labor and financial markets to exchange rate regimes, fiscal policy rules, and the nature of automatic stabilizers and emergency measures, needs to be in place to prepare economies for such shocks. Many countries in the Region are already better prepared than their European peers. But the crisis gives reason to review and strengthen this system.

Another aspect is the need to prepare the Region for a future where the global economy will be characterized by a much stronger role for the Asian economies, where the global climate change will affect many aspects of the economy, and where the demographic change will make a huge imprint on prosperity and economic weight. Why not build on the Nordic Globalization initiative, discussed in Part A of this Report, and make this a core element in a broader effort at the Baltic Sea Region level?

This part of the State of the Region Report discusses the EU Baltic Sea Region Strategy. Last year's Report provided background information on the Baltic Sea Region's deep integration into the European Union, its institutions and its policies. In 2009, the European Commission prepared a communication to the other leading EU institutions in which it outlines the EU Baltic Sea Region Strategy, the first European strategy for a meta-region of neighboring member countries. This section describes and discusses main elements of the Strategy.

Section C: The EU Baltic Sea Region strategy

The Baltic Sea Region is closely integrated into the European Union, with a deep network of institutional and contractual ties. The European Union has a strong legislative influence on the laws and regulations in the Region. And it provides significant financial resources, roughly €15 billion annually, to projects implemented around the Baltic Sea. The EU Baltic Sea Region Strategy process has presented the European Commission with an unusual task: it was asked, initially by a group of EU parliamentarians from the Region and ultimately by the European Council on the initiative of Sweden, to act as a guide, facilitator and moderator in the process of designing a strategy for the Region. The strategy that emerged is now up for endorsement by the European Council during the current Swedish EU Presidency.

This section provides three different perspectives on the Baltic Sea Region strategy. First, the EU Commission provides its views on why this process was launched, how it was organized, and what it delivered in terms of action plans and implementation structures. Second, Vinnova, the Swedish Governmental Agency for Innovation Systems, presents its ideas for one of the flagship projects that have been identified to implement the strategy. Third, the author of this Report provides his assessment of the EU Baltic Sea Strategy that has emerged.

1. Drafting the EU Baltic Sea Region strategy: the perspective from the European Commission

This section has been written by Anders Lindholm, DG Regio, who has been intimately involved in the Commission's work on the EU Baltic Sea Region strategy. The formal statements by the European Commission about the strategy can be found in the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions concerning the European Union Strategy for the Baltic Sea Region (COM(2009) 248 final) and the accompanying Commission Staff Working Document (SEC(2009) 712), which includes the full action plan.

Background

On 14 December 2007, the European Council in its Presidency Conclusions invited the Commission to present a European Union strategy for the Baltic Sea Region no later than June 2009. This followed on the increasing awareness of serious problems and weaknesses in the development of the Region, most obviously visible in the degradation of the Baltic Sea itself but also in the disparate growth and development paths of the countries in the region.

Eight of the nine states bordering the Baltic Sea are members of the European Union since 2004. The introduction of Community rules and regulations, and the opportunities created by Community instruments and policies (for example cohesion policy, environmental policy, the internal market and the Lisbon Agenda) have opened new possibilities for deeper cooperation in the Baltic Sea Region. This constitutes a significant and fundamental change in the preconditions for the development of the Region. At the same time, actors in the Region have found it hard to progress as much as expected in their work together, to take advantage of the new opportunities and adequately address the challenges.

There are a significant number of collective challenges that require action at the level of the Baltic Sea Region. In the context of the environment, particular importance can be given to eutrophication, overfishing, and as a horizontal theme, climate change adaptation and mitigation, and, connected to these issues, research on the state of environment of the Region. The main challenges identified in the field of prosperity are innovation, and linked to this issue, demography, education, and entrepreneurship, as well as the functioning of the single market. Ensuring the competitiveness of energy markets is also a high priority challenge to be addressed. Priority issues for accessibility and attractiveness are transport links of macroregional relevance, focusing in particular on sustainability of transport modes. Finally, cross-border crime, safety at sea, communicable diseases, energy dependency, adaptation to effects of extreme weather events on transboundary infrastructure, and reduction of the risk of oil spills, are of particular relevance for safety and security.

No country can handle all of these challenges on its own; deeper and more effective cooperation is needed. Since most of the challenges and opportunities are linked, there is also a need to establish cooperation that cuts across sectors and focuses on the combined results rather than on the individual components. The role of the EU Baltic Sea Strategy is to be a focal point bringing together the different initiatives and activities to address the common challenges and the new opportunities.

The formation of the Strategy

The European Commission has engaged in an intensive consultation process which has had three principal components: non-papers (discussion papers without formal binding power) from governments and other official bodies in the Region; stakeholder events to allow official, NGO and private sector participants to contribute their expertise; and public consultation through the Europa web site which elicited a very wide response.

The messages were clear:

- *No new institutions*. The Baltic Sea Region has many cooperative structures: new ones that could impose added administrative overheads without contributing to effective action should not be created.
- *Not just a strategy*. There must be concrete, visible actions to overcome the challenges facing the region. In its action plan, therefore, the Commission insists that Member States and other stakeholders take responsibility as lead partners for specific priority areas and flagship projects, for example by developing integrated maritime governance structures in line with the Integrated Approach to Maritime Policy.
- *European Commission involvement*. This should go beyond monitoring the implementation of funding programs and the transposition of Directives. The Commission could fulfill the need for an independent, multi-sector body that can guarantee the necessary coordination, monitoring and follow-up of the action plan, as well as a regular updating of the plan and strategy as necessary.

Content of the EU Baltic Sea Strategy

Guided by the almost unanimous position of respondents to the consultations, from every level and type of partner, the European Commission is convinced that these challenges and opportunities can best be addressed by an integrated multisectoral regional strategy.

The EU Baltic Sea Strategy addresses, in a concrete way, the four key issues facing the Baltic Sea Region today:

- to deliver a sea which is less affected by eutrophication and which has sustained biodiversity.
- to develop a more prosperous Region with increased trade and more innovative companies.
- to give rise to a Region that is more connected both in terms of transport and electricity, and
- to assist the Region to better handle accidents and to combat cross-border crime.

These four pillars provide the framework for the Strategy. The actions and projects to be delivered must be consistent with the pillars. Herein lies one of the underlying principles of the Strategy – the individual actions and projects being carried out will be coordinated with other on-going activities to provide a coherent, overall approach to development in the region. This addresses one of the weaknesses identified during the preparation of the Strategy, that all too often, activities were being implemented without sufficient coordination with other actions.

The implementation of the Strategy's Action Plan is central to the whole process. The Action Plan provides the necessary details by setting out fifteen Priority Areas where cooperation is required to improve the economic and social development of the Baltic Sea Region.

The priority areas are implemented through detailed actions which are also described in the Action Plan. Some of these actions are "strategic" for the Baltic Sea Region as a whole. They are designed to address specific and important issues for its regions, citizens and enterprises. Other actions are "cooperative", meaning they are based on the benefits from improving cooperation on issues where Member States, regions and other actors are ready to do so. Examples of such projects are:

- removing phosphates from detergents in all Member States with the aim of reducing nutrients in the sea.
- implementing a "Baltic Energy Market Interconnection Plan" to better connect Latvia, Lithuania and Estonia to European networks.
- connecting Warsaw to Tallinn with the "Rail Baltica" by 2013, with a target speed of 120 km per hour.
- creating a joint maritime surveillance system.
- considering a funding mechanism for innovation and research based on the experience of the Nordic Council of Ministers, , using national and private funding to tailor research activities to the specific strengths of the Region.

Governance and implementation

The European Commission and all of the stakeholders are very aware that the European Union Strategy for the Baltic Sea Region will only be useful and effective if it leads to specific actions on the ground. For this reason, the European Commission has published an indicative Action Plan, prepared in very close cooperation with the Member States and other partners in the region, which incorporates both ongoing and planned actions as well as specific flagship projects.

The Commission is not proposing additional funding or other resources at this time. However, some of the specific actions and projects will require financial support. A major source is the Structural Funds[1] available in the region – most programs already allow actions envisaged in the strategy. Programming authorities can review the allocation criteria and facilitate the selection of projects aligned with the strategy. Furthermore, the Commission will welcome appropriate modifications of the programs where necessary.

In addition, Member States have agreed to examine funding projects and actions aligned with the Strategy priorities from their own resources. The European Investment Bank and other international and regional financial institutions, such as the Nordic Investment Bank and the European Bank for Reconstruction and Development, could also contribute.

As author and coordinator of the Action Plan, the European Commission will be fully committed to monitoring, coordination and promotion of the implementation of the actions and projects within it. The success of the strategy will depend, however, on the commitment and active involvement of the stakeholders, particularly in

1 European Regional Development Fund, Cohesion Fund, European Social Fund, European Agricultural Fund for Rural Development, European Fisheries Fund.

the concrete implementation of the actions and projects.

In order to ensure a full flow of information and sustained involvement of partners and stakeholders in the Strategy, an Annual Forum will be organized. It will involve the European Commission and other EU Institutions, Member States, Regional and Local Authorities and Inter-Governmental and Non-Governmental Bodies and can be open to the public.

Next Steps

The Strategy was adopted by the European Commission on 10 June 2009. The Strategy was then passed formally to the Council. The Swedish Presidency has set up a “Friends of the Presidency” group to co-ordinate the discussions on the Baltic Sea Strategy in the Council. The group is cross-sectoral which is important, given the broad scope of the Strategy.

The intention is for the General Affairs Council to adopt conclusions on the Strategy during its meeting on 27-28 October 2009, which will be followed by the European Council conclusions in October. That will constitute the formal green light for the Strategy. Of course, there will also be continued dialogue with the Parliament, Committee of the Regions and the Economic and Social Committee to ensure that their views are fully taken into account during the implementation of the Strategy.

The first review and update of the action plan will take place during the Polish presidency in 2011 (hopefully to be followed during later presidencies held by EU member countries from the Baltic Sea Region, for example Denmark 2012, Lithuania 2013, and Latvia 2015).

2. Implementing the EU Baltic Sea Region strategy: the perspective from VINNOVA

This section has been written by Karin Nygård Skalman, VINNOVA, with the support of Emily Wise, Research Fellow at the Research Policy Institute of Lund University. Both are working on the flagship project that VINNOVA will lead under the umbrella of the EU Baltic Sea Region Strategy. The project builds on previous efforts, including "BSR InnoNet, The Baltic Sea Region Innovation Network", a EU-funded effort to improve innovation policy around the Baltic Sea Region.

The vision of prosperity in the Baltic Sea Region macro region

On 10 June 2009, the European Commission published a Communication on the EU Strategy for the Baltic Sea Region. This is the first time that a comprehensive Strategy, covering several Community policies, is targeted on a "macro-region". The strategy seeks to provide a coordinated, inclusive framework in response to the key challenges facing the Baltic Sea Region, and concrete solutions to these challenges. The accompanying indicative action plan includes 80 flagship projects which address the four key challenges requiring urgent attention: to enable a sustainable environment, to enhance the Region's prosperity, to increase accessibility and attractiveness, and to ensure safety and security in the Region.

The Action Plan covers the following priority areas to enhance the region's prosperity: (1) to remove hindrances to the internal market in the Baltic Sea Region; (2) to exploit the full potential of the region in research and innovation; (3) to implement the Small Business Act, to promote entrepreneurship, strengthen SMEs and increase the efficient use of human resources; and (4) to reinforce sustainable agriculture, forestry and fishing.

In order to exploit the full potential of the Region in research and innovation, and be competitive in the global innovation landscape, new ways of working and linking together people, companies, research organizations and innovative milieus will be needed. There are a number of motives for strengthening transnational linkages in the Baltic Sea Region. Future challenges demand solutions from more than one country. SMEs can gain from increased linkages to other companies, to research institutions and to skilled labor within the whole Region. For research institutions, a larger critical mass of R&D, and new projects, can be created.

For societal partners, cooperation between the countries can lead to joint actions in order to solve future challenges for society. Increased linkages between the Baltic Sea Region countries and its companies, research institutions and societal partners make the Region more attractive to partners and investors outside the Region.

One of the proposed flagship projects is to develop a transnational program with interacting clusters, innovative milieus and SME networks. The transnational program should be well-anchored in the Baltic Sea Region countries and relevant Ministries. The objective is to create prosperity, economic growth and new jobs in the Region through enhanced cluster and innovation cooperation. The long-term vision is to establish the Baltic Sea Region as a functioning macro-region with an internationally competitive position in a number of strategically-prioritized areas. The Region will be globally-recognized for its multidisciplinary research and education, attractive business conditions, open and internationally collaborative innovation environments, and high quality of life.

The Flagship Program on Innovation, Clusters and SME Networks

The proposed flagship project, "The Flagship Program on Innovation, Clusters and SME Networks", is led by Sweden and Lithuania. It is one of the fast-tracked flagships, and is proposed to be launched during 2010, following agreement on the EU Baltic Sea Region strategy and action plan before the end of 2009. The project builds on experiences from previous cooperation on innovation and cluster policy between the countries in the region (BSR-InnoNet) funded by DG Enterprise and initiated by VINNOVA, FORA, and The Nordic Council of Ministers.

The program is suggested to contain the five modules.

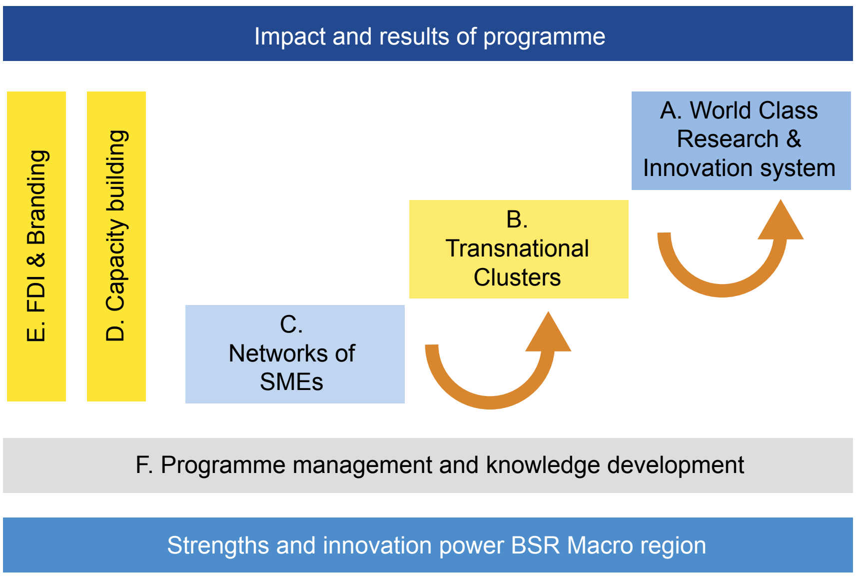
- *World Class Research & Innovation Systems collaborations.* This part of the program is suggested to support the collaboration of strong innovation-milieus in the Baltic Sea Region. The participants from each country should fully exploit the possibilities of the participation of business (including SMEs), academia and society in each country. There will be a strong focus on joint R&D projects and on commercialization of R&D. Linking different strong national research and innovation milieus will create a larger critical mass of research and development resources in order to solve important future challenges for the Baltic Sea Region.
- *Transnational Cluster collaborations.* This part of the program is suggested to support the collaboration of strong clusters in the Baltic Sea Region. Clusters include both large companies and SMEs, their partners in the value chain, institutes, universities, capital providers and different kinds of intermediaries. The aim is to create commercial value and links between the clusters in the Region. This will be done through cluster initiatives exploring and testing new forms of transnational collaboration. Experience from the BSR InnoNet will be an important input.

- *Innovative SMEs and networks.* This part of the program aims at strengthening the SMEs in their ambitions to improve business activities across the region and/or improve cooperation within R&D. Support to SME networking is seen to strengthen innovation activities and knowledge exchange.
- *Capacity building.* This part of the program has the aim of building capacity and spreading knowledge on themes which are important for the development of the different parts of the program. Capacity building activities will address issues regarding commercialization, cluster facilitation, internationalization, R&D strategies and communication.
- *FDI branding of the BSR Macro Region.* An important part of being a world class region within different sectors is also that the competitive strengths are well-known. This part of the project suggests cooperation between national agencies in order to market the strengths and cooperation of the Baltic Sea Region as a whole.
- *Program management and knowledge development.* The governance of the program is very important, as this is a tool to strengthen the links between countries as well as promote the strategy in the desired direction. Program management will be responsible for coordinating, steering and evaluating actions. This part of the program will also initiate different research and learning projects within areas of importance for the development of the region. An important aspect will also be the spreading of knowledge to policymakers and practitioners around the region.

It is important that all countries in the Baltic Sea Region participate in creating the program, and that all countries' experiences and knowledge in the area of clusters, innovation systems and SME networks are taken into account. Lessons learned from national and transnational programs are an important base for creating the future program.

A High Level group was created in April 2009. This forum consists of national partners (agencies/ministries) from the different countries in the Baltic Sea Region and is led by VINNOVA. The High Level group will finalize the actions, arrange and coordinate funding, and initiate the program. The development of the program will be done jointly by the countries during 2009.

Figure 64: The Flagship Program on Innovation, Clusters and SME Networks



- **The EU Baltic Sea Region Strategy is an important step forward for regional collaboration**
- **To reap the full benefits of the Strategy, countries in the Region now need to act on aligning activities at different geographic levels and creating an institutional framework to sustain the Strategy**
- **The EU Baltic Sea Region Strategy could become a powerful innovation towards a new phase of European integration, if the political will can be mounted at the European level**

3. Assessing the EU Baltic Sea Region strategy

This section has been written by the author of the State of the Region Report. It has benefited from many discussions across the Region over the last months. A number of other documents provide further important context: Esko Antola's "Political Challenges for the Baltic Sea Region", Konrad-Adenauer-Stiftung, written as an input to the strategy process, puts the EU Baltic Sea Region strategy into the wider context of how the strategy can fit into a new, more regionalized governance structure for Europe. Carsten Schymik and Peer Krumey provide in "EU Strategy for the Baltic Sea Region: Core Europe in the Northern Periphery?", Stiftung Wissenschaft und Politik (SWP) Berlin, a detailed and somewhat skeptical assessment of whether the documents now put forward by the European Commission really have the necessary features to be called a strategy. Pertti Joenniemi's "The EU Strategy for the Baltic Sea Region: A Catalyst for What?", Danish Institute for International Studies, comes to a somewhat more positive conclusion. Hans Brask's "Crossing Perspectives is the Order of the Day," Baltic Development Forum, points out that it is the Region's own responsibility to leverage the opportunities that the EU Baltic Sea Region Strategy provides, rather than to assume that the strategy will deliver benefits automatically.

A framework for assessing the EU Baltic Sea Region

Any assessment of the EU Baltic Sea Region strategy has to define a benchmark against which the actual outcomes can be compared.

The *first question* to ask is whether the strategy addresses the actual problems the Region is facing. This would be especially critical, if the Region had so far failed to devote any attention to these topics.

The process through which the European Commission developed the strategy ensured that stakeholders in the Region had multiple opportunities to raise the specific problems that they perceived in the Region. Anders Lindholm in outlined in his contribution to this Report how the Commission solicited input and arrived at action proposals in the four key areas of competitiveness, environment, security, and physical infrastructure networks. Carsten Schymik and Peer Krumey question in their assessment whether the number of areas might not even be too many for a strategy document. They also note that spatial planning and education are not taken up specifically, although issues in these areas are addressed in the economic pillar of the strategy. There seems to be a consensus in the Region that the proposed strategy and action plan cover most, if not all, of the important issues the Region is facing. The Baltic Sea Region's main competitiveness issues, as identified in this Report, are generally well covered.

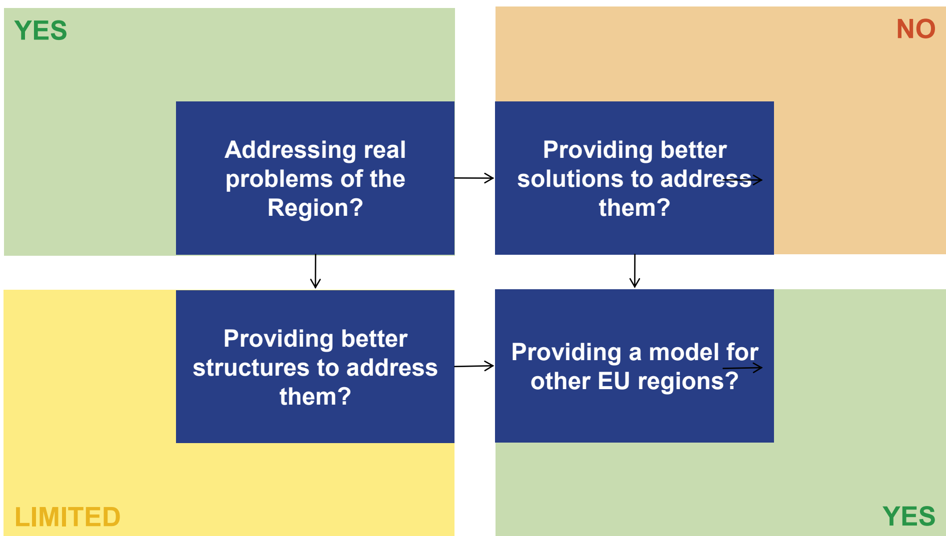
But of course the Baltic Sea Region did not start to think about addressing these challenges only when the EU Baltic Sea Region strategy process came under way. These issues have been around for some time and the Region has been actively addressing them over the years. Past issues of this Report looked at different aspects of these joint efforts over time. The initiative to launch an EU Baltic Sea Region Strategy was taken not because there was no activity in the Region on these issues; it was taken because there was a broad sense that what was being done was not sufficiently effective in improving outcomes. Either the Region was not coming up with the right solutions, or it was not able to create a structure that could deliver them effectively.

The *second question* to ask then is, whether the EU Baltic Sea Region Strategy provides any new or better answers to the challenges the Region is facing. It is certainly possible that what has been lacking in the Region was the knowledge about how to improve in the areas that need to be addressed.

On this perspective there is little evidence to suggest that the lack of knowledge about the right policy answers ever was the problem in the Baltic Sea Region. And if it was, there is little hope that the EU Baltic Sea Region Strategy will provide any significant improvements. The projects suggested, are, to an overwhelming degree, the logical continuation of efforts that have already been under way. Policy learning within the Region has been a key issue for a number of years already. This does not have to be a failure. But if there is a hope that the EU Baltic Sea Region Strategy will lead to a significant change in the Region, it will not be because it addresses new problems or suggests new solutions.

The *third question* to ask is whether the EU Baltic Sea Region Strategy provides a better overall structure to unblock, coordinate, and integrate activities. From the discussions especially of the last two years, this is a central issue for the Region, some efforts, for example around the HELCOM action plan but also in the area of energy and physical infrastructure, have been agreed to for some time, but the implementation has been sluggish. Other efforts, for example on branding

Figure 65: Assessing the EU Baltic Sea Region strategy



and innovation, are under way but there is a multitude of efforts from different groups within the Region with little coordination to achieve consistency and maximum impact. Beyond individual efforts, there is no organized overall prioritization and coordination among them. This leads to concerns about a lack of focus on the most critical issues and the danger of some efforts working at cross-purposes.

The achievements of the EU Baltic Sea Region Strategy on this question are mixed. This reflects the Commission's limited mandate, which as Anders Lindholm points out above, was charged not to create new institutional structures, and was not in a position to define a comprehensive top-down strategy that others in the Region would be obliged to take as their orientation.

On the level of individual activities, some interesting innovations have been suggested to ensure improvements in how the Region operates. There will be clearly identified national responsibilities for coordinating individual actions. Flagship projects, as the one discussed by Emily Wise above, have been suggested to ensure that political ambitions and objectives are translated into real actions. Some of these have been designated as fast track activities to mobilize quick action. And the European Commission aims to organize an Annual Forum to review the progress of project implementation.

On the level of overall coordination and integration across activities, much less has been achieved. While the strategy document talks about the need for cross-sectoral integration and coordination among activities, there is no obvious process through which this happens, especially between the four large areas of activity. The separation between prosperity (competitiveness) and accessibility (infrastructure) seems anyway artificial. And with the huge focus on making environmental products and services a core element of the Region's economic strategy, alignment between the activities in prosperity and environment is clearly crucial. There is no mechanism to evaluate all potential projects and activities according to one central benchmark in order to decide what to do and what not to. There is no structure to align activities by the EU, the member states, and regional/local authorities, or to identify the different roles that these levels of government should play. And there is no consistent approach on how to open up the decision making and implementation to groups outside of the public sector. Past editions of this Report have repeatedly pointed out the insufficient level of private sector involvement in efforts to improve competitiveness.

To a large degree, the EU Baltic Sea Region Strategy provides a new framework in which existing efforts are organized, not more and not less. Whether this new framework will change the way that these efforts are coordinated will depend on the actions now taken; the current structure does not yet force such change to happen. What it has done, however, is to increase the pressure on countries in the Region to deliver. Many governments have invested considerable prestige and political capital in the EU Baltic Sea Region Strategy. To make this investment pay off rather than haunt them, they have much reason to push forward, drawing on the opportunities that the Strategy has created.

The *fourth question* to ask is whether the EU Baltic Sea Region Strategy provides a new policy model for the European Union. There are few signs that this was the intention when the European Council gave the green light to develop the Strategy. The language used to focus the mandate on environmental issues and highlight the need for the Strategy to respect the decisions made in the EU maritime policy, set a narrow perspective on the work to be done. The clear understanding that no new money and no new institutions were to be involved further indicates the relatively modest status of the effort. Nevertheless, there is a broadening discussion in Europe about the need to develop new governance models to revive the dynamism of the European Union. Esko Antola's paper mentioned above explicitly suggests more intense cooperation among groups of neighboring countries as a possible way forward.

On this dimension, the EU Baltic Sea Region Strategy has become an interesting role model for the rest of Europe. For no other Region has there been such an effort, based on the intense collaboration between the European Commission and stakeholders in the Region. The strategy suggests a new role for the Commission as a facilitator of intense regional collaboration, with the ultimate ownership of these efforts in the hands of the Region. In many respects there is an interesting parallel to the Lisbon Agenda process after the 2005 relaunch. The EU Baltic Sea Region Strategy is broader in scope and lacks the explicit reporting to the Commission and the evaluation mechanism. The Lisbon Agenda process is narrower and lacks the cross-national dimension. Both could benefit by learning from each other. And both have some common challenges to face, in particular devising a robust financial structure in line with their objectives.

Because the EU Baltic Sea Region Strategy was not commissioned as a pilot for the rest of Europe, significant political debate at the EU level is needed to assess whether this approach is perceived as an interesting way forward. Not all of the features of the Region can be applied everywhere else in Europe; as a Region with many small countries, the dynamics of integration are different from parts of Europe where there are fewer but larger countries. The specific historical legacy of the regional cooperation structures is also quite unique. But nevertheless the meta-region approach, as Esko Antola called it in his paper, has interesting potential for Europe. And the strong performance that the Baltic Sea Region registers on many indicators, not just the Lisbon strategy and competitiveness as documented again in this Report, gives further credibility to using this Region as a model. If this happens, it could ironically be the case that ultimately the EU Baltic Sea Region Strategy is more important for Europe than it is for the Baltic Sea Region itself. Europe can benefit from many of the policies that are being implemented in the Baltic Sea Region; there might be more room for learning from this direction than within the Region. But even more so, Europe can benefit from the structural innovation of organizing cross-national collaboration. The Baltic Sea Region is not optimal in this respect, and the EU Baltic Sea Region Strategy might not have delivered the structural change that many hoped for. But it is already far ahead of other regions in Europe and globally, and the strategy will contribute to its further development.

Where to from here?

It is easy to be critical about individual aspects of the EU Baltic Sea Region Strategy, especially if a benchmark is used that goes far beyond the mandate that was given to the EU Commission. But looking at what was feasible, the strategy process has already been a significant accomplishment. It reinforced the many connections across the Region, and mobilized people in a common effort. It has been, quite unintentionally, a stabilizing factor for regional collaboration at a time when the economic turbulences tend to work in another direction. And it will provide a structure for joint activities into the future.

Whether the EU Baltic Sea Region Strategy ultimately will be a success for the Region remains uncertain. Structural weaknesses in the collaboration, which were the main reason for the frustration in the Region before, have not been addressed in any fundamental way. The strategy now provides a structure in which this can be tackled. But that will require a new push from the stakeholders in the Region. It is not a task that the EU Commission can do for them, especially not without an explicit mandate.

Whether the EU Baltic Sea Region strategy will be a success for Europe, too, depends on policy choices yet to be made. There is neither consensus on the exact nature of the structural problems the European Union faces, nor on the possible solutions. The general public is highly skeptical about grand European designs, as the referenda about the European constitution have shown. The discussions about the post-2010 Lisbon Agenda provide an interesting area for experiment. Meta-regions could, on a voluntary basis, be asked to provide regional reform programs (RRPs) as compliments to their national efforts. The European Commission could serve as a management agency to provide technical input, make EU policy instruments available, and evaluate progress. And why should not the Baltic Sea Region be the first region to take up this invitation?

Final observations

The year that has passed has been a trying time for the Baltic Sea Region, as it has been for the world economy at large. Economic outcome indicators have dropped with a ferocity that was not thought possible. The policy responses, too, have led many countries in the Region and elsewhere into uncharted territory. Uncertainty about the future remains high, despite the slight improvements visible in the recent months and weeks.

On looking back at events before 2008, there is a need for reflection. This Region was doing well and was confidently talking about being the Top of Europe. How much of this was reality and how much was wishful thinking? Does the crisis of 2008/2009, hitting this Region more strongly than many other parts of Europe and the global economy, expose fundamental flaws in the assessments of the past?

Reviewing the State of the Region Reports of recent years, the answer is, not surprisingly, mixed. Past Reports did not pay sufficient attention to the extent of the overheating in the Baltic economies and Iceland. Tracking these macroeconomic imbalances was never the aim of these Reports. But with growth rates too good to be true, and certainly too high to be reasonably explained by improvements in competitiveness, warning bells should have rung more loudly. Past Reports also did not point out the flip-side of the strong integration of the Baltic Sea Region into the global economy. While this propelled the Region forward in good times, it was also going to expose the Region disproportionally to global shocks. A stronger focus on the need to prepare for such a situation would have been prudent. This being said, past Reports did repeatedly expose the lack of progress on competitiveness upgrading in the Baltic countries and Russia. The imbalances that developed between competitiveness and prosperity are a crucial factor for why these countries were now hit so hard. The findings from past Reports on the strong competitiveness of the Region remain accurate. These fundamentals now give the Region a good chance of emerging from the crisis faster and stronger than other parts of Europe. Overall, the analysis of the past was correct, but with hindsight, incomplete.

This is also a time for reflection on regional collaboration across the Baltic Sea. In some respects, the conditions for such collaboration have never been better. The EU Baltic Sea Region Strategy provides a powerful structure for the Region to push its collaboration to the next level, increasing the consistency and coordination among activities. The Strategy might not be perfect but if the Region is willing to use it, the potential for achieving a step change exists. The relaunched Northern Dimension provides a framework that both Russia and the other countries in the Baltic Sea Region are comfortable with. Relations will never be simple, but if the willingness for collaboration is there, the structures are in place to make it work. In other respects, however, regional collaboration is under severe duress. The economic crisis has inevitably led to a stronger national focus of policy making. Differences across the Region, in economic situation, policy priorities, and public perceptions, are rising. And the citizens in some countries are becoming less willing to help others in the Region, seeing other parts of the Region as the source of some of their problems. Independently, the process of developing the EU Baltic Sea Region Strategy has created expectations, especially among those working on regional issues, of a significant change in the nature of collaboration. Depending on what happens next, this will either lead to real progress or fundamental disillusionment. Given the extent of the global crisis, it is easy to see the Region as being the mere object of external forces. For regional collaboration, however, this is clearly not the case. Decision-makers in the Region, not the European Commission or others, hold the fate of this collaboration in their hands. Over the last year it has become more complex to push for regional collaboration. But the importance of working together has not diminished. The Region will either come out of this crisis stronger together or weaker apart.

2009 is a year dominated by the onslaught of the global crisis and the need to react quickly to the short-term challenges it created. We are only now able to look forward again and assess the long-term implications. If this Report provides decision-makers in the Baltic Sea Region with useful data and analysis to make the necessary short-term decisions with a view on those long-term outcomes, it will have served its purpose.

About the author

Dr Christian H. M. Ketels

Dr. Christian Ketels is a member of the Harvard Business School faculty at Professor Michael E. Porter's Institute for Strategy and Competitiveness. He holds a PhD (Econ) from the London School of Economics, degrees from the Kiel Institute for World Economics and Cologne University, and has been awarded an Honorary Professorship by the European Business School in Oestrich-Winckel. He is currently a Visiting Professor at the Asia Competitiveness Institute, National University of Singapore, and a Senior Research Fellow at the Center for Strategy and Competitiveness, Stockholm School of Economics. Dr. Ketels has led cluster and competitiveness projects in many parts of the world, is a Director of TCI, the global network of cluster and competitiveness practitioners, and member of economic advisory groups in Europe, the Americas, and Asia. He lives with his wife and three sons in Stockholm, Sweden.

Email contact: cketels@hbs.edu
Web sites: www.isc.hbs.edu, www.sse.edu/csc

Layout: Bitdesign, Leena Närhi, Finland
Photo credits: page 12, Magnus Fröderberg – norden.org, page 48, www.oresundsregionen.org, page 102, Johannes Jansson – norden.org
Printing: InPrint, Riga, Latvia

Baltic Development Forum
The leading high-level network for decision-makers from business, politics, academia and media in the Baltic Sea Region.

Nygade 3, 5th floor
P.O. Box 58
DK-1002 Copenhagen K
Denmark
Telephone +45 70 20 93 94
Fax +45 70 20 93 95
bdf@bdforum.org
www.bdforum.org

Baltic Development Forum

sustainable growth · innovation · competitiveness