STATE OF THE REGION REPORT™

2010

The Top of Europe Recovering: Regional Lessons from a Global Crisis

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Key messages

- The Baltic Sea Region has been hit disproportionally hard by the global crisis, with both labor productivity and labor mobilization dropping; the current speed of recovery is high but fragile
- The dramatic fall in exports has been accompanied by a worrying loss of market share; the crisis might have accelerated structural trends in the global economy working against the Region
- The competitiveness fundamentals remain strong; the on average solid fiscal position of governments even creates opportunities to pull ahead of some international peers
- The level of regional collaboration remains strong, with the EU Baltic Sea Region strategy an important reference, but the governance structure is only emerging
- The last decade has been a period of impressive overall performance for the Baltic countries; they have been remarkably resilient in the difficult adjustment progress; the deep current crisis signals, however, that the economic policy approach needs to be fundamentally reviewed
- Macroeconomic policy in the Baltics has been too narrowly focused on meeting the legal requirements for Euro-zone accession, neglecting the medium-term sustainability of financial markets and, in some countries, public finances
- Microeconomic upgrading in the Baltics has been effective in market opening and (mostly) in the adoption of EU rules and regulation; it has largely failed in building distinct competitive strengths and especially in leading to the fundamental upgrading of local companies
- Poland's better performance during the crisis is not a reflection of higher or more robust competitiveness, but the result of country-specific factors; its good current position is a unique opportunity to address the country's competitiveness weaknesses
- To take full advantage of its unique level of existing regional linkages despite a complex political situation following the crisis, the Region should *renew* the argument for regional collaboration, *rethink* the appropriate approach towards competitiveness upgrading, and *rebuild* the institutional framework for collaboration.

Acknowledgement

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Foreword

In the aftermath of the crisis, economic recovery and sustainable growth is on the minds of both public and private decision-makers on national, regional and European levels. Many businessmen and investors in the region are still very cautious and they want to know more before taking decisions on new business projects.

The impact of the crisis in the Baltic Sea Region was different across the countries. Severely hit by the recession, the three Baltic States had to introduce sizeable policy measures to offset the negative impact on their economies. As a result, all three economies showed a turnaround during 2009 and recently entered a recovery path. At the same time, Poland was the only country in the Region that did not experience economic recession during the crisis. What are the reasons behind and does it reflect a special policy choice?

This year's State of the Region Report rightly focuses on the Baltic countries and Poland by presenting individual chapters on these four countries. It addresses the question mentioned and draws up the lessons learnt from the crisis. In this sense, the State of the Region Report continues to be an important document for public and private decision-makers that are involved in the future of the Baltic Sea Region. As always the report also provides useful information on competitiveness trends in all countries bordering the Baltic Sea and on cooperation priorities of the regional organisations.

With the adoption of the EU Strategy for the Baltic Sea Region it has become even more important to have an overview of activities of key organisations in the region and to have a common reference document. Hopefully this report can play this wider role. More generally, it is our hope that the State of the Region Report would give some guidance to the EU Strategy by providing economic data on key aspects of competitiveness and sustainable growth that must be at the heart of this strategy.

The sponsors of this report - Baltic Development Forum, Nordic Council of Ministers, European Investment Bank – have their particular roles in the development of the Baltic Sea region. A stronger cooperation in the area is supported by the Baltic Development Forum, being a leading high-level networking organisation, and the Nordic Council of Ministers, as a forum for Nordic governmental cooperation. EIB, through its mandate to support EU policy, has a special responsibility to contribute to the success of the EU Strategy for the Baltic Sea Region. In this endeavour it is important to build strong bridges to both EU institutions and Nordic organisations. The State of the Region Report is one such bridge which we hope will be fully utilized.

We wish you good reading and at the same time we remind that the opinions and final observations of this report do not necessarily reflect the views of our organisations.

Copenhagen/Vilnius

May 2010

Hans Brask
Director
Baltic Development Forum

Eva Srejber
Vice President
European Investment Bank

Halldór Ásgrímsson
Secretary General
Nordic Council of Ministers

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Executive Summary

The 2010 State of the Region Report, the seventh in this series of annual evaluations of competitiveness and cooperation across the Baltic Sea Region, takes the Region's economic temperature in the first year after the full onslaught of the global crisis. The focus of the policy debate is shifting towards the exit from last year's emergency measures and the design of growth strategies that can put the economy back on a sustainable development path. It is in this context of how to achieve sustainable growth that the analysis of competitiveness and of the role regional collaboration can play in strengthening is playing an important role.

Part A of the Report tracks different indicators of competitiveness and cooperation in the Region, much as in previous Reports. Due to the earlier launch date for this year's Report, driven by the timing of the BDF Summit in conjunction with the CBSS Summit, there is less new data available. The Report highlights the changes since last October and provides a summary assessment of the situation in other areas. Part B focuses on the longer-term economic trends in the Baltic countries and Poland. The dramatic shift from high growth to deep recession in the Baltic countries raises fundamental questions about the future economic policy approach.

Baltic Sea Region competitiveness and collaboration after the crisis

The global economic crisis has clearly hit the Baltic Sea Region hard. Prosperity has gone down in all but one country across the Region, sharply in some cases. The downfall in demand has been accommodated through both lower employment and a drop in productivity. Exports have fallen sharply and the Region was disproportionally affected by the reduction in global trade. Investment activity, traditionally an Achilles heel of the Region, has slumped after some improvements in the run-up to the crisis.

The drastic slowdown of the Baltic Sea Region economy is to a large degree the natural result of a global crisis hitting a group of small open economies. But the quick return of business climate sentiments to the pre-crisis level of mid-2008 is surprising: the return to growth is still fragile and driven by the willingness of local consumers to spend. Exports are still weak, despite more encouraging recent signs. Investment activity, too, remains low. And if the Greek crisis leads to a serious setback for the main economies in Europe, it will not leave the Baltic Sea Region unaffected. There are also more long-term concerns: the loss of market share in global trade could herald a more permanent loss of position versus Asia. It is too early to tell whether this is the case. There is no reason for pessimism but it is too early to call the crisis over.

The longer-term outlook for the Region depends on its level of global competitiveness. While there has been little new data since the last State of the Region Report was published in October 2009, there is no evidence of an erosion of the Region's strong competitiveness. In some areas, particularly in macroeconomic policy, there are even signs that the Region has weathered the crisis better than most peers in Europe and the OECD. Most of these improvements are driven by short-term economic trends. The future path of the Region's competitiveness will instead depend on the policy decisions made in response to the crisis. The tighter budget conditions in many countries in the Region will also play a role. So far, there are few signs of a fundamental review of competitiveness policies across the Region. In countries with solid competitiveness this might be justified; reforms in specific policy areas might be enough. But there is a real danger that either more pressing macroeconomic challenges or overconfidence after a quick recovery will stop a more fundamental review of growth strategies elsewhere in the Region as well.

Whether the regional level can make a contribution to competitiveness upgrading depends on the nature of collaboration across the Baltic Sea Region. Collaboration remains high and is becoming more integrated across the different networks and projects. The EU Baltic Sea Region strategy has made a significant positive contribution to this process, and could in the future become a regional complement and concrete representation of the Europe2020 strategy. But at least so far the strategt has not been the step change in joint action that many in the Region had hoped for. To reach the next level, it will require the further engagement of political leaders from the Region to create an effective institutional architecture for action. This does not require new organizations but a more systematic alignment of regional efforts with activities pursued at the national (or EU) level. For this to happen, political leadership from within the Region is critical. It is too early to let the public administrations take over from the elected officials.

This is not an easy time for deepening regional collaboration and linking national policies closer to a regional agenda. The focus of economic policy remains strongly on macroeconomics. Politically, this raises the importance of the national and the EU/global level. There is little that cooperation at the Baltic Sea Region level can do in terms of macroeconomic policy coordination. In addition, the crisis has increased the heterogeneity across the Region in terms of economic conditions, competitiveness, but maybe most importantly also of attitudes and perceptions. The crisis in Stockholm, Warsaw, and Hamburg has been quite different from the crisis in Reykjavik, Riga, and Moscow. The EU Baltic Sea Region strategy and the strong existing networks across the Region have provided much needed robustness to regional collaboration. But it is critical to again make the argument for regional collaboration for the broader public. This is not easy at a time when there are debates about the role of foreign banks, about fiscal rescue packages for countries in need, and about competitive devaluation. Without convincing the public at home, it is futile to expect politicians across the Baltic Sea Region to make decisive steps towards further integration.

A decade of boom and bust: lessons for the Baltic countries (and others)

The last decade has seen a dramatic economic transformation of the three Baltic countries and in Poland. that has moved this part of the Baltic Sea Region from a phase of systemic transition into an era of normal economic development. Seen in the historical context of the last two decades, the economic achievements remain impressive. And despite relatively poor rankings on institutional quality, governments across the Baltics have been able to remain effective in dealing with the crisis. This compares quite favorably, not only with the experience in other parts of Europe but also globally. Despite this relatively positive assessment, it is crucial not to be fooled into seeing the crisis just as a deep but ultimately temporary bump in the road. Any discussion about a new growth strategy for the Baltic countries needs to start with a critical assessment of the last decade: has the inability to avoid macroeconomic overheating been the sole problem, or was there also a failure to upgrade underlying competitiveness? Chapters by local experts from the Baltic countries and Poland provide important insights into this issue.

In terms of *macroeconomic competitiveness*, the EU accession process defined standards for both institutional quality and for macroeconomic policy. Social infrastructure and political institutions are, at the aggregate level, relative strengths for Estonia and Latvia and are neutral for Lithuania (and Poland). The EU standards were clearly helpful in defining clear external benchmarks on what had to be achieved. Macroeconomic policy presents a more mixed picture, with Estonia and Lithuania registering it as a relative strength while Latvia's (and Poland's) performance in this area is much weaker. The narrow focus on the Maastricht criteria for Euro-zone accession did not provide sufficient guidance for a robust and consistent policy.

In terms of *microeconomic competitiveness*, progress was more limited. The Baltic economies opened up to foreign trade and investment, and rules and regulations were brought in line with internationally established EU standards. Factor input conditions such as skills and infrastructure continued to be seen as relatively strong. But there was limited progress in developing these assets further, despite the inflow of EU funds. Most importantly, there was very little upgrading within local companies and foreign investment did not close this gap. Analyzing and addressing this failure is one of the key tasks economic policy makers in the Baltics should now be concerned with. The EU context provided many useful tools but not an integrated strategy for creating competitive advantages; it focused on reducing weaknesses and even there track record has been mixed. More technical assistance in project implementation, like in the new Commission-EIB JASPERS program, could help, even if they do not close the strategy gap.

Macro- and microeconomic competitiveness interact in important ways; sustainable growth requires progress in both dimensions. The Baltic countries provide yet another example of this process. Solid macroeconomic competitiveness and market opening can easily lead to overheating and crisis if there is insufficient upgrading of company sophistication: this has been the experience not only in the Baltics but in the past also in parts of Latin America and Asia.

Poland, it turns out, is not a role model for the Baltics. Poland continues to have a full agenda of action items to upgrade its competitiveness. The good performance during the crisis, driven by country-specific circumstances that have little to do with high competitiveness, allow it to make progress on these issues. Poland cannot afford to waste this opportunity.

What now? Three priorities for action

- ***Renew*** *the argument for regional collaboration.* While the people involved in regional collaboration continue to work in joint efforts, the broader public no longer is so sure. The case thus needs to be made forcefully and publicly: more collaboration can help countries in the Region to overcome some of the costs of their small absolute size; and collaboration across the Region can help to turn heterogeneity into an advantage, bringing benefits to both sides. Without regional collaboration, upgrading competitiveness will be significantly harder for all countries in the Region, whether they are strong or weak.
- ***Rethink*** *the appropriate approach towards competitiveness upgrading.* The crisis has been more than a deep bump on the road. For the Nordics (and Germany), it might have very well accelerated structural changes in the global economy that work to their disadvantage. For the Baltics, Poland, and Russia, it has in different ways signaled the need to adopt a new and more balanced approach towards upgrading competitiveness across all dimensions. Both groups of countries have sufficient assets to successfully address the challenges that the future holds. The biggest danger is not the competition from abroad but complacency and unwillingness to change at home.
- ***Rebuild*** *the institutional framework for collaboration.* The Region needs not only a vision and a mission, it also needs the tools to implement them. The individual pieces are there: a wealth of linkages through organizations, networks, and projects; the EU Baltic Sea Region strategy process as an integrating factor. But it is now critical to put them together in a coherent and effective architecture that is able to deliver. This will require another decisive step by government leaders across the Region.

Introduction

2010 is the first year after the crisis, for the Baltic Sea Region as well as globally. Since last year, the policy focus has gradually shifted from short term crisis intervention to managing the exit from the highly expansionary fiscal and monetary policy stance adopted in 2009. This transition is difficult: exiting too slowly risks leading to rising concerns in the financial markets about unsustainable debt burdens and future inflation; exiting too quickly risks undermining the improvements in business sentiment so far, stopping the emerging recovery in its tracks. And it is getting even more complicated as a new wave of concerns about public debt levels is affecting financial markets, especially in Europe.

Behind these difficult short-term choices looms a more permanent challenge that countries in the Region and elsewhere are facing: how to achieve sustainable long-term growth? Without growth, the problems of public debt are impossible to solve without severe damage to prosperity. But clarity about the need for growth does not imply clarity about the policy approach to get there. Prior to the crisis, the Baltic Sea Region was growing at a fast but unsustainable rate. The challenge, then, is to find a new approach that is able to deliver a return to growth without creating the seeds of another overheating crisis.

The 2010 State of the Region Report, the seventh in this series, continues to focus on the role that collaboration across the Baltic Sea Region can play in enhancing competitiveness. National policies were crucial for crisis response and remain at the forefront as macroeconomic policies are brought back to sustainable levels. Collaboration at the European or even global level takes center stage for emergency help and changes in the regulatory framework. Collaboration at the level of the Baltic Sea Region is becoming more important as countries in the Region consider policies to regain growth. But even when the economic argument for regional collaboration gains weight, the political challenges remain: the crisis in Reykjavik and Riga was very different from the crisis in Stockholm and Warsaw. While collaboration with high growth economies was easy to sell before the crisis, support for countries hit by crises seems now much less popular, especially when their plight has negative repercussions for the rest of the Region and is at least partly the result of their own policy mistakes.

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

This Region is home to 57.5 million people, about 500.000 less than at its peak in 1997. While the Nordic countries — together representing slightly less than 45% of the Region's inhabitants — have continued to gain population, the decrease elsewhere, especially in north-western Russia and the Baltics, has been growing. The

Region's labor force of 27.5 million employees in 2009 has been falling by 635.000 in one year, 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 a decade ago. The Nordic countries accounted for 57% of this gain, and now account for 45% of the Region's total employment. The Region created an annual GDP (PPP adjusted) of slightly above €1,200 billion ($1,700 billion). This is similar to about 11% of the EU-27 economy or roughly the size of the Italian economy. The Nordic countries account for 58% of the total. Northern Germany and Northwestern Russia account for roughly 14% each. The Baltics contribute close to 7% and Northern Poland the remaining 5.5%.

There is no scientific way to exactly determine the boundaries of the Baltic Sea Region. We proceed conservatively, including only 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 further away from the Baltic Sea are not included, because their economic ties with the Baltic Sea Region are limited. This makes the definition used here more restrictive than the ones used by other institutions. For comparisons, the Report looks – depending on data availability – at the EU-15 (old member countries), the EU-8 (new central European member countries), regions within Europe (Iberian Peninsula (Spain, Portugal), British Isles (UK, Ireland), NAFTA (US, Canada, and Mexico), Oceania (Australia, New Zealand), the Asian Tigers (Hong Kong, Singapore, Taiwan, and South Korea), and occasionally the OECD.

The structure of the State of the Region Report Broadly following the structure developed since 2004, **section A** provides a discussion of the recent trends in competitiveness and collaboration across the Baltic Sea Region since last October. The discussion is organized in three parts. The first part looks at the current economic climate in the Region, an important influence on the policy environment for long-term competitiveness upgrading. The second part looks at competitiveness trends, covering data on economic outcomes, intermediate indicators, and competitiveness fundamentals. The third part gives an update on the activities of the main regional organizations and projects, with a special focus on the progress made in implementing the EU Baltic Sea Region Strategy launched late last year.

Section B discusses the medium-term developments in the Baltic countries and Poland. In the Baltics, record high growth was followed by the deepest recession on record in the EU. A series of country-specific chapters written by experts from each of the Baltic countries and from Poland reviews the economic evolution of these countries over the last decade. Based on these chapters, the section provides a number of emerging conclusions about the lessons to be learned. Policy makers in the Region, but also at the EU level, face a decision on whether they should aim for a quick return to pre-crisis strategies or need to consider a fundamental change in policies. While these are difficult questions, it is important to withstand the temptation to ignore them and concentrate only on the immediate policy decisions ahead.

The Report closes with some overall reflections on the current state of the Baltic Sea Region. A good deal has been achieved and the level of collaboration is much higher than across any other comparable regions in Europe, including those for which the EU is preparing similar regional strategies. But during the crisis, many experienced the interdependences across the Region, through the exposure of banks or the impact of changing exchange rate relations, as negative. With the attention of political leaders occupied elsewhere, this puts a high burden on the political will of leaders in the Region to pursue the ambitious objectives of the EU Baltic Sea Region strategy.


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Section A: Competitiveness upgrading in the wake of the global crisis

- The Baltic Sea Region has been hit disproportionally hard by the global crisis; the current speed of recovery is high but fragile
- The fall in demand has led to marked reductions in both labor productivity and mobilization, signaling a significant degree of flexibility in the Region's labor markets
- The dramatic fall in exports has been accompanied by a worrying loss of market share; the crisis might have accelerated structural trends in the global economy working against the Region
- The competitiveness fundamentals remain strong; the on average solid fiscal position of governments even creates opportunities to pull ahead of some international peers
- The crisis has increased the heterogeneity in economic conditions across the Region; whether this will also increase the gap in competitiveness depends more on the political choices made in response to the crisis than on the different fiscal assets available across the Region
- The level of regional collaboration remains strong, with innovation and environment frequent themes and the EU Baltic Sea Region strategy an important reference
- The governance structure for more effective collaboration across the Region is still emerging, with further political leadership from the Region critical to make real progress

This section of the State of the Region Report describes the context for cross-national cooperation in the Baltic Sea Region, updating the information provided in previous Reports. It provides data and analysis on the current economic climate in the Region; on indicators of competitiveness – from economic outcomes to competitiveness fundamentals; and on the activities of key organizations working across the Region to strengthen integration and competitiveness. Because of the timing of this year's Report, the discussion is more brief in those sections where little new data has become available since the launch of last year's Report in October 2009.

Competitiveness upgrading is a long-term set of activities that are pursued in the context of short-term economic needs and political opportunities. For a broad-based analysis of competitiveness and collaboration in the Baltic Sea Region it is therefore useful to take these different dimensions into account.

The first part of this section provides an overview of the current economic climate. The global economy and the economies of the Baltic Sea Region are slowly clawing their way back in the wake of the deep financial and economic crisis. For policy makers, this creates a complex policy agenda: emergency measures need to be reduced, keeping a balance that avoids endangering long-term sustainability as much as undermining short-term recovery. At the same time, growth needs to be stimulated, having a clear eye on avoiding another build up of unsustainable imbalances that triggered the recent crisis. Without long-term growth, there is little hope to regaining fiscal balance.

The second part of this section provides a review of the competitiveness of the Baltic Sea Region. It discusses the most recent data on economic outcomes, components of economic prosperity as well as other indicators of economic activity, particularly on trade, investment, and innovation. This data is then put into the context of an assessment of the competitiveness fundamentals across the Region. Apart from an update about newly available data, there is also a short recap of the key findings from the last State of the Region Report 2009. Since the last Report was published in October 2009, only a moderate amount of new data has become available in this area. The performance of the Region on the objectives set out by the EU Lisbon agenda, a constant feature of past Reports, has been made obsolete by its replacement through the Europe 2020 strategy. An assessment based on that new strategy and the national performance objectives to be developed from the EU level targets will be included in the future.

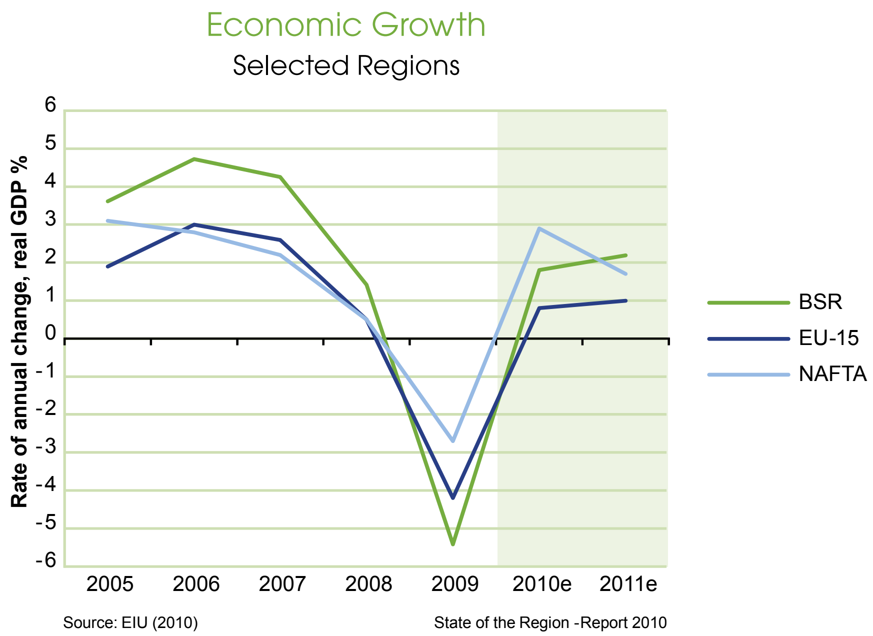
The third part of this section discusses the activities across the Baltic Sea Region on upgrading competitiveness and regional collaboration. As in past Reports, the main activities conducted by key regional organizations and projects over the last few months are documented. With the EU Baltic Sea Region Strategy adopted by the European Council on 26 October 2009, implementation is now under way. A few of the strategy's flagship projects are highlighted and the general progress in working with the strategy is discussed.

Together, these three dimensions provide the backdrop for identifying conclusions and action recommendations that are intended to stimulate the policy debate about the future of cooperation for competitiveness in the Baltic Sea Region.

1. Current economic climate in the Region

The State of the Region Report does not aim to provide an in-depth assessment of the current economic climate in the Region. Many government agencies, research institutions, and banks are focused on this task. Instead, the Report discusses medium-term data related to the level of economic performance that the Baltic Sea Region countries will be able to achieve over time. The short-term fluctuations of the economy provide only very limited information on these trends. But they do set the context in which many policy decisions with longer-term implications are being made.

The Baltic Sea Region had until 2008 grown at rates close to the global average, significantly above the level of the North American and the Western European economies. During the crisis of 2009, it then experienced a much more dramatic drop then other world regions. For 2010, the EIU expects a solid recovery that would push the growth rate in the Region back above the level of growth in the



EU-15 countries. For 2011, growth across the Baltic Sea Region is then predicted to continue, while especially the US economy could lose some steam as the fiscal stimulus is reduced and monetary policy tightened. This would put the growth rate of the Baltic Sea Region back above the level of both North America and Europe. The IMF's most recent World Economic Outlook of April 2010 is more pessimistic about the prospects for Europe, including the Baltic Sea Region, while it sees stronger 2011 growth in North America and Asia.

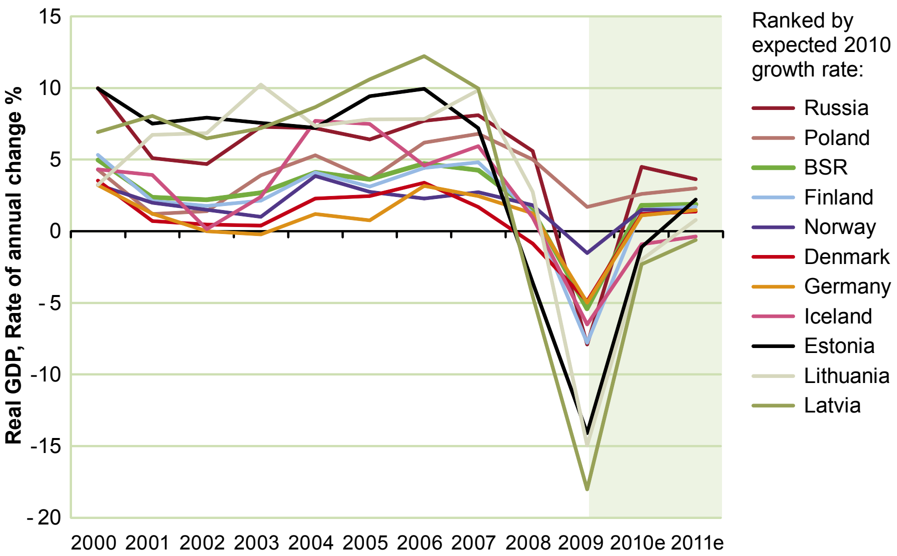
The slow-down in growth has led to a marked cooling of inflation, which across the Region dropped from 5.7% in 2008 to between 2% and 3% in 2009 and 2010. As in other world regions, there are concerns as to whether the highly accommodating monetary policy stance taken in response to the crisis could trigger another round of inflation in the future. Unit labor costs have fallen in 2009, after years of brisk growth, but are set to rise again in 2010. The Region continues to run a significant current account surplus, a situation that has been in place since 2000. The surplus had become smaller in the run-up to the crisis as domestic demand outstripped export growth. The short term effect of the slow-down was a reversal of these dynamics, bringing the Region's current account surplus back to 6% of GDP in 2009. This surplus is forecasted to shrink gradually over the next few years, driven by a slow resumption of world trade.

Within the Baltic Sea Region, Poland was the only country with positive growth in 2009. Norway followed with a moderate decline. The Baltic countries saw GDP drop by around 15%-20%, with the rest of the Region contracting by 5% to 10%. They all experienced a dramatic reversal from a large current account deficit of 10% of GDP or more in 2008 to a surplus of between 3% and 9% in 2009. For 2010, Russia and Poland are forecasted to grow the fastest. The Baltics and Iceland are set to contract at a low rate, with the rest of the Region resuming slow positive growth. In 2009, unit labor costs measured in US-Dollar dropped by more than 10% in Iceland, Poland, and Sweden, in all cases driven to a large degree by exchange rate movements. Conversely, unit labor costs went up significantly in Finland and Denmark.

The recovery that now seems to be under way across the Baltic Sea Region is largely driven by an improvement in economic sentiment. While the Region had tracked the EU average for most of the post-2000 period, the perception of consumers and companies held up better during the crisis and kept this higher optimism through the crisis. This is positive in the short-term but also entails risks. If the recovery is entirely driven by domestic demand,

Economic Growth:

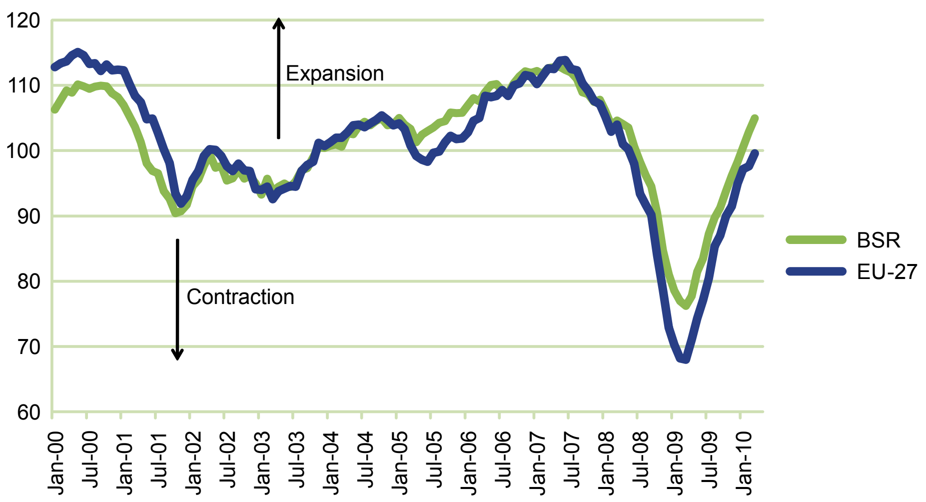
Baltic Sea Region countries



Source: EIU (2010) State of the Region -Report 2010

Evolution of Economic Sentiment

Baltic Sea Region vs. EU-27



Note: BSR excluding Iceland, Norway, and Russia

Source: EU (2010) State of the Region -Report 2010

Growth Rates of GDP Components

Selected Regions

	Baltic Sea Region		EU-27		OECD	
	2009	2010	2009	2010	2009	2010
Consumption						
Private	-3.4%	+1.4%	-1.6%	+0.2%	-1.0%	+1.1%
Public	+2.1%	+1.8%	+2.1%	+1.5%	+2.1%	+1.9%
Investment	-13.8%	-0.7%	-15.6%	+1.3%	-16.8%	+4.6%
Trade						
Export	-11.3%	+3.5%	-12.7%	+3.3%	-12.1%	+5.0%
Import	-17.0%	+6.6%	-12.1%	+3.0%	-12.5%	+4.6%

Source: EIU (2010) State of the Region -Report 2010

it becomes highly susceptible to shocks, for example in the form of tightening monetary conditions that raise the costs of mortgages.

Unfortunately, there are signs that the current growth in the Baltic Sea Region is much more driven by domestic consumption than elsewhere in Europe or the OECD. In 2009, all regions saw a massive drop in trade and investment as well as a significant drop in private sector consumption, the largest component of GDP. Only public consumption grew as governments tried to stabilize the economy. In 2010, the Baltic Sea Region is forecasted to return to private consumption growth with a positive swing of almost 5%-points in the growth rate compared to last year. Trade makes no positive contribution to growth, with imports rising faster than exports. Investments continue to fall while the growth rate of public consumption is slowing down. In both the OECD and the EU-27, the swing in private consumption is much more moderate at around 2%-points. Both also benefit from investment activity rising again. In the OECD, even trade makes a positive growth contribution. If these projections turn out to be true, policy makers in the Baltic Sea Region have the delicate task of reducing emergency measures without spooking private consumers too much.

Looking at individual countries within the Baltic Sea Region gives a sense of the differences across the Region but also of the extent to which sentiments, especially consumer sentiments, have moved beyond the crisis in parts of the Region. The countries in the Region reached their peak in the recent cycle over a period of 18 months. Denmark reached the top in October 2006 while Poland registered the highest economic sentiment only in March 2008. Country-specific factors clearly played an important role for the timing. The crisis, however, was driven by global events and all countries reached the bottom in terms of business sentiment between February and April 2009. Interestingly, this means that it took Denmark 28 months from peak to bottom while Poland made the same journey in only 12 months. Since the bottom was reached at the end of the first quarter of 2009, sentiments in the Region have improved significantly. In Sweden and Denmark, the current level of business sentiment is at more than 95% of the highest level ever reached in the run-up to the crisis. In one year, about 90% of the drop in sentiments that it had taken about two years to occur has been recouped. In Germany and Finland the perceptions are not quite as positive, but still better than in the EU average. The Baltics and Poland remain more skeptical than the EU, although even crisis-hit Latvia has experienced a remarkable improvement in sentiments.

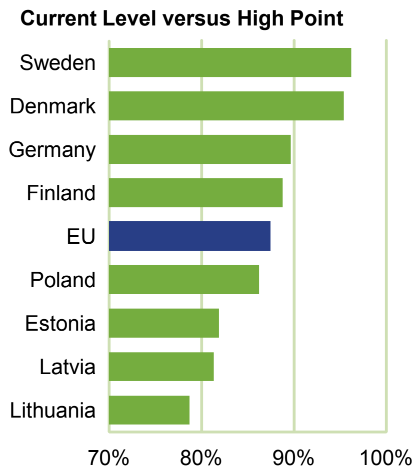
Not only the perceptions are different across the Baltic Sea Region, the actual growth drivers are as well. The aggregate profile for the Region is most closely matched in the Scandinavian countries, except Iceland. Germany depends most heavily on government consumption. Finland is expected to have less consumption growth (public and private) but to get some impulses from trade. For Iceland, trade is the only dimension of GDP expected to grow. The Baltics also benefit from trade while otherwise even public consumption has contracted. In Poland and Russia, investments are starting to grow again. Both countries also have domestic markets growing faster than external demand, leading to net trade being a drag on growth, especially for Russia.

Unemployment and public debt are two of the primary consequences of the global crisis: unemployment as the market response to a sudden drop in demand; public debt as the result of government responses to soften the impact of market forces. On unemployment, the Baltic Sea Region saw rates go up pretty much in line with the European average, but from a lower level. Much more dramatic was the development in NAFTA where unemployment rates, especially in the US, initially moved up quickly and reached the level of the Baltic Sea Region. They

Evolution of Economic Sentiment

EU Countries in the Baltic Sea Region

Source: EU (2010)



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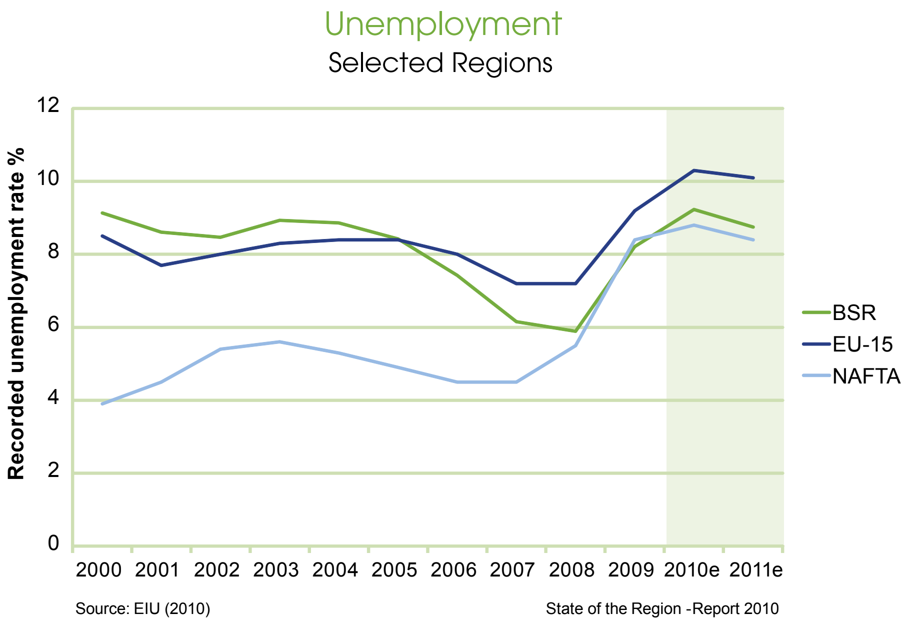
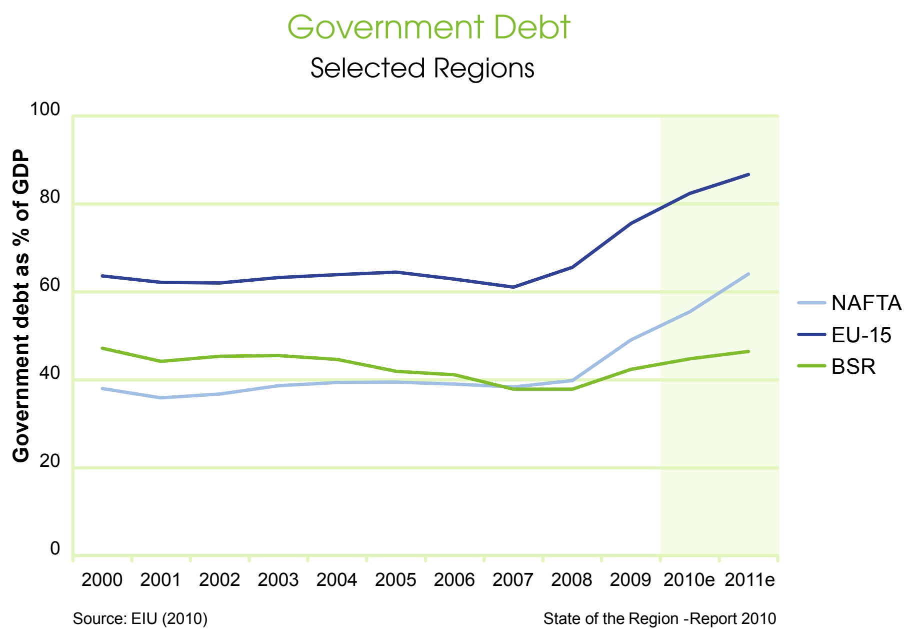
are now expected to stabilize and then drop more quickly than in the Baltic Sea Region.

On government debt, the Baltic Sea Region experienced a much less significant increase than both the EU-15 and NAFTA. Especially the US has embarked on a heavily debt-financed stimulus package. While NAFTA and the Baltic Sea Region entered the crisis with public debt at roughly the same level of GDP, by 2014 the NAFTA countries are expected to have a debt level about 75% higher than the Baltic Sea Region. Overall, the Region has come through the crisis reasonably well, especially given the disproportionally large drop of GDP in 2009.

For individual Baltic Sea Region countries, the picture is again quite different. The Baltic countries all experienced a huge rise in unemployment from low initial levels. Latvia and Lithuania registered a large increase in government debt. In Latvia, the government was forced to turn to a coalition of

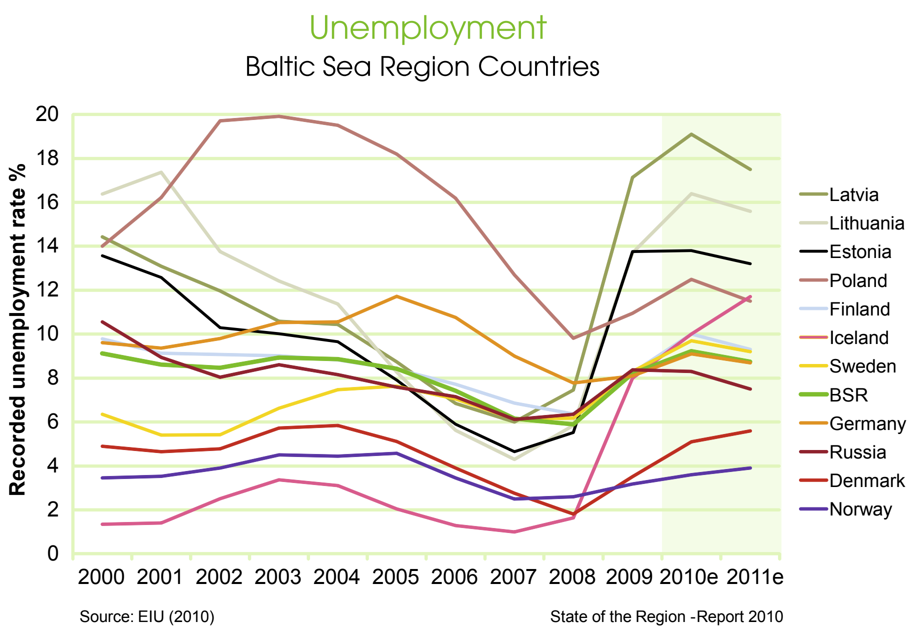


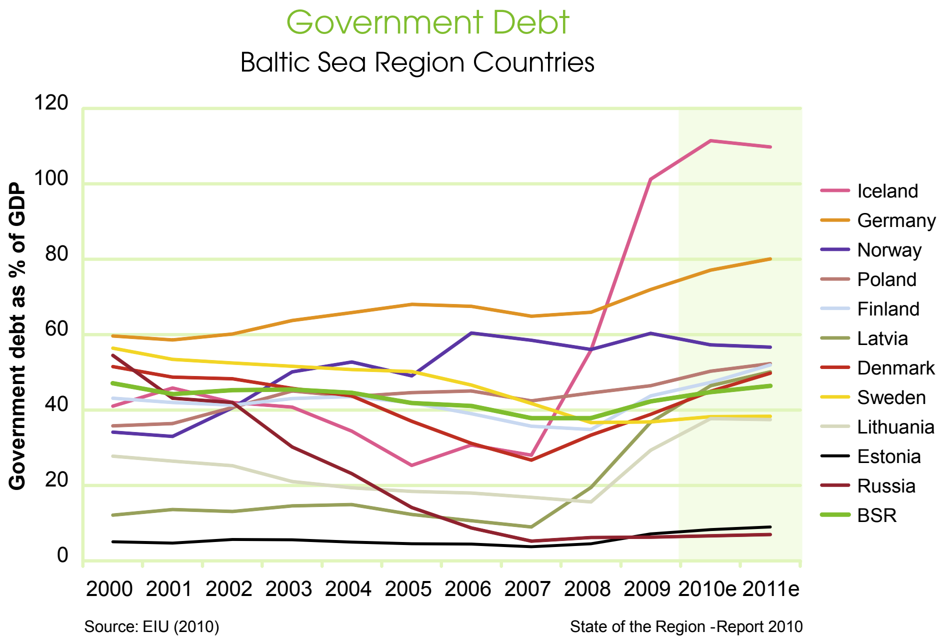


neighboring countries in the Region, the EU, and the IMF to match the government financing shortfall. Estonia's debt level remained low through the crisis as the government kept deficits around 2% of GDP despite the huge fall in GDP.

Among the three countries that are only in part included in this Report's analysis of the Baltic Sea Region, Poland was much less affected, with moderate increases in unemployment and public debt. It was the only country in the Region that registered positive growth in real GDP even in 2009. Germany was hit hard by the drop in world trade but managed to keep the rise in unemployment at moderate levels. This was achieved through a fiscal stimulus package and financial support for short-term work that allowed companies to keep on employees despite the fall in demand. Russia was hit hard by falling oil prices and a severe financial market crisis in 2009. Unemployment went up significantly, and the budget balance swung from roughly +4% of GDP in 2008 to about -6% of GDP in 2009. Russia's huge fiscal reserves allowed it to keep the public debt level at very low levels. Unemployment went up. For 2010, a strengthening oil price and a normalization of financial markets support a significant improvement in overall conditions.

Among the Nordic countries, Denmark and Norway continue to register very low unemployment rates even though the Danish rate almost doubled in 2009. The Danish public debt was pushed up to finance the crises response, albeit from low levels. Norway started out in a less beneficial situation but kept the government debt stable. Norwegian government debt does not include the petroleum fund. The significant losses of the fund, exacerbated through its active investment approach, have led to discussions about whether to move to a passive strategy instead. In the meantime, much of the losses have been recouped. Sweden's unemployment rate was already higher at the beginning of the crisis and increased in 2009 more than in the other Nordic countries, except Iceland. For 2010, however, the additional increase in unemployment is expected to be lower than in Denmark and Finland. After five years of budget surpluses, the Swedish budget was in deficit in 2009 and a further deterioration is likely for 2010. The public debt burden will rise moderately, with Sweden still registering one of the lowest government debt rates in the Region. Finland's traditionally high unemployment had been falling gradually before the crisis but by 2010 all gains of the previous period had been eroded. There are significant concerns that the crisis might result in structural change that could further increase the skills mismatch between the unemployed and the needs of the economy. Finland has been relatively conservative on a fiscal stimulus, relying instead on the automatic stabilizers in its tax and social security system to provide expansionary





impulses. Its public debt burden is closely matching the Baltic Sea Region average, with modest increases through the crisis. Iceland remains to suffer from the aftermath of its financial sector collapse. Unemployment was traditionally the lowest in the Region but is now dramatically rising, with double-digits predicted for 2011. The public debt has exploded from around 30% to more than 100% of GDP, driven by the assumption of foreign debt's run up by the country's banks. This has led to political turmoil, when President Grimsson refused to sign a law that would have agreed to the terms negotiated by the Icelandic government with the UK and the Netherlands to cover the losses incurred by Icesave customers in the two countries. The law was rejected by an overwhelming majority in a subsequent referendum. Without an agreement on this issue, there is uncertainty about the international financial support for Iceland as well as for the country's EU application, even though an official link between these issues is denied by the governments involved.

Overall, not only the crisis but also the recovery looks very different across the individual parts of the Region. This is creating different policy challenges across the Baltic Sea Region countries. And it is exposing politicians across the Region to very different demands by the electorates. Last year's State of the Region Report identified the divergence during the crisis as a major challenge to regional integration and joint policy making. The recovery has brought little if any improvement to this situation.

2. Competitiveness

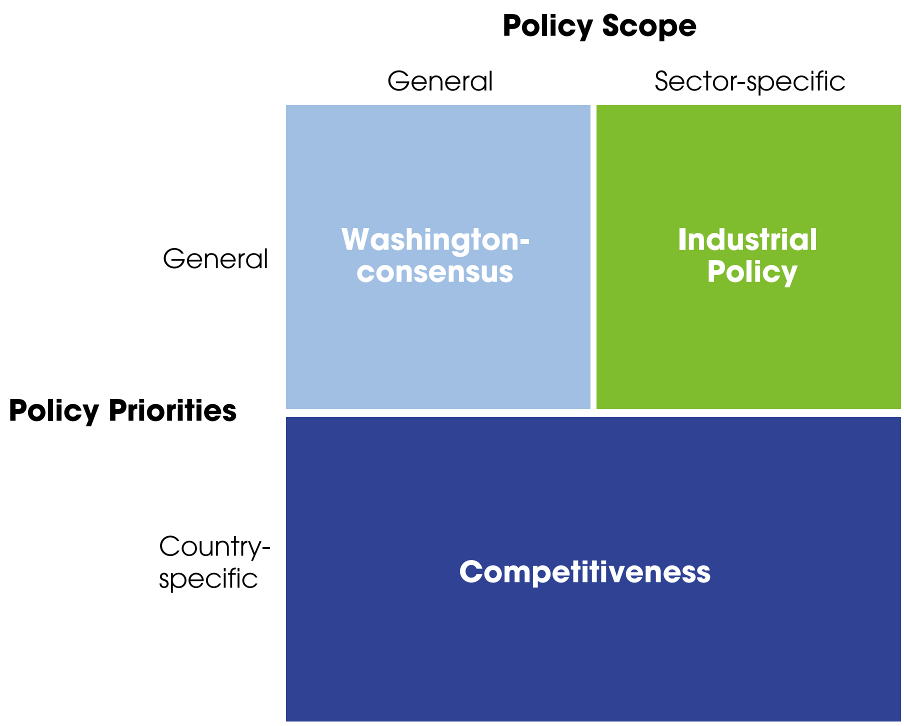
There is wide agreement that a long-term path out of the current crisis will require sustainable growth. Without growth, there is little hope to create new jobs for the employees that have lost their positions in the downturn. Without growth, there is also little hope to generate the government revenues necessary to rebalance public sector budgets and reduce the debts that have been accumulated during the crisis. Growth has been achieved before but to keep it sustainable, economic policies that lead to a resumption of economic activity without creating new imbalances and speculative bubbles are required.

A successful growth strategy needs to be based on a foundation of solid macroeconomic policies, i.e. monetary and fiscal policies that keep inflation and government debt at moderate levels. How and when to migrate from the current macroeconomic policy stance to this benchmark is under debate but the ultimate goal is not. Solid macroeconomic policies alone are not enough, even though they are important. One school of thought argues that the other element of the policy mix has to be a generally business-friendly environment, from solid infrastructure to open markets. This position has often been associated with the term "Washington-consensus" because it has been claimed to characterize the policy advice usually given by the IMF and World Bank. The alternative "industrial policy" position argues that in addition government should take a more active stance in supporting the development of specific economic activities and sectors. This position has taken its inspiration from the experience of East Asian economies where high growth was achieved in the presence of strong and active governments. While this debate is far from a resolution, both positions are facing significant criticism. The Washington-consensus is by many economists seen as fundamentally sound but incomplete. It works in the long-term but is insufficient to generate solid short-term growth. The failure to deliver short-term results has traditionally made the industrial policy approach very attractive to policy makers. The poor track record that many countries have in replicating the success of the Asian tigers has, however, led to significant hesitance against following this approach again in the wake of the current crisis.

The competitiveness framework grounded in Prof. Michael E. Porter's work builds on both of these positions in important ways. As the Washington-consensus, it puts competitive markets at the heart of the policy mix. It disagrees with the tools traditionally used for industrial policy - in particular, it is strongly opposed to efforts that reduce the intensity of competition. But it shares the notion that there is a case for government to actively develop sector-specific microeconomic conditions alongside the quality of the general business environment.

But the competitiveness approach also marks an important departure from both traditional strategies: it argues that the identification of appropriate policy priorities is context-specific and requires an in-depth analysis of the current

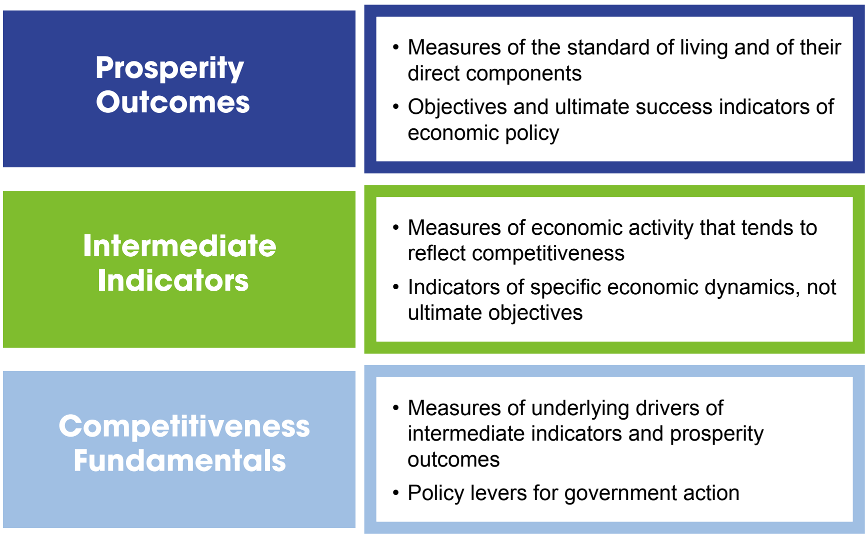
Perspectives on Economic Growth Strategies



circumstances in a location. The Washington consensus instead provides a generic list of policy recommendations that are applied everywhere. And the industrial policy approach identifies specific sectors as generically "more attractive" and suggests them as targets for all countries.

An in-depth competitiveness assessment, then, is the foundation of any effective competitiveness action agenda, whether for an individual country or a group of neighbors like the Baltic Sea Region. As in previous years, the State of the Region Report conducts this assessment at three levels: *Prosperity outcomes* give a sense of how competitiveness is reflected in the standard of living, the ultimate objective of economic policy. *Intermediate indicators* are analytical indicators that track the translation of competitiveness through economic activity into ultimate prosperity outcomes. *Competitiveness fundamentals* are the root causes of the higher level outcomes and indicators observed, and are the level at which economic policy can most effectively intervene. When the relationships between individual fundamentals, indicators, and outcomes are multifaceted and complex, an integrated view of all three layers provides more robust insights than overreliance on one individual dimension of data.

The Three Layers of Competitiveness Assessment



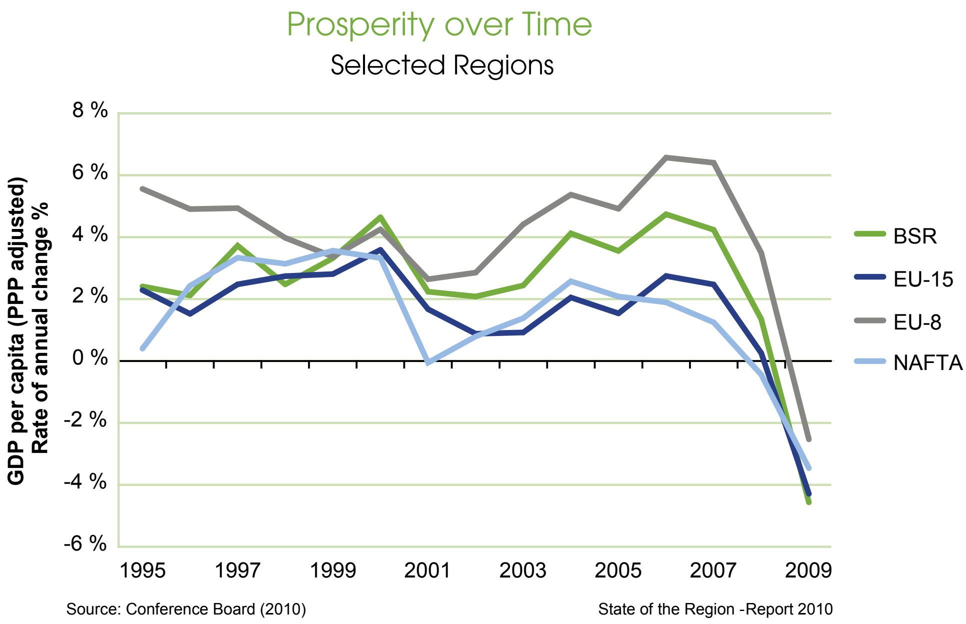
2.1 Prosperity outcomes

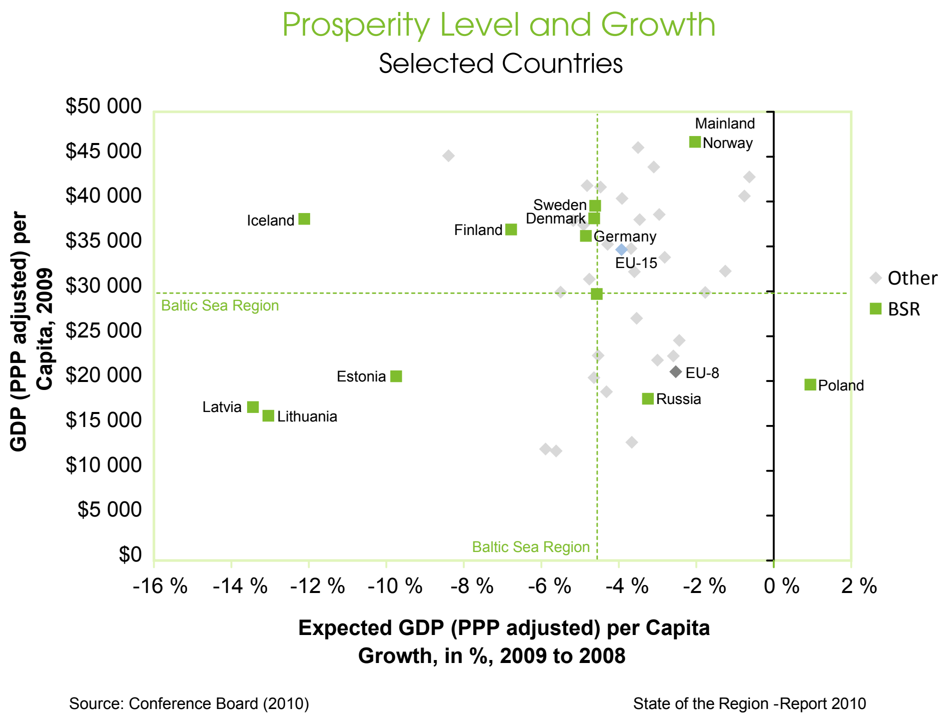
The central measure of prosperity we use is gross domestic product (GDP) per capita, adjusted by purchasing power parity. Additional insights into the drivers of prosperity can be derived from a decomposition that separates the impact of labor productivity, labor mobilization, and price levels on overall GDP per capita.

Prosperity

The Baltic Sea Region has in 2009 experienced a significant reduction in prosperity, with average GDP per Capita (PPP adjusted) across the Region dropping by -4.6%. This is only slightly better than the forecasts reported in last year's State of the Region Report. Among peer regions, only the British Isles registered a stronger drop with -5.2%. In Europe, the EU-15 (-4.3%) and especially the EU-8 (-2.5%), the Central European countries that joined the EU in 2004, were somewhat more robust. Outside of Europe, NAFTA's average prosperity dropped by -3.5% while Oceania registered the strongest performance among advanced country regions with a drop of only -0.8%. Less developed Asian countries and regions did much better (China: +7.3%, ASEAN: +0.2%) but the more advanced Asian tigers also dropped by -3.4%

Within the Baltic Sea Region, there has been a dramatic reversal of the catch-up in prosperity rates that had been visible throughout the last decade. The Baltic countries in particular proved to be much less resilient in the face of the crisis than their Nordic peers. Poland is an exception and has seen prosperity growth despite the crisis. Iceland is the exception to the other extreme, having suffered a dramatic drop in prosperity despite being a still very prosperous country. Compared to 2008, the most dramatic change in growth dynamics was experienced in Lithuania with a swing of 16%-points from +3% to -13%. Other countries with high swings were Iceland (-12%-points), Russia (-9.4%), Latvia (-9.1%), and Finland (-7.5%). These figures are higher than in any other OECD country. In the EU, Bulgaria, Romania, and the Slovak Republic also experi-





enced changes in growth dynamics by more than 10%-points.

The crisis is severe but follows a period of high growth. For Denmark and Iceland, 2004 was the most recent year with lower prosperity levels than now. For the Baltics, Finland, Germany, and Sweden, the drop pushed them back to 2005 levels. Average regional prosperity has been higher than 2009 only in 2007 and 2008.

From prosperity to the quality of life

GDP per capita is a central indicator of prosperity but there is a recognition that other factors, like social and environmental conditions, matter as well. The French government recently created a high-level Commission that presented its proposal on how to better measure economic performance and social progress in the fall of 2009. Last year's State of the Region-Report discussed the UNDP Human Development Index, the World Economic Forum Gender Index, and the Yale Environmental Performance index as sources of relevant data to measure important non-income related dimensions of the standard of living. On these indicators, there is either no now data available or the position of the Baltic Sea Region countries hasn't materially changed from their strong rankings reported previously.

The economic crisis has played its part in leading to further demands to measure the standard of living through more robust concepts than GDP per capita, which, as it turns out, had for many countries overstated the sustainable level of prosperity that economies could support. The French government has created a blue-ribbon group of scientists the Commission on the Measurement of Economic Performance and Social Progress, which published their findings in the fall of 2009. The Legatum Institute, a London-based think tank, has started to publish a global prosperity index that draws on rankings in nine areas, covering both income and non-income related dimensions of the standard of living. Finland ranks 1st globally and is in the Region followed by Sweden (3rd globally), Denmark (4th), and Norway (5th). Germany ranks 14th, Poland 29th, Estonia 31st, Latvia 37th, and Russia 69th. Iceland and Lithuania are not covered. The Nordic countries get strong marks across the board, while for Estonia, Latvia, and Russia the profile is more mixed with strengths in some areas but considerable weaknesses in others. Estonia and Latvia receive particularly low ranks on social capita. Russia registers a number of areas of weakness, but gets high marks on education.

Prosperity accounting

The Baltic Sea Region registered in 2009 a balanced performance on both labor mobilization and labor productivity. For this year's Report, labor productivity is registered in purchasing power terms to reduce the volatility through exchange rate swings. The productivity data thus covers both the effects of productivity and of local price levels. Given the relative high local prices in the Baltic Sea Region reported in previous years' Reports, this leads to a lower ranking for the Region on productivity.

Compared to its European peers, the Baltic Sea Region does well on labor mobilization and

Prosperity Decomposition

Selected Cross-national Regions in 2009

GDP per Capita (PPP)		Employment-Factor		Productivity-Factor (PPP)
OCEANIA	=	ASIAN TIGERS	x	OCEANIA
NAFTA		OCEANIA		B ISLES
B ISLES		NAFTA		EU-15
EU-15		IBERIA		NAFTA
ASIAN TIGERS		B ISLES		IBERIA
IBERIA		Baltic Sea Region		Baltic Sea Region
Baltic Sea Region		EU-8		ASIAN TIGERS
EU-8		EU-15		EU-8

Note: Working hours for Russia are estimated
Source: Groningen Growth and Development Centre and The Conference Board (2010), authors'calculations

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Prosperity Decomposition

Baltic Sea Region Countries in 2009

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

Note: Working hours for Russia are estimated
Source: Groningen Growth and Development Centre and The Conference Board (2010), authors'calculations

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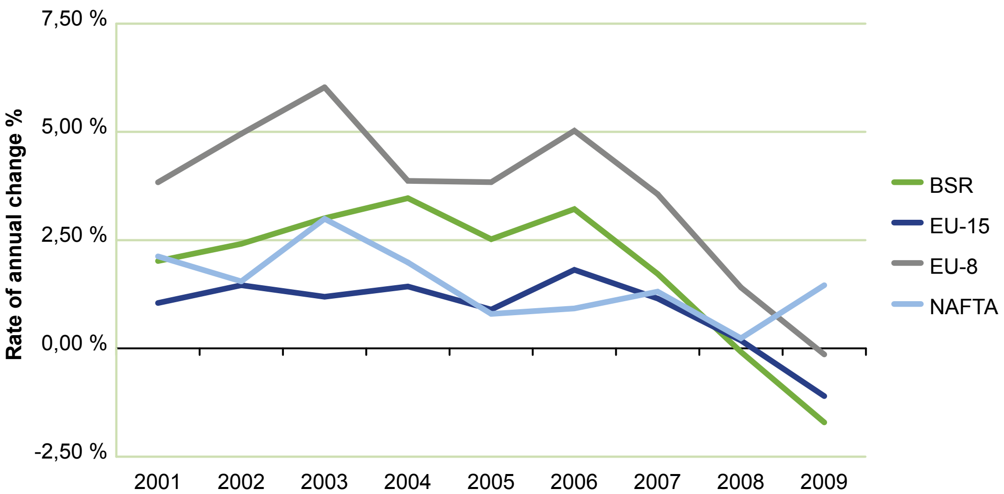
continues to outperform the EU-8 on productivity. The Region is behind advanced non-European peers in Oceania and North America. Its somewhat higher productivity level is not sufficient to compensate for the labor mobilization deficit versus the Asian Tigers. The Nordic countries alone register highest on labor productivity and fourth on labor mobilization in this peer group.

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 continues to stick out with exceptional levels of labor mobilization, still leading the Region on this indicator despite the crisis but lower labor productivity. Germany is similar to the larger Nordic countries on productivity, but does worst in the Region on labor mobilization. Estonia, Latvia, and Russia have low labor productivity but high labor mobilization. Lithuania and Poland rank relatively weak on both dimensions.

Labor Productivity Growth over Time

GDP (PPP-adjusted) per hour worked



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

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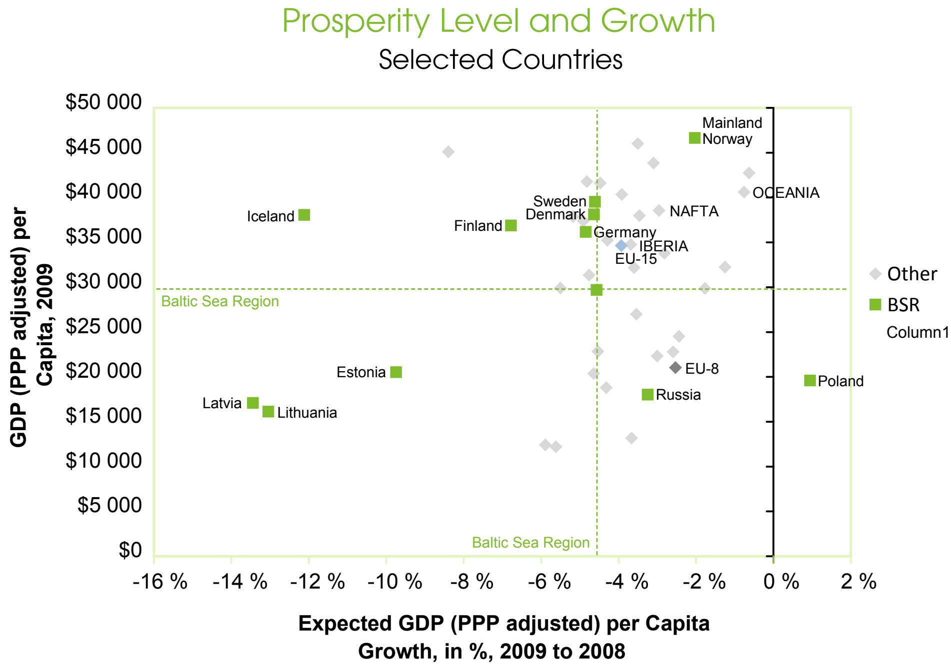


Source: Conference Board (2010) State of the Region -Report 2010

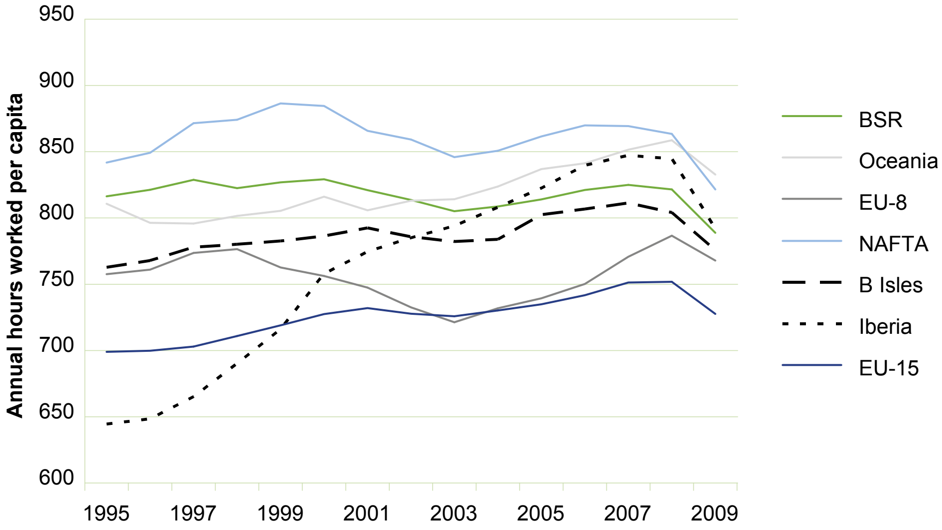
Labor productivity across the Baltic Sea Region, measured by GDP (PPP adjusted) per hour worked, dropped by -1.7% in 2009. This is somewhat less than expected but still significantly worse than the development in the NAFTA countries or for the average of the EU-15 and EU-8. For North America, labor productivity growth had almost come to a halt in 2008 but then resumed growth in 2009. For the EU, labor productivity growth turned negative but, compared to the Baltic Sea Region, the drop was less severe in the EU-15 while the EU-8 came from a higher previous growth rate. Among other world regions, Iberia and Oceania registered labor productivity growth while the drop in labor productivity was much higher in the Asian Tiger economies than in the Baltic Sea Region. Labor productivity on the British Isles developed at the same rate as around the Baltic Sea.

Within the Baltic Sea Region, Norway (mainland economy) continued 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 on second rank, despite a severe drop in labor productivity. Sweden, Denmark, and Finland follow close after, all with labor productivity losses in 2009. Denmark and Sweden had seen an even stronger fall already in 2008, while in Finland the trend worsened in 2009. Iceland, traditionally the Nordic country with the lowest level of labor productivity, saw productivity drop by 8.5% in 2009. Among the countries in the Region with lower productivity levels, Lithuania suffered the largest fall followed by Russia. At the other extreme, Poland registered accelerating labor productivity gains. Latvia and Estonia were in the middle close to the average fall in labor productivity across the Baltic Sea Region.

In **labor mobilization**, measured by annual hours worked per capita, the Baltic Sea Region has lost some ground but remains ahead of most European peers. The drop in employment has been most pronounced on the Iberian Peninsula, where annual hours per capita dropped by -53, and in NAFTA, where they drop was -42, compared to -24 in the Baltic Sea Region. In most other European regions the changes were similar to the Baltic Sea Region, ranging from -28 on the British Isles to – 19 in the EU-8 countries. The Asian Tiger economies even registered a slight increase in hours worked per capita, although the data is not very reliable.

Within the Baltic Sea Region, relative positions have stayed generally the same, although Norway and Poland registered relative improvements compared to previous years. Germany dropped to the lowest rank in the Region but

Labor Utilization over Time
Selected Regions



Note: Russia data estimated at 1700 hours per employee and year
Source: Groningen Growth and Development Centre and The Conference Board (2010), authors' calculations

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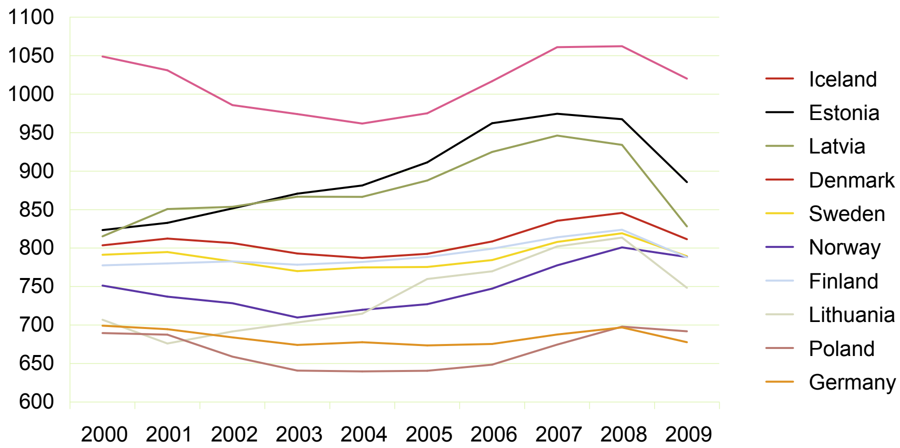
Labor utilization over Time
Baltic Sea Region countries



Source: Groningen Growth and Development Centre and The Conference Board (2010)

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did quite well in relative terms with a loss of -19 hours per capita. Most Nordic countries registered loss of around -30 to -35 hours, with Norway (-12) and Iceland (-42) being the two extremes. The most dramatic drop was registered in Latvia, where in 2009 106 hours or about 2 ½ weeks less work were registered per capita compared to one year before. In Estonia and Lithuania, the drop was above -50 hours. For Russia there is no reliable data available; on the broader measure of employees as a percentage of population, Russia registered stability between 2008 and 2009.

In terms of price levels, the latest data provided by Eurostat is for 2008 and was already discussed in last year's Report. The high local prices remain a drag on the actual standard of living that citizens in the Region can enjoy. Denmark and Norway are the most expensive countries in the Region and across Europe. In the Baltics, the speed of price increase has significantly slowed down as the crisis hit.

Assessment

The short-term impact of the global crisis on prosperity in the Baltic Sea Region has been severe. For the Nordics and Germany, GDP per capita has in the post-war period never registered such a percentage drop (for Finland, the 1999 comes within a whisker of the 2009 contraction). For the Baltics, Poland, and Russia, the GDP fall in the transformation period of the early 1990s was more severe (for Russia also the 1998 crisis) but also subject to more uncertainty about their real impact in terms of the standard of living.

Despite the severity of the crisis, it has so far put economic development back by "only" between three and five years. Whether it will stay at this depends on how quickly economic activity returns to its normal level of capacity utilization, and on how the crisis impacts the growth rate of potential GDP. The first depends on the success of managing the macroeconomic climate discussed in chapter A.1. The second depends on the impact the crisis has on investment and competitiveness, the topics of the following two chapters.

The way that the drop in GDP and prosperity has been shouldered by labor productivity and labor mobilization respectively has differed across regions. In North America, the US in particular, the highly flexible labor market has overcompensated for the drop in GDP. As a consequence, labor mobilization has dropped while labor productivity has even improved. In Europe, Germany in particular, labor mobilization was kept relatively stable. While there has been a lot of flexibility to reduce working hours, governments and labor market partners have used work time reductions to avoid large scale unemployment. For companies, a main motivation was the threat of losing competence in the workforce that would be hard to regain in the future given Germany's demographic profile. The cost has been a significant drop in productivity; for Germany, GDP per hour worked dropped by -2.2% while GDP per employee fell by -4.8%. In the Baltic Sea Region, labor mobilization and labor productivity played an equal role in the adjustment. Relatively flexible labor markets, also in the Nordics, have led employment levels to react strongly to the drop in demand. Hours worked per employee have, in fact, dropped by less than in the EU-15 and NAFTA average (-14 vs. 19 hours). But unlike North America, productivity levels in the Baltic Sea Region also dropped, providing some of the adjustment that otherwise would have to be achieved through even higher unemployment.

The length and nature of the crisis will determine which of these adjustment strategies is more effective over time. The German model works well if the crisis is relatively short and does not lead to significant structural change. If neither is the case, especially if the jobs lost will not return, an adjustment strategy that accepts short-term unemployment and focuses resources on regaining growth and employability in other parts of the economy is the better choice.

2.2 Intermediate indicators

Exports, investments, and patenting are important indicators of underlying patterns of strengths and weaknesses in competitiveness fundamentals. They are also 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.

Trade

In world market export shares, the Baltic Sea Region has suffered a significant drop in the turmoil of faltering global trade in the wake of the global crisis. The total value of the Region's export in US-Dollars dropped by more than 26%, compared to 21% for global trade overall. For goods, still close to 70% of all exports from the Baltic Sea Region, the drop was even higher at 29%. While the loss in the Region's service export revenues was at -18.9% somewhat less sever, this reflected an even higher loss of world market share. While the Baltic Sea Region lost market position, the EU overall held its market share, while ASEAN, China, and the NAFTA countries all improved their positions. To some degree, this is the consequence of falling oil prices affecting the export positions of Russia, Norway, and Denmark. For

services alone, where this effect does not matter, the picture is somewhat different but not more encouraging for the Baltic Sea Region. The EU also lost position in this market but relatively less than the Baltic Sea Region. China registered no change while ASEAN and NAFTA both gained share.

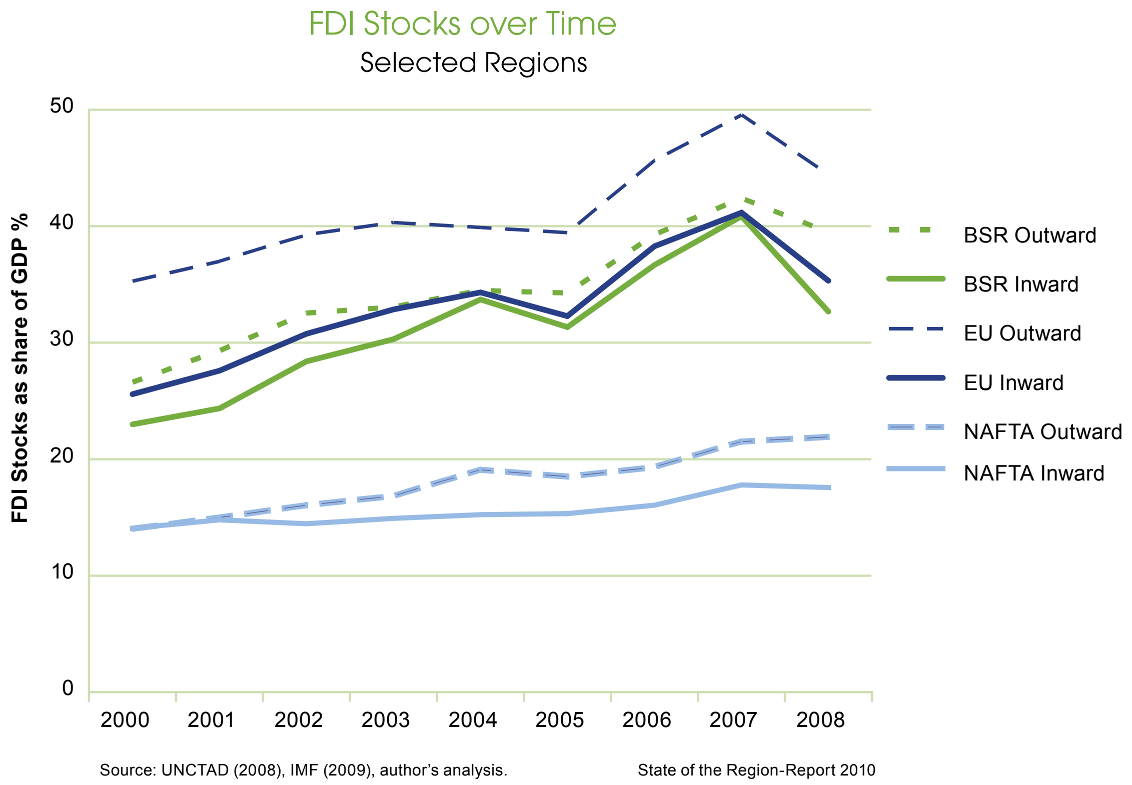
This dramatic drop of Baltic Sea Region market shares in 2009 comes after a period in which the Region had been among the few world regions that had consistently increased their global export market shares despite the rise of China. From 2000 to 2008, the Baltic Sea Region had increased its market share by more than 25%. At the same time, regions like the total EU (at about 40% of world exports) and ASEAN (at 6%) gained less than 10% and stagnated since around 2003. NAFTA, at 13% of world exports in 2008, had fared even worse, losing about 30% of its market position.

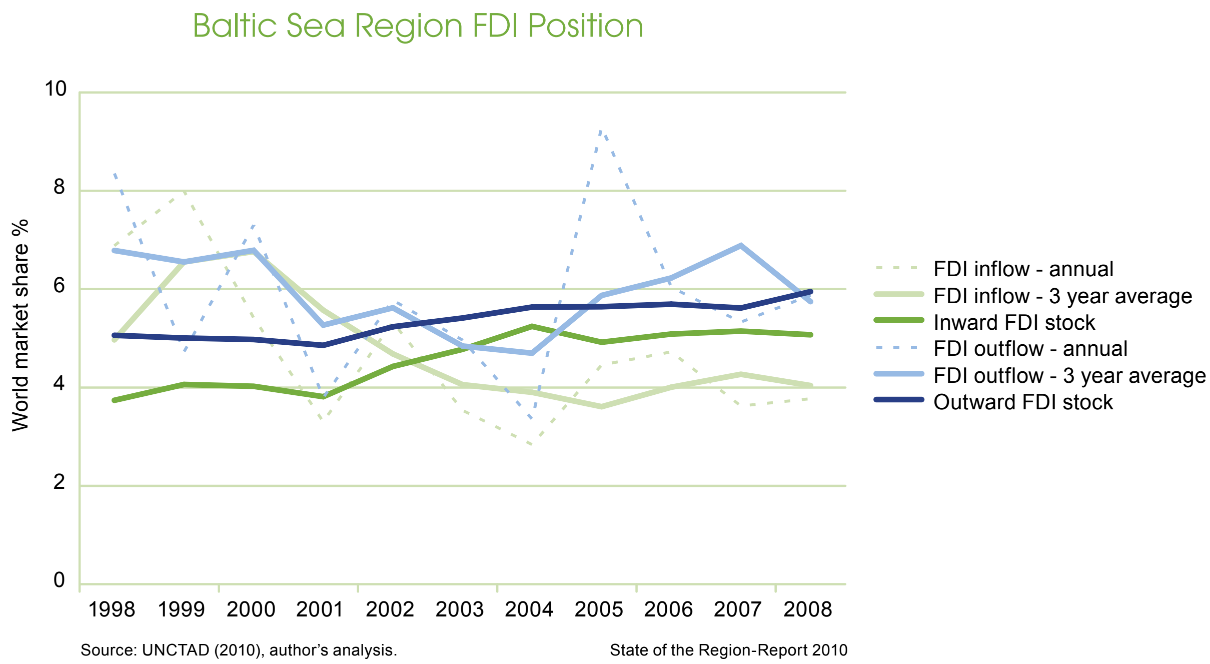
In terms of individual countries across the Baltic Sea Region, Russia's absolute level of export revenues dropped the most (-34%), closely followed by Finland and Lithuania. Exports held up the best in Iceland and Poland, both benefiting from a lower exchange rate followed by Germany and Denmark. Denmark, Poland, and by a narrow margin Germany, gained relative position in goods exports by seeing their export volumes in this area drop less than the world average. Iceland registered even absolute growth in service exports. Germany was the only other Baltic Sea Region country where service trade developed better than the global average. While service trade held up better than goods trade globally, Denmark's service exports – to a large degree in shipping – dropped even more than its goods exports. Within the Region, Iceland and Poland did best in overall world export market share changes followed by Germany. Russia, Finland, and Lithuania experienced the largest relative drop.

Foreign Investment

In terms of inward and outward foreign direct investment (FDI), the Baltic Sea Region has in 2008 - the most recent year for which globally comparable data is available – seen its position slightly erode relative to GDP, much like many other countries.

For inward FDI, the drop relative to GDP was most noticeable. After reaching a record value of almost 40% of Baltic Sea Region GDP in 2007, the ratio dropped to 33% in 2008. Both lower inflows and revaluations of foreign owned operations in a period of already deteriorating equity valuations have played a role. The slow-down was less pronounced in the EU overall and hardly noticeable for the NAFTA countries. In 2008, 5.1% of the total stock of FDI was located in the Baltic Sea Region, somewhat lower than previously but still high in historical comparison.





Among Baltic Sea Region countries, Denmark was the only one in the Baltic Sea Region that in 2008 registered a rising role of inward FDI relative to GDP. Germany, Latvia, and Norway had small negative changes. In Iceland the stock of foreign FDI dropped by -45% of GDP, in Russia by -25%. Estonia and Sweden remain the countries in the Region with the highest relative share of inward FDI, both despite drops of around 10% in the value of inward FDI relative to GDP.

Globally comparable FDI data for 2009 will become available only in the fall of this year. But the existing partial data suggests that, as for exports, the Baltic Sea Region has been disproportionally hit by the global down. While global inward FDI flows were down 40% in 2009, Invest Sweden, for example, expected a drop of 60% in Swedish FDI inflows.

For outward FDI, the situation has been more stable and the Baltic Sea Region registered less of a slow-down than Europe overall. Both flows and stocks were at close to 6% of the total global outward FDI activity, similar to the average of the last decade.

Among Baltic Sea Region countries, Iceland experienced the most dramatic fall of outward FDI stocks, which saw their value drop from 148% to 97% of GDP. Russia also saw a significant reduction of the value of its outward FDI stock (-16.5% of GDP), despite relatively stable FDI outflows relative to GDP. Relative to GDP, the Nordic countries and Germany all register relatively high outward FDI activity, in particular Sweden. Sweden alone accounts for 2% of all outward FDI stocks in the world.

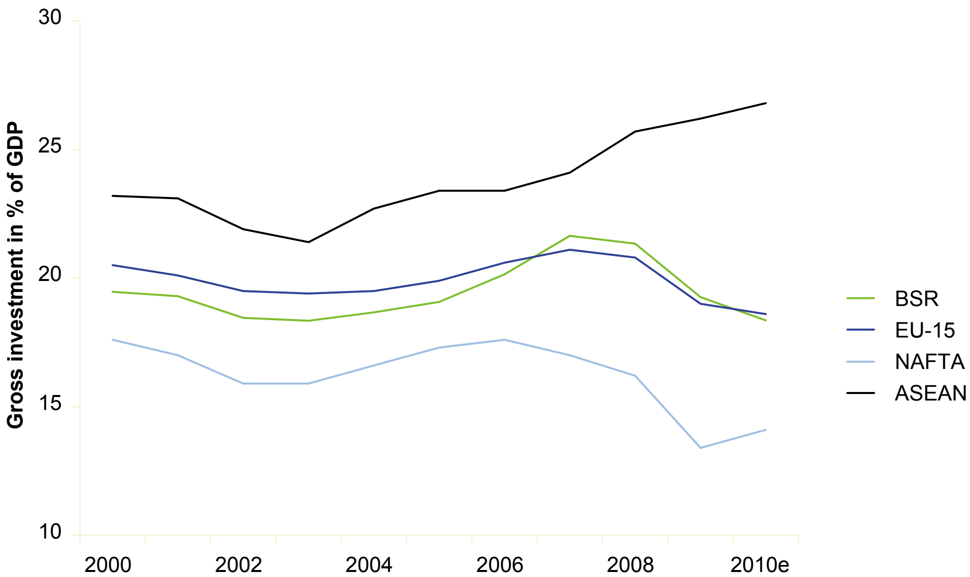
Domestic Investment

In terms of deepening the capital stock, the Baltic Sea Region has traditionally suffered from a relatively low investment rate. Despite a lower GDP per capita rate and thus the potential for catch-up driven by increasing capital intensity, the Region's investment rate has for many years been below the level of the EU-15. This had changed in 2006 but the improvements are currently being reversed. In 2009, the investment rate for the Baltic Sea Region was still a nudge above the EU-15 level but it is forecasted to drop below this benchmark in 2010. Remarkably, the investment rate continues to fall in the Region as well as in the EU-15, while the NAFTA economies are expected to see investment activity to pick up again this year.

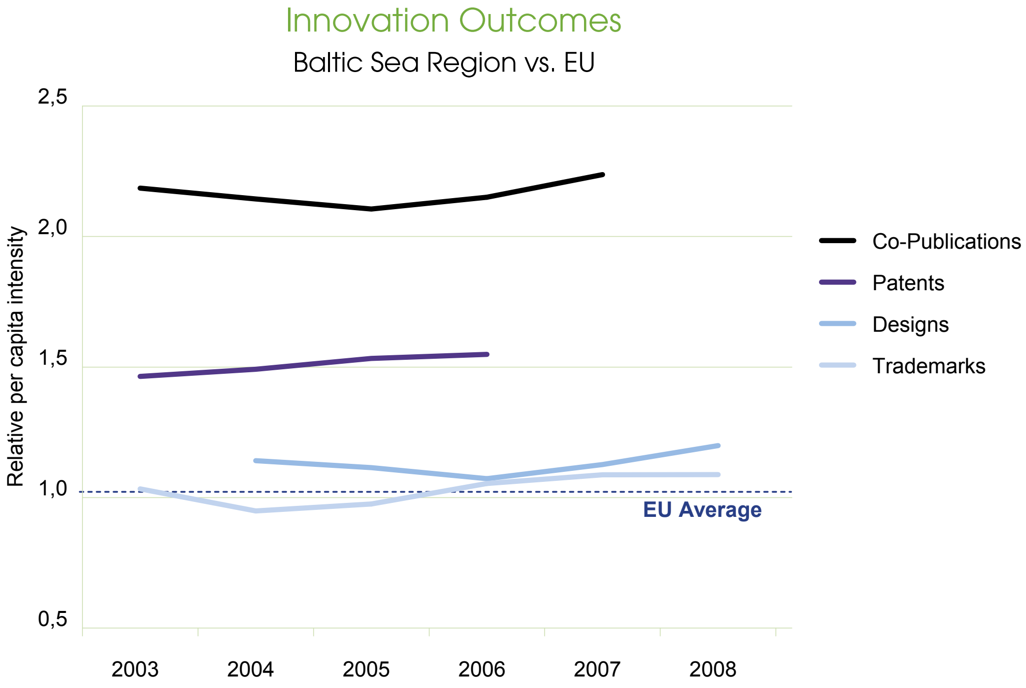
Among Baltic Sea Region countries, Latvia registered still the highest investment rate in the Region, despite a drop from 29% to 22% of GDP. For 2010, however, it is expected to see this ratio drop further below the level of Estonia. Among the Nordic countries, Iceland's investment rate dropped from 24% to 14%, while Norway was the only country in the Region with a slightly increasing investment rate. Lithuania is, apart from Iceland, now the country in the Region with the lowest investment rate, followed by Sweden and Germany.

Domestic Investment over Time

Selected Regions



Source: EIU (2009) State of the Region -Report 2010



Source: EIS (2010), author's analysis. State of the Region -Report 2010

Innovation

In terms of patenting and other regularly used indicators of innovation, the Baltic Sea Region tends to perform well but not quite as dynamically as the best global peers. Last year's Report looked at US patenting up to 2008 and found the Baltic Sea Region to be high on patenting intensity but falling behind Asian tigers, in particular South Korea and Taiwan. There is no updated USPTO data available. The recently published European Innovation Scoreboard provides comparative data for European countries covering the Baltic Sea Region with the exception of Russia. These indicators confirm the position of the Baltic Sea Region as an innovation leader. But they also suggest that relative to its European peers, the Region is stronger on innovative outputs related to scientific invention than on outputs closer to market use.

Among Baltic Sea Region countries, the differences in innovation performance across countries are a multiple of the differences in GDP per capita. This is especially the case for indicators of scientific innovation where per capita intensities in the leading countries are up to 90 times as high as in lagging countries in the Region. Germany leads on patenting intensity ahead of Sweden and Finland. The Nordic countries are, however, much stronger on public-private publications, highlighting better linkages between companies and the public research community. There is no evidence that differences in innovation outcomes across the Baltic Sea Region countries are becoming smaller over time.

Assessment

The global economic crisis has had a deep impact on the intermediate indicators of economic activity. Sufficiently updated data is available for trade and domestic investment. For FDI and innovation outcomes, the latest internationally comparable data is from before the full onslaught of the crisis in 2009.

The Baltic Sea Region experienced a dramatic drop in exports. While a severe reduction in trade was to be expected given the global trends, the data reveals a more than proportional drop in the Region's position on international markets. The loss of market shares went across different segments of the export market. And the downturn of Baltic Sea Region exports seems, at least so far, more prolonged than for other exporting countries. The Region also registered a painful drop of the domestic investment rate. This drop has been slightly worse than in the EU-15 and affects a Region that given its lower GDP per capita should have more potential for profitable investments that raise capital intensity.

The FDI data reflects the increasing dominance of domestic demand in the run-up to the crisis. It also reflects the structural imbalance between higher outward FDI activities from the Baltic Sea Region than attractiveness of the Region for foreign investors. The innovation data shows the Region's advantage on innovation versus European peers to be much more pronounced on measures related to scientific activity than to commercial activity.

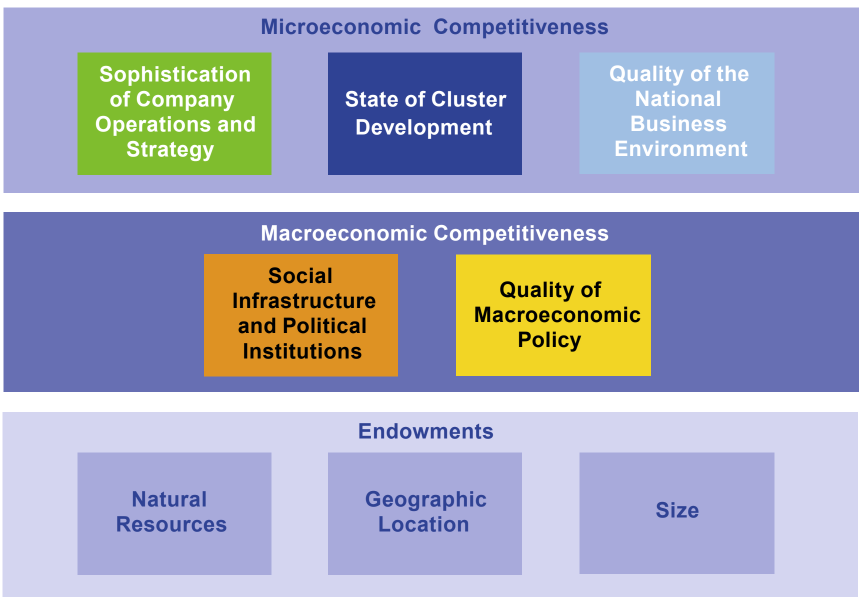
Overall, the data shows a Region that is strong and highly integrated into the global economy. But it also shows the Region slowly losing position with the current crisis having the potential to accelerate these changes.

2.3 Competitiveness fundamentals

Prosperity outcomes and the economic activity measured by intermediate indicators are ultimately driven by the competitiveness fundamentals in an economy. The complex mix of fundamentals can be organized in two broad categories: macroeconomic and microeconomic factors. Macroeconomic factors set the general context for firms but do not affect productivity and innovation directly. This group includes both the quality of social and political institutions and the quality of macroeconomic policy. Microeconomic factors have a direct impact on the productivity with which companies can transform inputs into economic value. This group includes the quality of the business environment, the presence and dynamism of clusters, and the sophistication of companies. Both groups interact with endowments, including its geographic location and profile, its size, and its natural resource wealth, to set the level of prosperity a location can support.

The organizing framework for the many individual factors that have an influence on competitiveness fundamentals has been introduced by a research team under Professor Michael Porter's leadership in 2008.[1] The raw data covering about 130 countries is drawn from the World Economic Forum's Global Executive Survey. The framework for aggregating the individual indicators that seemed conceptually relevant was developed with a view on two key objectives. First, the overall index had to have the empirically proven ability to predict a country's prosperity given the level of its fundamental competitiveness. The index was thus designed to have maximum predictive power in

Competitiveness Fundamentals



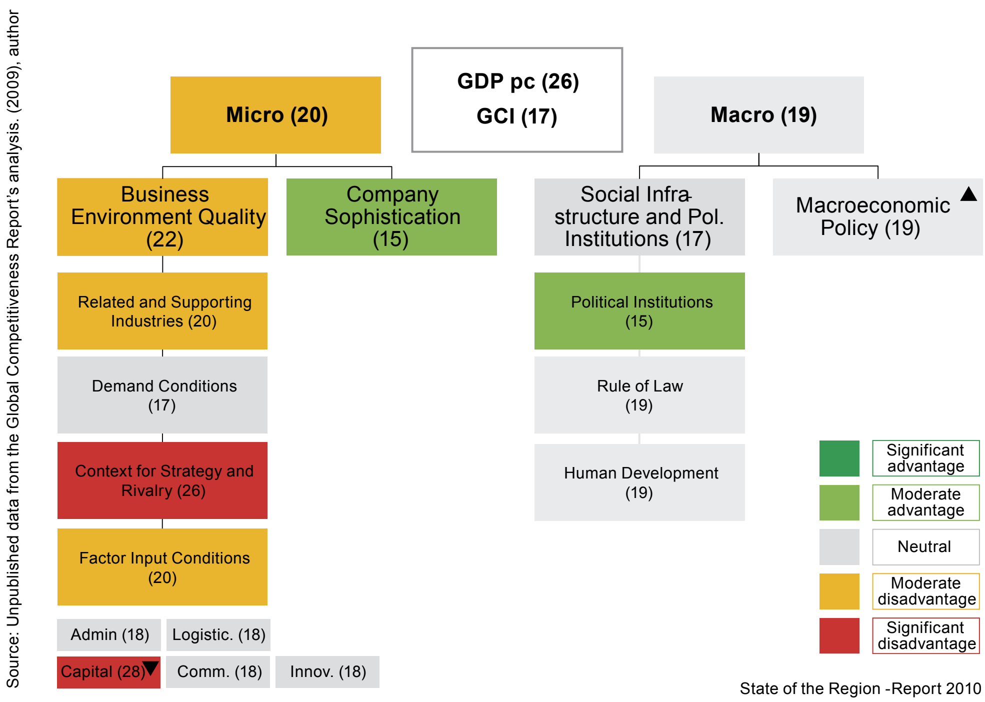
1 Michael E. Porter, Mercedes Delgado, Christian Ketels, Scott Stern (2008), Towards a New Global Competitiveness Index, Global Competitiveness Report 2008, World Economic Forum: Geneva.

explaining GDP per capita (PPP adjusted) across a wide range of countries and years. Second, the elements of the index had to be organized in a way that supports evidence-based policy making. This required individual indicators to be organized in groups with similar policy making processes and decision making groups. And it required the groups of indicators to be organized in a way that enabled policy makers to prioritize between different areas. The index was thus designed to distinguish between macroeconomic policy areas under the control of central government and microeconomic policy areas affected by a broad range of public and private sector institutions. And it was designed in a multi-level pyramid-structure that allows drilling down in specific areas identified as action priorities.

Many of the most relevant datasets used in previous editions of the State of the Region Report are published in the second half of the year. Given that the launch of the 2010 State of the Region Report has been pushed forward to early June in order to coincide with the joint BDF Summit/CBSS Heads of State Meeting, this reduces the availability of new data compared to last year's Report. This section summarizes key findings from last year's Report where no new data is available and highlights any new data that has been published in the meantime.

As an overview, last year's Report included the schematic of relative strengths and weaknesses in the competitiveness profile of the Baltic Sea Region as well as of all individual countries in the Region. Strengths are indicated in shades of green for rankings that are at least two ranks higher than the average rank (strong strengths: five); weaknesses are indicated in orange/red the same way. The average picture indicates balanced positions across the broad areas of macro- and microeconomic competitiveness, with more pronounced strengths and weaknesses at the level of more narrow indicators. Company sophistication in micro- and political institutions in macroeconomic competitiveness stood out as particular strengths. The context for strategy and rivalry, and, after a significant drop in 2009 (with data from early in the year), capital market infrastructure were identified as weaknesses.

The Baltic Sea Region's Competitiveness Profile



Macroeconomic competitiveness

The Baltic Sea Region gets traditionally solid marks on macroeconomic competitiveness, with particular strengths in political institutions. Last year's Report also highlighted the improving relative position on macroeconomic policy.

The Global Corruption Perception Index published late last year confirms this view. Six Baltic Sea Region countries are among the global top fifteen in terms of low levels of perceived corruption. Estonia follows on rank 27th as the highest ranked Central European country. Poland (now 49th), traditionally the laggard among the EU member countries in the Region, has made a significant jump forward and moved beyond Lithuania (52nd) and Latvia (56th). Latvia slight deterioration is surprisingly moderate given the country's economic turmoil and the reduction in public sector wages and employment that have followed. Russia (146th) continues to face by far the largest challenges in the Region and has made little progress.

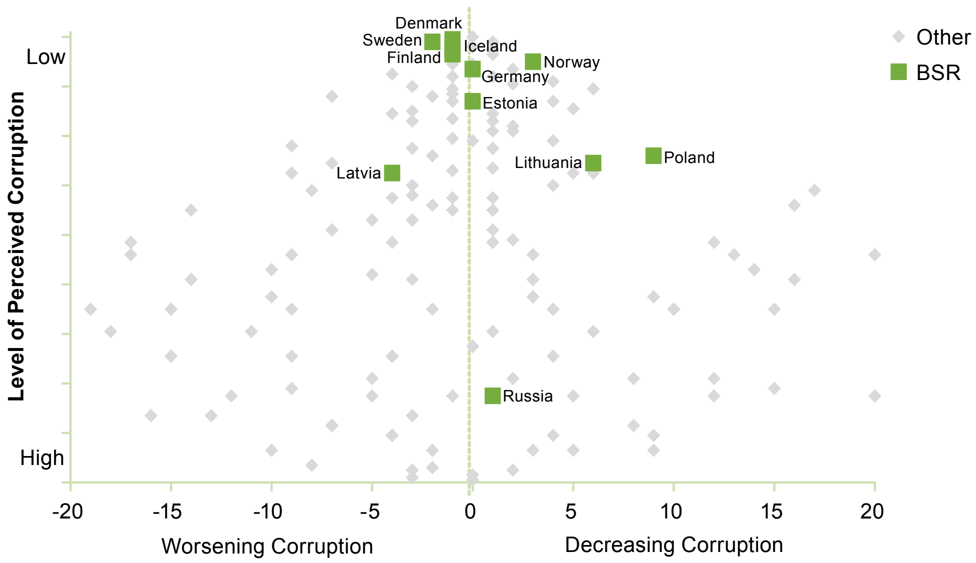
With the exception of Russia, all Baltic Sea Region countries are rated as free in the "2009 Freedom of the World Index". Outside of Russia, Latvia was the only country in the Region that did not receive the maximum assessment in all categories. It was downgraded marginally in response to the 2007 decision to suspend the head of the anticorruption agency. The ensuing controversy ultimately led to the fall of the government, which was replaced by a new government under the current Prime Minister Valdis Dombrovskis.

The 2009 Press Freedom Index, compiled by Reporters without Borders, places almost all Baltic Sea Region countries in the global top twenty of countries in which journalists are free to operate. Poland is ranked outside this group as 37th but with a strong positive trend. Russia's situation is again seen as by far the most problematic with the trend going in a negative direction. The 2009 Freedom of the Press Index by Freedom House comes to a very similar result, with the five Nordic countries at the top of the ranking, and all countries in the Region except Russia ranked as free.

The Region's position on macroeconomic policy is generally perceived to be strong. This is an area where it is hard if not impossible to evaluate the underlying quality of policy in the face of huge changes in short-term indicators driven by shocks and cyclical movements.

On fiscal policy, the position of the Baltic Sea Region in 2009 seems strong. Public sector deficits and debt levels are moderate compared to other countries. On both indicators, the crisis has left its mark but the Region has done better than many other economies.

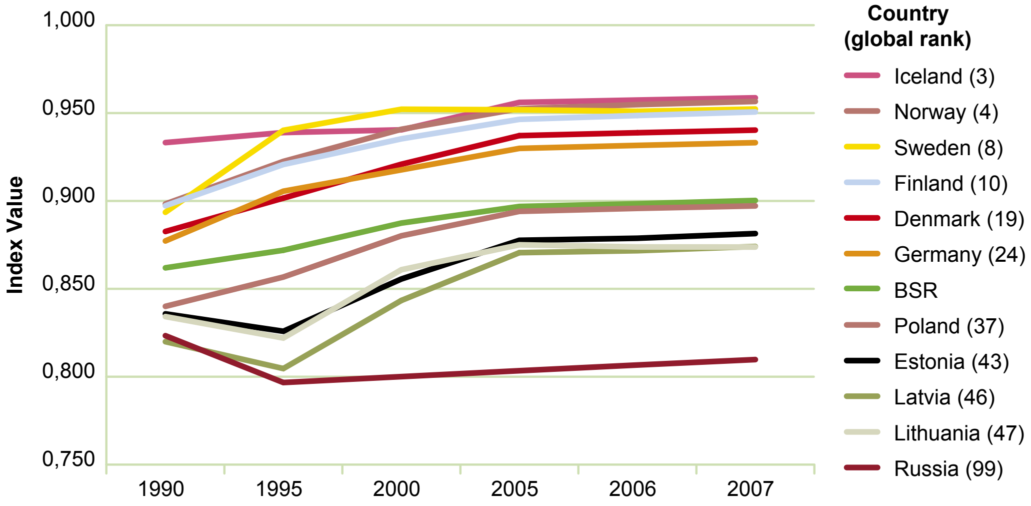
Corruption Perception Index 2009



Source: Corruption Perception Index (2009)

Human Development Index 2009

Non-GDP Elements



Source: UNDP (2009), author's calculations

Macroeconomic Policy Indicators

2009

	Denmark	Estonia	Finland	Germany	Iceland	Latvia	Lithuania	Norway	Poland	Russia	Sweden
Fiscal Policy											
Government budget balance (in % of GDP)	-2.80	-1.72	-2.20	-3.10	-9.10	-7.60	-9.10	9.72	-1.77	-5.90	-1.60
Government debt (in % of GDP)	38.90	7.22	44.00	72.00	101.20	36.80	29.35	60.40	46.48	6.30	36.70
Monetary Policy											
Inflation (annual change in %)	1.33	-0.09	0.01	0.32	12.04	3.52	4.50	2.11	3.45	11.65	-0.32
Interest rate spread (in %-points)	3.20	4.57	0.86	5.60	9.30	12.00	1.95	2.00	3.38	6.73	2.72

	BSR	World	EU-27	OECD	NAFTA
Fiscal Policy					
Government budget balance (in % of GDP)	-3.11	-6.20	-6.70	-7.30	-9.10
Government debt (in % of GDP)	48.91	62.30	73.00	75.00	49.10
Monetary Policy					
Inflation (annual change in %)	3.43	2.40	0.80	0.50	0.20
Interest rate spread (in %-points)	4.41				

Source: EIU (2010), author's calculations

On monetary policy, the pattern is less positive. The average level of inflation remains high compared to peers, driven by Iceland and Russia. In the remainder of the Region inflation is low, for Sweden and Estonia the EIU even registered deflation, which also has its problems. A key issue remains the multitude of exchange rate systems, from membership in the Euro-zone to parity to the Euro with an aspiration to join the Euro to a flexible exchange rate. Different choices can be appropriate given the different circumstances across the Region. But the recent crisis has highlighted the challenges of monetary policy driven by an exchange rate target. And the volatility of exchange rates within the Region is reducing the level of market integration which can be achieved.

A third dimension of the quality of macroeconomic policy is the ability to avoid structural imbalances. This has clearly failed in Iceland and the Baltic countries, to some degree also in Russia.

But across the Region, the reaction to problems has been quite impressive. Even in Iceland and Latvia the governments have earned respect for the way they have pursued difficult policies to rebalance their economies.

Overall, there is no indication that the crisis has dented the Baltic Sea Region's strong overall position on macroeconomic competitiveness. If anything, the crisis has strengthened the relative position of the Region on macroeconomic policy performance. But it also increased the need to perform and, potentially, collaborate in this area.

At the level of individual countries, the larger Nordic countries continue to lead the world in the quality of their institutions and benefit from solid macroeconomic policies. But the differences in the Region are significant and there is no indication that they have substantially decreased since last year's Report: Iceland, Latvia, and Lithuania register highly problematic macroeconomic policy indicators. For Latvia and Lithuania this is a clear deterioration relative to last year. Germany continues to be somewhat weaker than the other larger high income countries in the Region on macroeconomic policy. The highly expansionary fiscal policy stance has reduced the impact of the crisis but has significant worsened the government's debt position. Conversely, Poland's macroeconomic policy indicators have benefited from the country's much better growth performance. Russia continues to perform relatively well on macroeconomic policy but remains a dramatic negative outlier on the quality of its political institutions and the rule of law. The most recent data indicates no change to this pattern, which continues to be a drag on Russia's ability to upgrade or even fully leverage its existing assets.

Microeconomic competitiveness

The Baltic Sea Region benefits traditionally from its strong position on company sophistication and generally solid business environment with particular strengths on demand conditions and a number of factor input conditions. The data that has become available since the last Report was published in October 2009 generally confirms this view.

The World Bank's Logistical Performance Index collects data on the physical transportation infrastructure as well as on the availability of efficient public and private logistical services. For an export-oriented region like the Baltic Sea, these factors have particular importance. The most recent Index, prepared by the World Bank in collaboration with the Turku School of Eco-

World Bank Logistical Performance Index 2010

Source: World Bank (2010), author's analysis. State of the Region-Report 2010 nomics, shows the Baltic Sea Region countries with a strong and improving position. Germany is ranked best globally, with Sweden following on 3rd rank. All Baltic Sea Region countries, except Denmark, have improved their position relative to the last assessment in 2008. Russia continues to rank far behind the rest of the Region. The further delays to the country's WTO accession have not helped, although the weak rank also relates to the poor state of advanced logistical services in Russia. Discussions about a possible EU-Russia FTA remain stuck.

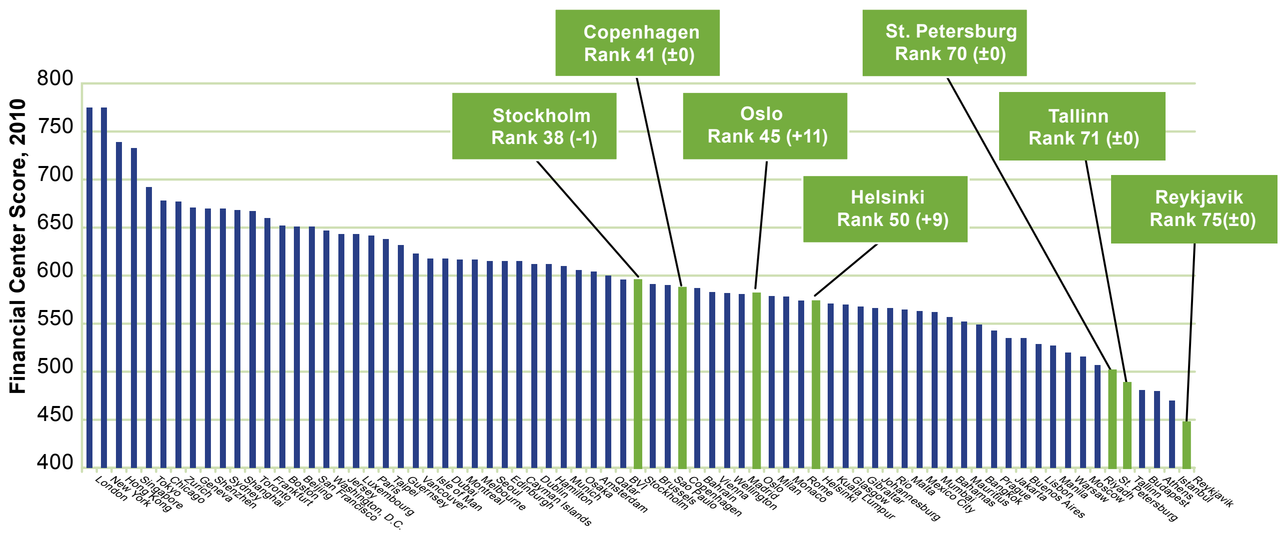
The Global Financial Center Ranking conducted by the City of London and a London-based consulting firm ranks financial centers on a wide range of indicators. Apart from the rank, the analysis also provides a classification of the functional role that the particular financial center plays.

The analysis is not a direct indicator of capital market infrastructure, an area in which the Baltic Sea Region had recently lost some position. But it gives important insights into the relative place of leading Baltic Sea Region financial centers in global comparison. Stockholm and Copenhagen, the leading financial centers in the Baltic Sea Region, are the only ones classified as having a transnational importance. Oslo and Helsinki have gained ground in terms of absolute performance but remain classified as established local centers. St. Petersburg, Tallinn, and Reykjavik all remain behind as emerging local centers. The overall number of globally visible financial centers in the Baltic Sea Region is significant but none of them has entered the small group of truly global centers.

The Economic Freedom Index is annually calculated by the Heritage Foundation. It ranks countries on an overall index as well as ten specific subject categories. While many of the categories have some relation to the context for strategy and rivalry, an area in which the Baltic Sea Region has traditionally performed relatively weak, the Economic Freedom Index has a much stronger ideological orientation. The classification is informed by a solid open-market view of the drivers of economic performance, which sees government involvement as generally problematic.

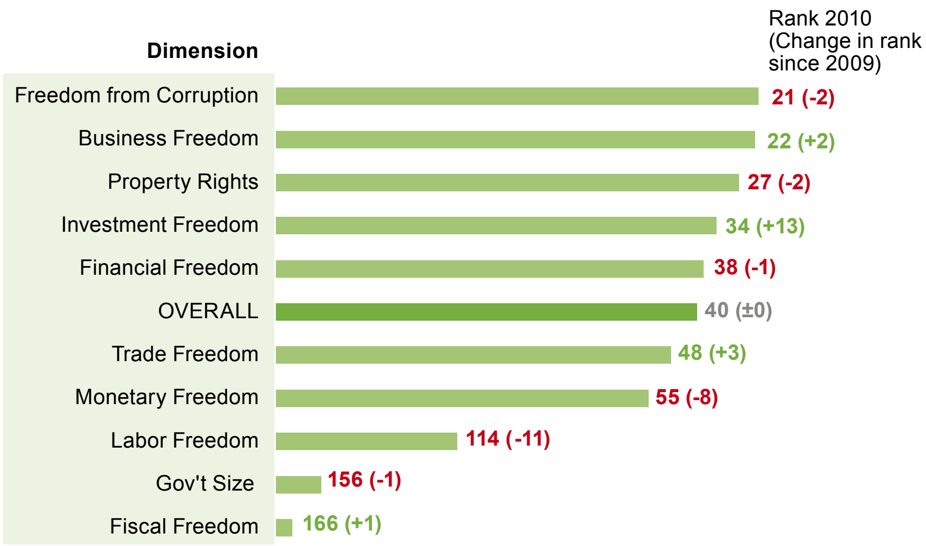
The Baltic Sea Region has kept its overall position on economic freedom at a level that is considerably below its performance in other dimensions of competitiveness. It has lost position in six areas and gained ranks in four, spread across both relative strengths and weaknesses. In investment freedom there was a remarkable improvement, driven by better assessments for a range of countries in the Region. On labor freedom, an area covering the regulations affecting the labor market in which the Region does traditionally poorly, there were slight deteriorations in a few countries in the Region while peers improved their relative position. This data suggests that the context for strategy and rivalry remains an area of relative weakness for the Region.

Financial Centers Ranking



Source: Global Financial Center Ranking (2010), author's analysis.

Economic Freedom in the Baltic Sea Region



Source: Heritage Foundation (2010), author's analysis. State of the Region-Report 2010

The innovation infrastructure is a critical aspect of factor input conditions for an advanced region like the Baltic Sea. Last year's Report provided an analysis of the European Innovation Scoreboard data to assess both the overall level and the patterns of innovative capacity across the Baltic Sea Region (excluding Russia, which is not covered in this data set). This data has been updated since the last State of the Region Report was launched, the newest dataset covering data up to 2008 for some indicators, but for most the data goes only up to 2007 or 2006.

The Baltic Sea Region continues to be strong on overall innovative capacity. The Region lost position, often only marginally, in ten indicators and gained position in seven. The general pattern remains one of relative strengths in "enablers" (or factor inputs) and "firm activities" (company sophistication) but relative weaknesses in "outputs" (or intermediate indicators).

Innovation in the Baltic Sea Region

BSR Rank among European countries

Enablers

Human resources		
S&E and SSH doctorate graduates per 1000 population aged 25-34	8	(±0)
Participation in lifelong learning per 100 population aged 25-64	7	(±0)
S&E and SSH graduates per 1000 population aged 20-29	15	(-1)
Population with tertiary education per 100 population aged 25-64	13	(±0)
Youth education attainment level	18	(+1)
Finance and support		
Public R&D expenditures (% of GDP)	4	(±0)
Venture capital (% of GDP)	5	(+1)
Private credit (relative to GDP)	13	(+2)
Broadband access by firms (% of firms)	21	(-4)

Firm Activities

Firm investments		
Business R&D expenditures (% of GDP)	6	(±0)
IT expenditures (% of GDP)	9	(-1)
Linkages		
SMEs innovating in-house (% of SMEs)	9	(-1)
Innovative SMEs collaborating with others (% of SMEs)	10	(-2)
Throughputs		
Technology Balance of Payments flows (% of GDP)	8	(+2)
EPO patents per million population	9	(±0)
Community designs per million population	10	(-1)
Community trademarks per million population	15	(-1)

Outputs

Innovators		
SMEs introducing product or process innovations (% of SMEs)	12	(±0)
Reduced labor costs (% of firms)	15	(+4)
Reduced use of materials and energy (% of firms)	18	(-3)
Economic effects		
Knowledge-intensive services exports (% of total services exports)	10	(+1)
Employment in medium-high & high-tech manufacturing (% of workforce)	11	(+3)
Employment in knowledge intensive services (% of workforce)	18	(-1)
New-to-market sales (% of turnover)	17	
Medium-tech and high-tech	19	(±0)
New-to-firm sales (% of turnover)	17	(-3)

Note: Coloring indicates relative strengths and weaknesses; numbers in brackets are changes relative to last available year
Source: European Innovation Scoreboard (2010), author's analysis. State of the Region-Report 2010

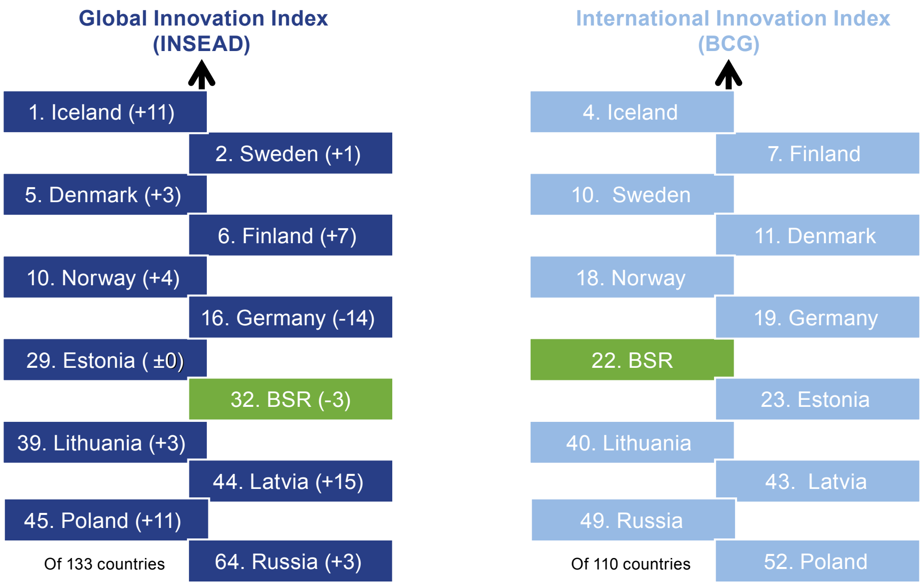
Since October 2009, a number of global rankings of innovation have also been launched or updated. The data used in these reports is, however, mostly from before the onslaught of the current crisis. INSEAD's Global Innovation Index draws widely on the GCR data that was already analyzed in last year's State of the Region Report. The Baltic Sea Region ranks strongly overall, with many of countries in the Region improving their position. Only the drop of Germany, related to factors with little direct on innovation, dragged the regional average down by three ranks. BCG's International Innovation Index draws more widely on the available statistical outcome data to come to a similar overall result as the INSEAD study. Both reports distinguish between innovation inputs and outputs. Somewhat perplexingly, INSEAD ranks the Region higher on outputs, while BCG ranks it higher on inputs.

These reports provided interesting data on many individual indicators, and confirm the generally strong and stable overall competitiveness of the Baltic Sea Region. But the selection of indicators and their aggregation into an overall index that would presumably explain actual levels of innovation tends to lack a convincing conceptual framework. The opposing findings on whether the Region is strong on outputs or inputs are just one sign of this weakness.

Overall, there is so far no indication that the crisis has dented the Baltic Sea Region's solid overall position on microeconomic competitiveness. The time lag on a good number of these indicators, and on the real impact of cuts in public investment in factor inputs or of tax hikes that affect market interaction suggests, however, that it is too early to give the all clear. The generally better situation of public finances in the Region, compared to international peers, signals room to even improve its relative position. But for the countries in the Region with severe fiscal problems, the situation is clearly different.

At the level of individual countries, there are no signs that the overall strong microeconomic competitiveness of Sweden, Denmark, and Finland might have deteriorated. They all continue to benefit from strong institutions, solid macroeconomic policies, and many microeconomic assets, in particular strong human and physical infrastructure as well as open markets. A challenge remains the shift towards a more entrepreneurial driven innovation society, where financing needs of the welfare system are realigned with the incentive structures for individuals. Norway remains somewhat behind its Nordic peers on overall competitiveness but seems to have made gains, for example as shown in the logistical performance indicator and the sophistication of

The Baltic Sea Region in Innovation Capacity Rankings



Source: INSEAD (2010), author's analysis. Source: BCG (2010), author's analysisState of the Region-Report 2010 the financial sector in Oslo. Germany continues to be world-class in some areas, such as company sophistication and logistical capabilities, while lagging behind in others. A striking example of the problems this creates is its innovation system, where highly innovative companies and world-class research institutions worry about an increasing shortage of skilled employees. Iceland remains behind this group of advanced economies in overall competitiveness. The country's challenges are not only related to the current shock but also to some more long-standing weaknesses in microeconomic competitiveness. It has suffered significantly since the outbreak of the crisis, and much political energy remains focused on coming to grips with the collapse of the financial system. The Baltic countries and Poland follow, with microeconomic competitiveness broadly in line (Estonia, Poland) or slightly weaker (Latvia, Lithuania) than their GDP per capita level. Section B of this Report provides an in-depth discussion of their medium-term development and the challenges they now face. Russia continues to suffer from significant weaknesses on institutional quality and microeconomic competitiveness, an observation that might have contributed to President Medvedev's increasing push for a modernization of the Russian economy and society. Worryingly, recent international assessments indicate that despite the recent rhetoric on innovation policies, Russia is losing ground against other emerging "BRIC"-economies on innovative capacity, its traditional area of strength. In other areas too there are signals pointing in different directions: the government has launched a privatization plan with the ambitious long-term goal of reducing the government share in the economy to 30%. But it has also decided to abandon its own WTO bid and aim for a joint WTO accession in a customs union with Belarus and Kazakhstan instead.

Assessment

The competitiveness of the Baltic Sea Region remains high, supporting the overall level of prosperity reached across the Region. In the macroeconomic dimension, both institutions and macroeconomic policy are solid. In microeconomic competitiveness, key strengths are the high openness to foreign trade and investment, the strengths of many factor input conditions, and the high level of company sophistication. Demand is generally sophisticated and cluster collaboration relatively high. In both dimensions, the small size of the economies in the Region creates challenges in exploiting these advantages fully. Weaknesses are mainly related to incentives and to the intensity of rivalry, often due to the large role of the government in the economies of the Region.

This general assessment obscures the high degree of heterogeneity in competitiveness that exists across the Region. The Nordic countries with their high share in regional GDP are most accurately reflected in these averages. For the Baltics, Poland, and Russia, however, the situation is significantly different. Part B of the Report provides a more in-depth analysis of the Baltics and Poland.

The available data shows little meaningful change in indicators of competitiveness due to the crisis. Partly this is a matter of timing: only few new relevant datasets have become available since the last State of the Region Report was launched in October 2009. But it is also a reflection of the nature of competitiveness indicators, which tend to be relatively stable in the short term. Where changes are visible, they are mostly related to macroeconomic policy. Here, the Region has done well on aggregate even though individual countries in the Region have suffered tremendously.

Longer-term changes in competitiveness will depend on the lessons countries draw from the crisis and on the remaining financial resources they have following the crisis. So far, there has been remarkably little change in economic policy approaches. Differences in investment capabilities are more visible but have not yet resulted in a clear impact on the trajectory for factor input conditions across the Region.

3. Collaboration for competitiveness across the Baltic Sea Region

This part of the 2010 Report gives an update on the state of collaboration on competitiveness upgrading across the Baltic Sea Region. The first section provides an overview of activities that have been pursued by regional organizations over the last 12 months. The second section then discusses in more detail the progress on implementing the EU Baltic Sea Region strategy, a critical element of collaboration in which all of the regional organizations were involved one way or another. The discussions of both the EIB and the NCM on their activities in the Baltic countries and Poland in Part B of this Report also reflect this connection to the EU strategy.

3.1 Regional organizations and initiatives

The Council of the Baltic Sea States (CBSS; www.cbss.org) is a regional forum for intergovernmental collaboration between the eleven countries of the Baltic Sea Region as well as the European Commission. Its work is organized around five main priority areas: environment, economic development, energy, education and culture, and civil security. Lithuania currently holds the Presidency of the CBSS and has decided to devote specific attention to four areas over the period 2009-2010: *Innovation, Cross-border cooperation, Clean environment and safe living conditions,* and *Active participation of the neighboring Kaliningrad region and Belarus.* Norway will take over the CBSS Presidency for the period 2010-2011 on 1 July.

Over the past four years, CBSS has gone through a major reform program, which, over the last year, has focused on the establishment of a new CBSS Expert Group on Maritime Policy, the integration of the Baltic 21 network into the CBSS structure, and the creation of a project facilitation budget line to be used as seed money for future CBSS projects. One of the major developments, which could have an impact on the future structure and operations of the CBSS, will be how the EU Strategy for the Baltic Sea Region implementation is dealt with and by whom. The CBSS could be utilized as a facilitator of cooperation and initiatives among both EU and non-EU member states for some of the action points.

Another main focus trend for the future of the CBSS will be how the interplay between the four regional councils of the north (Arctic Council, Barents Euro-Arctic Council, Nordic Council of Ministers and the CBSS), in terms of priority actions and synergies, pans out as well as how its sister organizations and the different governing members set the direction. The back drop for this interplay will, in part, be the aforementioned new EU Strategy for the Baltic Sea Region as well as the Baltic Sea Programme and its potential funds, combined with the ongoing developments of Northern Dimension Framework and policy.

On the side of the Northern Dimension, two new Northern Dimension Partnerships were established, notably the *Northern Dimension Partnership on Transport and Logistics* (NDPTL) and the *Northern Dimension Partnership on Culture* (NDPC). Within the Northern Dimension policy framework, the *Northern Dimension Institute* (NDI) and the *Northern Dimension Business Council* (NDBC) were launched to complement the ongoing work of the *Northern Dimension Environmental Partnership* (NDEP) and the *Northern Dimension Partnership in Public Health and Social Well-Being* (NDPHS), which is co-located at the CBSS Secretariat.

As of 1 January 2010, Baltic 21 was integrated into the CBSS as an Expert Group on Sustainable Development, which will have a substantial impact on the way the organization views project work. In the last two years, Baltic 21 has developed five Baltic Sea Programme Lighthouse Projects which have been accepted for funding:

- *Eco-region* aims to contribute to the development of the Baltic Sea Region into the world's first eco-region
- *New Bridges* aims to strengthen the quality of life through improved management of urban-rural interactions.
- The Baltic 21 Lighthouse Project *SPIN* aims to increase the innovation potential of small and medium-sized enterprises in order to enhance sustainable production processes (the project is profiled in the next section of this Report)
- The *Baltic Sea Bioenergy Promotion Project* (in cooperation with BASREC) aims to strengthen the development of a sustainable, competitive, and territorially integrated Baltic Sea Region in the field of sustainable use of bio-energy. The Baltic Sea Bioenergy Promotion Project, the development of which initially came from Baltic 21 has been earmarked as a Strategic Project (one of the six out of the 46 other projects approved so far) and compliments the implementation of the Strategy in the EU Strategy, the lead partner being the Swedish Energy Agency (STEM).
- the *Agora 2.0 Project* aims to develop heritage tourism, including both cultural and natural tourism, and is based on three principles of sustainability to increase a common Baltic Sea Region identity.

Furthermore, there is an initiative to develop new Lighthouse Projects: *Baltic Landscapes* for the sustainable use of forested areas and *Baltic Marine Litter* which will strive to address the problem of increased marine littering in the Baltic Sea, amongst others which have applied for funding in the 3rd call. The experience of the Baltic 21 network in developing projects will enhance the project orientation of CBSS.

The *Baltic Sea Labour Network Project* (BSLN), where the CBSS participates in the steering committee, is seen as an important contributor in the promotion of a pan-Baltic labor network, which will in time enhance awareness on the importance of labor market issues, and aid the development of the transnational dimension in labor market policies with joint innovative strategies, concepts and actions that address mobility and demographic changes. A number of these projects are specifically mentioned in the Action Plan of the EU Strategy for the Baltic Sea Region as examples of Flagship Projects – including EcoRegion, SPIN, AGORA 2.0 and BSLN.

So far, no further developments have taken place in the establishment of a particular Expert Group solely devoted to economic issues. Here, the future developments like the Northern Dimension Business Council will play a key part in determining which areas the Member States would like to stress. The technical work of the CBSS *Expert Group on Customs Cooperation and Border Crossing Aspects* continues.

BASREC has some important energy projects on the horizon, which will begin with an analysis and assessment of the conditions for expansion of wind power in the region as well as the issue of transportation and storage solution for CO2 in the Baltic Sea Region.

The *EuroFaculty* project in Pskov continues to update the curriculum of two universities.

The CBSS continues its work in the field of Civil Security, especially with the work of the *Task Force against Trafficking in Humans* (TF-THB), which has developed projects with the United Nations Office on Drugs and Crime (UNODC) in Vienna and the International Organisation for Migration (IOM). The *Expert Group on Cooperation for Children at Risk* is also about to embark on two interesting research projects involving universities both inside and outside of the region, funded by the most part by the European Commission. Civil Security structures and the proximity of the regional strategic architecture provide a real niche specialism for the CBSS. These networks include the *Prosecutors General network* and the *Group on Tax cooperation,* amongst others. The nexus between these groups will increase in the near future as cross-border crime is increasing.

All of these developments impact on the capacity, reach, and value added of the CBSS as the Member States and the EU Commission navigate the multi-layered cooperation terrain that has been developed over the last few years. The outcome will probably be a renewed push for streamlined policy making and intensified cooperation between the Councils of the North, along the lines of pre-defined Northern Dimension avenues in conjunction with the action points set out by the EU Strategy for the Baltic Sea Region, and in cooperation and consultation with Iceland, Norway and Russia. The inclusion of Belarus and Ukraine, alongside potential developments in the Eastern Partnership, will also be raised as is already happening under the current Lithuanian Presidency.

norden

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 Ministerial Councils. Traditionally, the areas of Education and Research, Culture, and Innovation cover over half of the total budget of approximately 900 million DKK. Over the last few years, collaboration on competitiveness issues, in particular research and innovation, has become an ever more prominent part of the agenda.

An area of high priority of the NCM is the Nordic cooperation effort to better meet the challenges and opportunities of globalization. This new priority was initiated by the Nordic Prime Ministers and 13 initiatives were started in 2008 to underpin the new focus on globalization. These 13 initiatives were presented in last year's State of the Region report with an annual budget of 60 million DKK. As some of these are close to being finalized, seven new or strengthened initiatives were launched in October 2009 to keep up the progressive work. In 2011, the budget for the globalization effort is expected to be increased by 71 million DKK. In brief, the seven new initiatives consist of:

- Strengthening of the "*Development and profiling of the Nordic Region as a centre for creative industries*"
- A program to stimulate major Nordic co-operation efforts in the *health and welfare* fields
- Further development of the Nordic Research and Innovation Area (NORIA) through cutting-edge *eScience* projects
- Further development of the Nordic Region as the "*Green Valley of Europe*"
- Support the Nordic countries' activities in relation to any changes in CDM (Clean Devel-

opment Mechanism) and JI (Joint Implementation) markets that may follow from COP15
- An analysis of the preconditions for an innovation program that would support the Nordic development and demonstration of energy-efficient and CO2-neutral construction, and energy-plus buildings
- Engage in the first global round of negotiations on mercury in 2010 to achieve a binding global mercury agreement by 2013

The third *Nordic Globalization Forum* took place on 20 May 2010 in Snekkersten, Denmark, based on "the Nordic way out of the economic crisis with the help of green growth". Two concrete challenges were in focus, the Nordic Region as a low energy society, and the Nordic Region as a green technology laboratory.

While the NCM focuses on collaboration among the Nordic countries, it works very actively with its neighbors in the Baltic Sea Region. The areas of priority in the cooperation with Estonia, Latvia and Lithuania and with North-West Russia are education, research, innovation, environment, climate, and energy issues. NCM is strongly committed to the Northern Dimension and would also contribute actively to the implementation of the Action Plan for the EU Baltic Sea Strategy. Both policies are integrated parts and priorities of the policy of NCM for cooperation with its' neighbors in the Baltic Sea regions and are seen as important frameworks for making the North of Europe 'the top of Europe'.

The NCM will contribute to the implementation of the EU Baltic Sea Strategy by taking the lead in several flagship projects and by keeping the strategy high on the political agenda. For instance, NCM will, in the coming months, organize seminars on the strategy in Brussels and in the Baltic Sea capitals in cooperation with other relevant partners. The flagship projects to be led by NCM are focused on cooperation in the areas of forestry, plant genetic resources and veterinary contingency planning. Also, a feasibility study on infrastructure for the fifth freedom is carried out in order to prepare for a possible flagship project. In other areas of the Action Plan, NCM is discussing with relevant partners the development of additional flagship projects and how the NCM regional network and experiences could be utilized. In addition, NCM plays an active role in involving Russian partners in the projects, for instance, in the field of cross-border marine pollution response cooperation.

The Nordic Investment Bank (NIB) is firmly rooted in the Baltic Sea Region, being an international financial institution with eight member countries; Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. The main part of NIB's lending is targeted on the member countries of the bank as well as on the neighbouring area, with annual disbursements in support of investments in the region on the level of EUR 2 billion over the last three years.

NIB NORDIC INVESTMENT BANK

Disbursed (in EURm)	2007	2008	2009
Denmark	90	315	235
Estonia	54	90	83
Finland	272	415	510
Latvia	36	107	111
Lithuania	6	15	67
Poland	76	62	96
Sweden	783	588	287
Iceland	139	–	–
Norway	339	226	336
Russia	142	114	121
TOTAL	**1938**	**1933**	**1846**

NIB provides long-term complementary financing, based on sound banking principles, to projects that strengthen competitiveness and enhance the environment.

NIB has identified four focus sectors that in particular contribute to the fulfilment of this mandate: environment, energy; transport, logistics and communications; and innovation. The bank also lends to projects in the manufacturing and service sectors as well as provides financing through financial intermediaries to smaller projects. In 2009 environment was the clearly largest sector for the bank with close to 50 % of the new lending, including environmental loans in other sectors such as renewable energy, sustainable transport, R&D related to eco-efficiency, manufacturing and environmental services. The Bank also provided loans to banks for on-lending to small and medium-sized companies to finance investments in smaller-scale projects such as wind turbines.

The implementation and development of renewable energy systems and technologies is a priority area for NIB. All the member countries of the bank have set ambitious and challenging targets to increase the share of renewable energy. The most important renewable energy sources with regard to their energy potential are: biomass (usually with a combined heat and power output), wind power (both land-based and offshore), geothermal power and hydropower. Hydropower development is mainly focused on increasing the efficiency of existing plants.

Security of supply and environmental sustainability are key challenges for the energy sector in the Baltic Sea Region. Enhanced integration of regional energy transmission is a necessity, not the least to enable a further increase of the share of renewable energy, and substantial long-term investments are needed in interconnectors and distribution systems. NIB is participating in the preparation of a number of priority projects, among others in the context of the Baltic Energy Market Interconnection Plan.

NIB takes active part in the regional cooperation. The EU Strategy for the Baltic Sea Region has established a new framework for this cooperation, laying down priority areas and identifying flagship projects. The priorities set out by the strategy, with its strong emphasis on the fields of environment, energy and transport, correlate well with the focus sectors of NIB, providing a good basis for the bank to be proactively involved in supporting the implementation of the strategy. NIB is committed to this aim and is cooperating closely with EIB in this respect.

In the wider regional context, the Northern Dimension, based on an equal partnership between the European Union, Iceland, Norway and Russia, creates an important platform for cooperation. In particular the specific partnerships established under the Northern Dimension, provide a framework for concrete activities. NIB plays an active role in the Northern Dimension Environmental Partnership (NDEP), which has been set up to coordinate and streamline the financing of environmental projects with cross-border effects in the Baltic Sea region, the Barents region and Northwest Russia, with projects benefitting from grants from the NDEP support fund. Up till today, all projects have been located in Russia but recently also Belarus has been approved as country of operations for the NDEP. NIB is acting as lead bank for a number of the projects, collaborating with, among others, EBRD, EIB and NEFCO.

A new initiative is the establishment of the Northern Dimension Partnership on Transport and Logistics (NDPTL). The purpose of this partnership is to facilitate cooperation on and implementation of regional transport infrastructure and logistics projects. Effective transport, logistics and communications form a cornerstone of the competitiveness of the Baltic Sea region. This applies to intra-regional transport and communication channels as well as to access links from and to the region. The goal is an effective flow of goods and people in the northern European region. NIB has actively participated in the preparatory process for the NDPTL and will continue to support concrete steps to launch the new partnership. A list of priority NDPTL projects is currently being developed by consultants on the assignment of the European Commission. Implementation of these projects is expected to benefit from close collaboration with the IFIs, including in relation to PPPs that can provide an effective mechanism for harnessing private sector competence and funding capacity in support investments.

NIB also supports the work of HELCOM to implement the Baltic Sea Action Plan (BSAP), which has been included as one of the priorities in the EU Strategy for the Baltic Sea Region. The aim of the plan is to restore the good ecological status of the Baltic marine environment by 2021. NIB has set aside EUR 500 million in a special Baltic Sea Environment Financing Facility (BASE) to provide loans supplementing the financing through national budgets and EU structural and cohesion funds, in order to finance measures that reduce pollution. At the end of 2009 EUR 97 million had been allocated under the facility. Loans under the facility are made in the ordinary course of business in accordance with NIB's lending policies.

Baltic Sea Region
Programme 2007–2013

The EU Baltic Sea Region Programme 2007-2013 (the Programme; www.eu.baltic.net) was set up as one of 13 European transnational cooperation programs. The strategic objective of the program is to strengthen the development of a sustainable, competitive, and territorially integrated Baltic Sea Region by connecting assets and capabilities across borders.

The program is now fully operational and approximately half of the total program budget of 237 million EUR has already been allocated to altogether 46 transnational cooperation projects. The third call for applications was closed in March 2010 and attracted some 61 applications from the whole Baltic Sea Region.

Currently, the program involves over 780 organizations from all countries bordering the Baltic Sea. Main actors are local, regional and national authorities but also research institutions and universities. A number of pan-Baltic organizations, such as HELCOM, BSSSC, UBC or CPMR are also involved in or provide support to projects funded by the Programme. The private sector is not directly benefitting from program funds but can get involved with own funding as associated organizations.

The Programme, with its unique character covering the overall Baltic Sea area, will clearly contribute to the implementation of the EU Strategy for the Baltic Sea Region and its Action Plan. By their nature, most of the 46 projects selected so far contribute to one of the priority areas addressed by the EU Strategy. Flagship project leaders and promoters have quickly discovered the Programme as a suitable financing instrument.

So far, start-up financing to eight projects labeled as flagships or parts of flagships of the Action Plan has already been granted. These projects are dealing with topics like innovations in SMEs for sustainable production, e-navigation, response to oil spills and environmentally friendly tourism. Several further projects are being developed in co-operation with the coordinators of the Action Plan. Limited program funds can by no means satisfy the needs for implementing the EU Strategy. A renewed Cohesion Policy should make better use of this already existing transnational financial instrument as one of the most suitable tools to implement the actions of the EU Strategy.

VISION & STRATEGIES 2010 AROUND THE BALTIC

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 chaired VASAB since July 2009.

The main part of the work during 2009 was devoted to the preparation of the comprehensive ministerial meeting and to the development of a new set of priorities for the future of spatial planning in the Baltic Sea region. In October 2009, VASAB held its 7th Ministerial Conference in Vilnius, where the new policy document *Long-Term Perspective for the Territorial Development of the Baltic Sea Region* (LTP) was adopted. The fine-tuning process included the VASAB Stakeholder seminar on 21 April 2009 in Riga on the spatial challenges of the region, and role of all actors in the implementation of the LTP. Back to back with the Ministerial Conference, VASAB organized a high level expert meeting on maritime spatial planning in the Baltic Sea Region.

VASAB's strategy for 2010-2011 is described in the VASAB Action Plan, foreseeing three strategic directions:

- Promoting urban networking and urban-rural cooperation
- Improving internal and external accessibility
- Enhancing maritime spatial planning and management

On the horizontal activities, VASAB will continue the promotion of best practice of land-based spatial planning and sustainable development, and will establish a monitoring mechanism for the territorial development of the Region. VASAB has also had an intense internal debate on closer cooperation with CBSS.

This year, VASAB has re-established the VASAB Working Group on Maritime Spatial Planning. The first meeting of the WG took place on 16-17 March 2010 in Riga.

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 subregions 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 2009/2010, BSSSC has prioritized action areas such as maritime policy, climate change and sustainable development, public health, transport and infrastructure, youth policy, and science and education.

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 on Maritime Policy. BSSSC will support projects of an integrated maritime policy to mitigate environmental impacts of maritime activities in the region. For example, it supports the introduction of land-based power supply or shore side gas supply for ships in ports across the Region, and the introduction of environmentally differentiated fair-way and/or harbor dues to promote environmentally friendly shipping and port management. BSSSC aims at contributing to the implementation of the priority "To become a model region of clean shipping" of the Action Plan to the EU Baltic Sea Strategy."

In the area of *climate change and sustainable development*, BSSSC focused on how regions can cope with the challenge of climate change at its Annual Conference in October 2009 in Zealand, Denmark. Subsequently, it submitted a special regional input to the UN Summit on Climate Change in Copenhagen (COP 15) in December last year. BSSSC supported the implementation of the HELCOM Baltic Sea Action Plan in collaboration with other partners like Baltic 21. Specific projects that are supported by BSSSC include "plan Baltic", a scientific project focusing on adaptation strategies in urban planning in the Baltic Sea Region. A BSSSC conference on the topic of adaptation of regions in the Baltic Sea Region to climate change is planned for 2011.

In the area of *transport and infrastructure*, BSSSC aims to open up the transport potential of linking the Baltic Countries, the 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 on sustainable societies in Region Zealand, Denmark, in October 2009. The main forum in 2010 will be the youth event on education and qualification in Tallinn in October.

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 cooperation 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 2010 will be the promotion of intensified co-operation with Russia, better use of EU programs for projects in the Baltic Sea 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. Under the title "Qualifying the Region for the Future – Implementing the EU Baltic Sea Strategy" BSSSC will focus its Annual Conference in October 2010 on the chances, challenges and changes for the Baltic Sea region in its development towards a knowledge-based society. The first Annual Forum of the EU Baltic Sea Strategy will be organized back-to-back with BSSSC's Annual Conference in Tallinn in October.

The Union of the 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.

UBC held its 10th annual General Conference in Kristiansand, Norway, on 23-36 September 2009, where it adopted the *UBC Strategy 2010-2015*, and the *UBC Sustainability Action Programme 2010-2015 - Agenda for Sustainable Baltic Cities*. A key conclusion from the conference resolution was to enhance its visibility at the regional and European arenas.

An area of key importance for UBC is the participation in the implementation of the Action Plan of the EU Strategy for the Baltic Sea Region. Through its Working Commissions, UBC worked intensively in 2008 and 2009 to contribute to the creation of the Strategy and prepared its own position paper. In addition, UBC issued a joint statement for the Baltic Sea Region together with BSSSC, B7, CPMR-BSC, BDF, and Euroregion Baltic.

Over the year, UBC worked intensively with its member cities and the commissions to find out what flagship projects they should engage in. At the UBC Executive Board meeting on 17 February 2010 in Naestved, Denmark, it was decided that UBC will focus on 4 flagship projects:

- Anticipate regional and local impacts of climate change through research
- Promote young entrepreneurs
- Make the Baltic Sea an Eco-efficient region
- Complete the agreed priority transport infrastructures

In 2009, two important UBC awards were handed out. The *Cultural Award* went to the City of Gdansk with the motivation *"The main aspiration behind the project 'The City Signs of Culture' is to democratize urban space through art and culture initiatives and it always helps raise awareness and sensitivity to receivers."* The *Best Environmental Practice in Baltic Cities Award* was given to the City of Umeå for the project "No idling taxicabs in Umeå" to combat the city's problem with air pollution.

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 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's four strategic focus areas were described in last year's report:
- Innovation promotion
- Regional identity building and marketing
- Infrastructure and sustainable development
- Integration and capitalization of urban expertise

In line with the EU Baltic Sea Region strategy, BaltMet has initiated two major projects. The first one aims at actively reducing the negative impact on the environment caused by an increase in sea traffic in the Baltic Sea, especially from cruise vessels. This was decided in November 2009, when BaltMet adopted a position paper on the *Sustainable Ports Initiative*.

The second one, *BaltMet Promo*, is a major flagship project aimed at contributing to the regional branding and identity building. Helsinki launched preparations for the project in the autumn of 2007. In September 2009, the project was granted EU funding of EUR 2.8 million from the BSR Programme for a two-year pilot phase, 2010-2011. It is planned that the project will continue with a wider partnership and scale of activities in an extension phase in 2012-2013. BaltMet Promo aims to attract tourists, talents and major international investment projects to the Baltic Sea Region. Three areas of pilot projects will be implemented as a test run for a lasting joint promotion. All this will be accompanied by a permanent policy dialogue among key opinion leaders and decision makers from the region, facilitated by Baltic Development Forum as one of the project partners. Other partners are the cities of Helsinki, Berlin, Riga, Vilnius and Warsaw, who will in turn involve their local partners from development agencies and universities. In addition, BaltMet Promo is supported by associate organizations from Copenhagen, Malmö, Oslo, St. Petersburg and Tallinn, as well as by 25 other associate organizations – including Baltic Sea Region networks, national investment and tourism promotion agencies and cultural institutions.

In a unique way, BaltMet Promo promotes co-ordinated horizontal activities related to regional identity building as part of the EU Baltic Sea strategy. The collaborative working method of BaltMet Promo is based on multilevel governance structure with a wide range of actors from the Commission, the state level and the local level, including private actors, both from businesses and private persons. The working method could become a model for similar co-operation in Europe.

ScanBalt BORDERLESS BIOTECH

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. Scanbalt's strategy "Innovation on top of Europe 2008-2011" defines three activity areas to promote the development of the ScanBalt BioRegion as a globally competitive meta-region:

- Project Incubator and Excellence
- Communication and Marketing
- Member Services and Organizational Development

In June 2009, ScanBalt released the *Smart Growth Innovation Agenda – Bridging Academia and SMEs in the Baltic Sea Region* as a delivery from the EU project, Bridge-BSR (EU FP 7). The Smart Growth Innovation Agenda proposed to establish the Nordic-Baltic area as a prosperous "health region". In addition, it proposed to initiate a cross-border financing structure for innovation, research and education, as well as to promote shared business services and support between clusters in the ScanBalt BioRegion in order to take the cluster collaboration one step further. The Smart Growth Innovation Agenda finally discussed the role of sustainability and ethics as a basic for the competitive development of ScanBalt BioRegion. Since the release of the "Smart Growth" Innovation Agenda last year, the ScanBalt BioRegion has focused on implementing concrete proposals.

In October 2009, the *ScanBalt Health Region* (SBHR) became an acknowledged flagship project within priority area 7 of the EU Strategy for the Baltic Sea. The mission is to promote health of the citizens, reduce costs of the health care systems and strengthen health economy in our region. Catalyzed by an open task force headed by BioCon Valley, Lithuanian Biotech Association and ScanBalt fmba, the flagship project serves as an umbrella for a multitude of coordinated activities applying shared visions and values for the development of the region and utilizing a common communication structure. The SBHR is a bottom-up approach combined with a top-down advisory structure which has been developed, tested and applied for the ScanBalt BioRegion since 2001. The advantage is that it ensures specific themes to be dealt with in depth by a multitude of relatively small teams whilst referring to an overall strategy and using existing structures. The SBHR Modus operandi is the result of intense dialogue and consultation with key stakeholders throughout the Baltic Sea Region at workshops and round-tables in e.g. Szczecin, Riga, Vilnius, Tartu and Gdansk over the last year. As a start, the SBHR addresses three key bottlenecks in innovation within health care:

- Insufficient commercial exploitation of ideas and inventions from health care practitioners and/or research organizations
- Procurement practices, which hinders SME access to health care market
- Cultural and competence differences between BSR health care providers and SMEs within different sectors of health economy

ScanBalt Academy (SBA) consists of distinguished and prominent life scientists from academia, industry, and government. SBA acts as an external advisory board to ScanBalt and has an important ambassadorial role. In 2010, the ScanBalt Academy has its annual meeting in Longyearbyen at Svalbard on 17-20 August. The scientific topic will be "Influences on biology, ecology and health of climate and milieu in the Arctic region". In addition, the SBA will discuss key topics of research policy of particular relevance to the Baltic Sea region. The ScanBalt Academy has over the year worked intensively on strengthening relations with Russia within the framework of the Northern Dimension.

The *Nordic-Baltic Expats Forum* has over the year provided service and information exchange for life science researchers/students/professionals living abroad who have their roots in the Nordic and Baltic countries, Poland, Northern Germany or Northwestern Russia (ScanBalt BioRegion) - or people from life science from abroad living in ScanBalt BioRegion. Science journalists and communication professionals have now been included to facilitate the dialogue between science and the media.

On 9 March 2010, the Pomorskie region inaugurated a *ScanBalt Liaison office*. The office is hosted by the Baltic Center for Biotechnology and Innovative Diagnostics, Biobaltica, located in the Gdansk Science and Technology Park. The ScanBalt Liaison offices play an important role in the development of the ScanBalt BioRegion, as they undertake specific tasks of particular interest of the region in which they are situated. They constitute a key pillar in the constant strive to decentralize the organization ScanBalt fmba, and enhance direct involvement of key stakeholders from the ScanBalt BioRegion community. ScanBalt Liaison offices are also a key to implement the ScanBalt Health Region. In addition to the liaison office in Gdansk, other offices are located in Rostock, Germany and Tartu, Estonia.

ScanBalt is coming to an end of its strategy "*Innovation on Top of Europe 2008 – 2011*". The strategy has been an effective tool over the past years, and a process has been initiated to ensure the continued development of the ScanBalt BioRegion. The aim is to promote more and better coordinated investments at the regional, national and supra-national levels in order to ensure a prosperous Baltic Sea Region and face challenges within e.g. health, environment and nutrition.

BCCA
BALTIC SEA CHAMBERS OF COMMERCE ASSOCIATION

The Baltic Sea Chambers 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 2009 and 2010, BCCA has continued its focus on the EU Baltic Sea Region strategy. A task force is conducting an analysis of the strategy, not least in lieu of the fact that any changes need long preparation. The BCCA believes that trade is a driver of innovation and prosperity and that trade facilitation is a key for success in other areas, which is an important outlook for this analysis.

In the longer term, BCCA is pushing for policies to leverage a number of key infrastructure investments that are under way. The BCCA keenly supports and takes part in a promising Project spearheaded by the Hamburg Chamber of Commerce, and the HWWI, which will scrutinize the impact of factors such as urban development and demography on the Baltic Sea Region.

Baltic Development Forum

sustainable growth · innovation · competitiveness

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

The EU Strategy for the Baltic Sea Region continues to be a top priority for the work of Baltic Development Forum (BDF). Throughout the years, an important aim for BDF has been to promote and find a new way to balance European and regional integration in a mutually supporting way. Thus BDF worked closely together with the Swedish EU Presidency on organizing the BDF Summit in Stockholm in October 2009. All relevant regional stakeholders were invited to the Summit and encouraged to be involved, not least the private sector which so far has not been sufficiently integrated into the process. BDF will be persistent in its ambition to correct this shortcoming.

The implementation of the EU BSR Strategy needs to be closely related to the economic recovery of the Region and the search for sustainable growth in the future. BDF hopes to see the BSR Strategy turn into a regional version of the EU's growth plan for 2020 where competitiveness and innovation capacity are essential themes. In cooperation with the company Copenhagen Economics and the Danish Industry Foundation BDF will put forward concrete proposals to the governments and the European Commission in June 2010. BDF will also continue to function as a stakeholder platform for the EU BSR Strategy and will work closely together with the Polish EU Presidency in the second half of 2011.

The economic crisis of the Baltic countries was also at the top of the agenda when the chairman of BDF Uffe Ellemann-Jensen participated as a key note speaker at a Baltic Council meeting in Latvia in January, in which the three Baltic Prime Ministers also took part. Closer integration between the Nordic and Baltic countries is one way of out the crisis and a means for increased regional competitiveness. BDF will continue promoting this dimension – not least through the State of the Region Report, and together with the present Danish Presidency of Nordic Council of Ministers. BDF has also worked intensively with the Lithuanian Presidency of the Council of the Baltic Sea States (CBSS) in organizing "One City – Two Summits" when the BDF Summit coincides with the Baltic Sea States Summit in Vilnius 1-2 June.

In parallel with the EU BSR Strategy, BDF continues to be committed to the Northern Dimension Cooperation, striving towards closer integration with the Russian Baltic Sea region provinces. In this regard, BDF will be supporting the work of the new Northern Dimension Business Council and the co-chairmen of this organization. BDF will also work with other partner organization within the Northern Dimension umbrella and the CBSS, not least during the Norwegian CBSS Presidency from July 2010 until July 2011 and the Northern Dimension Forum.

Climate and energy continues to be on the top of the agenda of BDF. The agenda-setting report "Sustainable Energy Scenarios – Energy perspectives for the Baltic Sea Region" was published in September 2009 on the initiative of BDF and co-sponsored by the Nordic Council of Ministers in particular. This report documented for the first time in data and facts that the Baltic Sea Region countries have a lot to gain from mutual cooperation in reaching the 20-20-20 targets of the EU climate and energy package. On this basis, BDF will argue that a clearer regional climate and energy "vision" needs to be formulated, and will initiate cooperation with relevant partners in order to present this vision to decision-makers.

The energy report became a starting point for the training course "Energy scenario analyses with Balmorel model", which took place in February 2010. Course participants were experts from Denmark, Estonia, Germany, Lithuania, and Sweden working with strategic energy planning and market development within energy companies, authorities and transmission system operators, as well as university students. The aim of the course was to provide useful knowledge into the energy planning tools that can help turn challenges into opportunities and develop a common energy approach in the Baltic Sea area. This course was the first in a series of courses aiming to establish long-term cooperation and knowledge exchange among system experts and the first step towards a common regional training program.

BDF will follow up on the energy report by making a complementary study on the Kaliningrad region, based on a sponsorship from the Danish Ministry of Foreign Affairs. Also in this regard, BDF will be working closely together with Russian partners and with the regional energy organizations BASREC (Baltic Sea Region Energy Cooperation) and BEMIP (Baltic Energy Market Implementation Plan). BDF also wants to put more focus on the infrastructure development of the gas sector by highlighting all the aspects involved.

Furthermore BDF has placed water as an area of priority. The Baltic Sea is an important uniting factor between the Baltic Sea States. It is also one of the most polluted seas in the world. At the Baltic Sea Action Summit in Helsinki in February 2010, many public and private commitments were made for addressing this problem in a more decisive manner. BDF participated in the Summit in Helsinki and made a commitment that this process will be continued at the BDF Summit in

Vilnius. In particular, BDF is advocating the need to focus on the opportunities this environmental challenge entails. Globally, water is a new booming business sector and the Baltic Sea needs to profit from the capacities within this sector, which is very strong in the Baltic Sea Region.

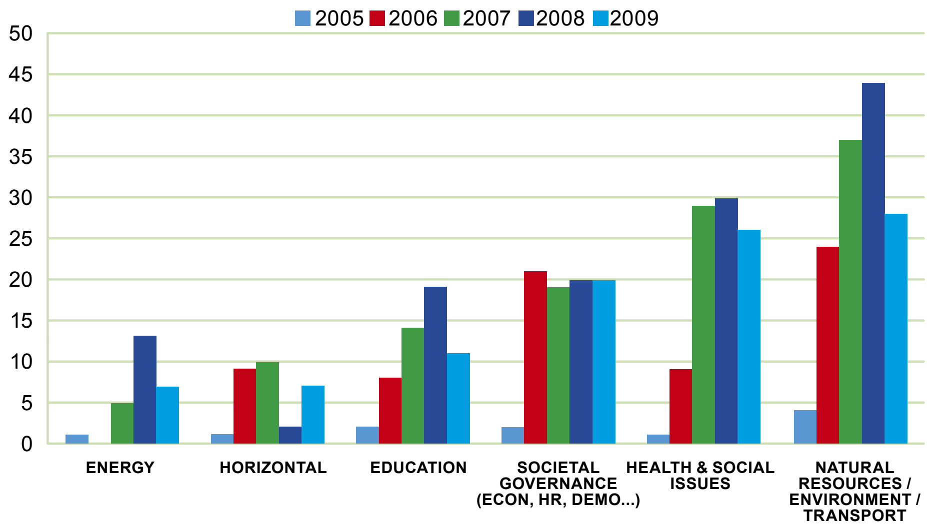
Another priority for BDF in 2010 is to work towards establishing a regional think tank. The idea of such a think tank was launched at the BDF Summit in October 2009 and BDF will now move forward with fundraising proposals and enlarge its existing network of researchers in the subject matters concerning the Baltic Sea Region. The objective is to establish a think tank which can contribute to the regional debate on regional cooperation dynamics, political/economic problems and priorities and, in this way, become a useful partner to the EU BSR Strategy. The Konrad Adenauer Stiftung in Riga will join forces with BDF in this endeavor.

Furthermore, in 2010 and 2011 BDF continues to be a part of the BaltMetPromo project, a Flagship project of the EU Baltic Sea Region Programme, thus supporting this networks' focus on regional identity building. BDF contributes to the project by bringing the discussion on regional identity and branding to the policy maker's level by arranging a series of so-called "policy round-tables", where important decision-makers from both business and politics in the Baltic Sea area will participate in a discussion on branding of the Region. The first policy round-table is to be held on 31 May in Vilnius in conjunction with the BDF Summit.

Sida
Baltic Sea Unit

Among the national agencies and organizations, the Baltic Sea arm of the Swedish International Development Cooperation Agency (Sida Baltic Sea Unit; www.sida.se/balticseaunit) is probably the most prominent one. It was created in the wake of the 2004 EU enlargement as a vehicle to further promote and develop relations and cooperation between diverse actors in the Baltic Sea Region. Since 2005, the Baltic Sea Unit, based in Visby in the middle of the Baltic Sea, has acted as a catalyst for cross-border cooperation in the region. At its disposal is a toolkit consisting of information, expert advice and financial support. The rationale of the unit is to make apparent and accessible the mutual benefits of cross-border cooperation as a means to solve issues of importance. In this sense, the Baltic Sea Unit has not been working with development aid but rather with what is termed international cooperation.

The requirement for being eligible to apply for support from the Baltic Sea Unit is that the project idea involves actors from two or more countries in the Baltic Sea Region and that the lead partner must be Swedish. Since inception (2005-2009) the Baltic Sea Unit in this way has helped to establish and fund some 470 different projects and initiatives – involving some 190 different lead applicants and a multitude of general project partners.



No. of projects annually supported by the Baltic Sea Unit within different subject areas.

The types of activities supported range from seed money to enable small informal workshops to co-financing of larger projects and feasibility studies for later project applications within, for example, the Interreg programs. The subject areas supported are also broad and many projects are fully in line with the priorities set forth by the EU Strategy for the Baltic Sea Region.

In comparison to the large number of actors involved in the projects, the total funding disbursed in 2005-2009 may seem limited (app. €8m) – but it must be noted that the funding provided by the Baltic Sea Unit should not be long-term or the sole source of financing. Rather, the funding and related advice and support is intended to be catalytic for initiatives, networks and projects to get started – initiatives that may later find funding elsewhere. Also, the indicative limit of funding to a maximum of €30,000 is something that underlines that the Baltic Sea Unit is about providing seed money rather than core funding. Even so, some of the partnerships that benefited from the support of the Baltic Sea Unit can today be found in the list of projects in the Action Plan accompanying the EU Baltic Sea Region strategy.

Given the line of work being pursued, it is only natural that the adoption of the strategy has been warmly welcomed by Sida. The Baltic Sea Unit actively took part in the many discussions that preceded the adoption of the strategy. For example, already in the summer of 2008, in cooperation with Baltic Development Forum and Södertörn University College, the Baltic Sea Unit organized a two-day international conference on the EUSBSR during that year's Almedalen politicians' week in Visby. The event brought together a large number of academics, politicians and other key figures from around the Baltic – including EU Commissioner Malmström – to discuss the Future of the Baltic Sea Region.

Perhaps, as a consequence of these types of activities, Sida in 2009 was the first public authority to be officially tasked by the Swedish government to "facilitate the implementation" of the EUSBSR. As part of this agenda, the Baltic Sea Unit in 2009 actively promoted discussion and general awareness of the EUSBSR through a number of public meetings and the production of the magazine "From a Baltic Point of View" and a film with the same name. These materials were distributed widely through a variety of venues throughout the year. Part of this awareness campaign was also a series of informal public talks organized during the 2009 Baltic Development Forum Summit focusing on the practical implementation of the EU Baltic Sea Region strategy.

More recently the Sida Baltic Sea Unit has strived to be able to provide its seed money to all actors in the region – irrespective of the nationality of the lead applicant. However, whatever the outcome of this initiative is, nothing in the current set-up hinders the existing facility to finance activities and actors throughout the Baltic Sea Region – as long as there is a Swedish lead applicant.

SUOMEN ITÄMERI-INSTITUUTTI
THE BALTIC INSTITUTE OF FINLAND

The Baltic Institute of Finland (BIF; www.baltic.org) is a collaborative body for the Baltic Sea region in Finland. Since its launch in 1994, the institute has promoted cooperation in the Baltic Sea region and contributed actively to the international network of collaborators in the region. The central aim of BIF is to promote the launch of tangible collaboration projects in the Baltic Sea region and to facilitate the participation of Finnish organizations in these initiatives. BIF is a network-based organization, and its principal focus is on planning and coordinating tangible collaborative projects and maintaining an extensive network of collaborators in the Baltic Sea region. In 2009 alone, BIF was involved in altogether 16 collaborative projects in the Baltic Sea region, and organized some 40 events in the Baltic Sea region and in Brussels. In recent years, BIF has especially concentrated on innovation related cooperation in the Baltic Sea region, e.g. through its *BSR InnoReg*, *SPb InnoReg* and *VBN InnoReg Interreg* projects.

Since the autumn 2009, BIF has been closely involved in the preparation of the Vinnova-led *BSR Stars* project – the EU Baltic Sea Region Strategy flagship project on research & innovation, clusters and SME networks. BIF is assisting the Finnish Ministry of Employment and Economy in the Finnish preparation of the flagship and in the chairing of the BSR Stars task force on transnational clusters. BIF is also represented in the High Level Group (HLG) of BSR Stars. BSR Stars paves the way for the next generation of transnational cooperation in the fields of innovation, research, clusters and SME networks in the Baltic Sea region. By building critical mass in capabilities and capacities through specific transnational collaborative commercial focused projects, the project promotes the creation of prosperity, economic growth and new jobs in the region.

Concerning the environmental priority of the EU BSR Strategy, BIF is the lead partner of the project proposal "*BSR InnoShip - Baltic Sea cooperation for reducing ship and port emissions through knowledge and innovation-based competitiveness*" which was prepared to apply for funding in the EU Baltic Sea Region Programme 2007-2013 third call by 22 March 2010. The HELCOM-supported BSR InnoShip is a part of the flagship project "Promote measures to reduce emissions from ships and enhance the development" under the Priority Area 4 (to become a model region for clean shipping) of the EU Baltic Sea Region Strategy Action Plan. The BSR InnoShip project will address the joint challenge of the Baltic Sea countries and the key maritime stakeholders to cooperate on minimizing ship-based air pollution, while aiming at optimizing competitiveness of the marine industry. The project will promote a new and innovative transnational approach to mitigate the different needs and interests of the maritime sector and to ensure the basis for a more sustainable and economically viable management of the Baltic Sea resources. Leading maritime stakeholders from all BSR countries are represented among the project's 19 partners and 24 associated partners.

BIF has good tangible experiences of projects, where Northwest Russia has participated in multilateral collaborative projects in the Baltic Sea region. The projects have helped to promote the development of an innovation system in St Petersburg, for example, by making use of the experiences of other countries in the Baltic Sea region. Other key themes of projects coordinated by the institute have included the development of an intellectual property rights system and anti-piracy measures in St Petersburg, which will ultimately have a significant impact on economic cooperation with Russia.

BIF is the lead partner of the European-wide "*eCitizen II – towards citizen-centred eGovernment in European cities and regions*" project (2010-2012). The project is financed by the EU Interreg IV C programme. eCitizen II is a three-year project designed to support European cities and regions in their joint efforts to accelerate the eGovernment through utilizing established networks, gained experiences and good practices to improve interaction between citizens and public authorities, better involving citizens in local decision-making as well as contributing to change in operational culture and attitudes within public administrations. The project partnership consists of ten partner cities and regions from ten countries including the city of Tampere, the city of Odense, and the city of Tartu from the Baltic Sea Region.

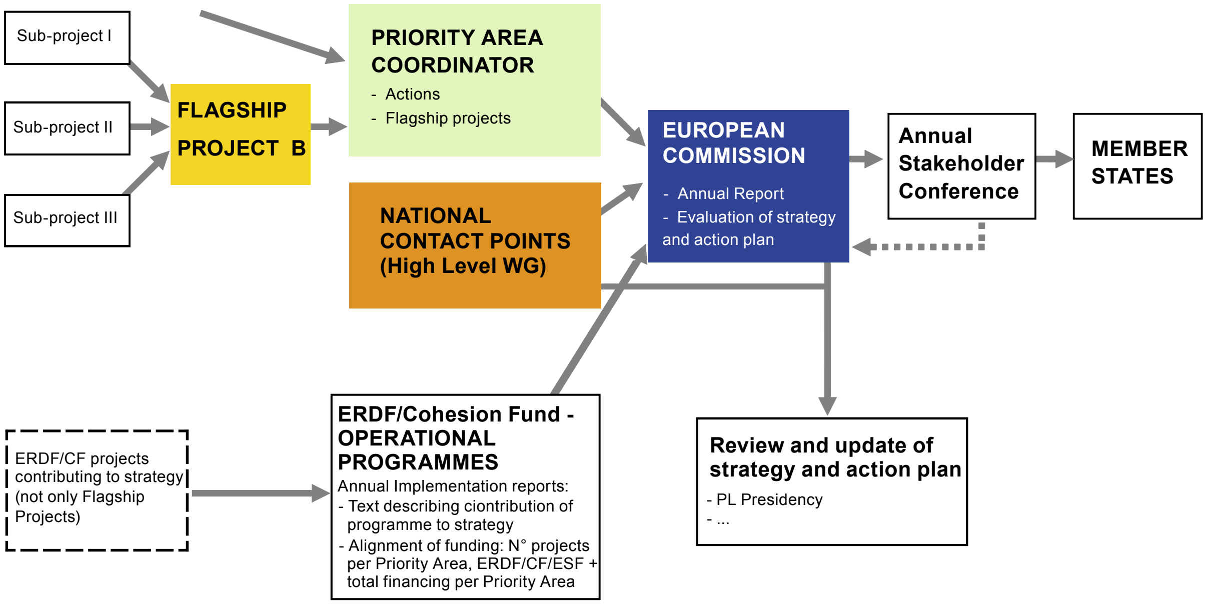
3.2 EU Baltic Sea Region strategy

3.2.1 Update from the European Commission

By Anders Lindholm, DG Regio, European Commission

In the six months that have passed since the endorsement of the EU Baltic Sea Region strategy by the European Council, the focus in the Commission has been on getting the operational structures up and running. The most important aspect is to get the Priority Area Coordinators to assume their roles as driving the process in the respective areas. To start the work, kick-off meetings have been organized for most of the priority areas. A large number of projects leaders and partners are working hard to launch their projects, the relevant partnerships are set-up, the necessary funding is made available, and the joint objectives are agreed. The leaders of the different actions and projects come from all involved Member states, representing ministries, regions, private initiatives, NGOs, etc.

To facilitate the work, several administrations have taken measures to adapt their organizations to this new context. The Commission has multiplied its initiatives to facilitate and to coordinate all these actions. The Action Plan has been updated to take account of the experience gained by all the relevant partners since the



launch of the strategy. European institutions like the European Investment Bank (EIB) are actively contributing to the implementation of the strategy (on the EIB specifically, see their chapter in Part B of this Report).

Many new projects have been initiated as a result of the strategy. Examples include the initiative to “Remove remaining single market barriers by strengthening the practical cooperation between the responsible authorities in the Baltic Sea Region” (led by the Polish Ministry of Economy), the project aiming to Develop a Baltic Sea Region Programme for Innovation, Clusters and SME Networks (led by Vinnova and the Lithuanian Ministry of Research), and the initiative to “Create a Baltic Sea Fund for Innovation and Research” (led by the Swedish region of Skåne). The project “Baltic Transport Outlook” has been initiated to base future transport planning on solid facts about the future transport needs of the entire region and beyond..

The concrete projects are the most visible parts of the strategy and the place where words turn to action. The Commission will focus more on communication, so that actions and projects underway or already implemented as part of the strategy can be better highlighted. It is also important to remember that a lot can also be gained from developing joint priorities and policies among the countries in the region. If the Region manages to come up with a set of priorities and policies to reach these priorities, be it within transport, energy, innovation or internal market, the chances of succeeding increase dramatically. This is true at the regional level but also when all 27 Member States meet to negotiate in Brussels. A well prepared and coordinated region will be listened to and respected in a way no single Member State can achieve on its own.

Some challenges still need to be tackled. In some Member States, the relationship between line ministries and the national contact points must be improved, in particular in countries where there is a gap between the political commitment expressed in the discussion phase of the strategy and the involvement for facilitating the achievement of the projects on the ground.

The implementation process of the strategy must also be made more visible to the funding programs in the region, and there is a need to establish closer contact between these programs and the Priority Area Coordinators. These issues are partly political, partly technical. After a recent meeting organized in Riga on 11 March 2010 with representatives of the Operational Programs and the Priority area Coordinators, the Commission committed to meeting with those Member States and program Managing Authorities that have requested more guidance.

The Baltic Sea Strategy has marked the beginning of a new way of working and thinking about cooperation between the EU Member States and with non-Member States. An EU Strategy for the Danube Region is already being prepared, using the experience of the Baltic Sea Region as a guide. A number of other regions have also expressed their interest in the Macro-regional approach. The existence of macro-regions makes it possible to manage more initiatives at this level instead of the EU 27 level. And through this approach, the work can be more efficient and achieve more outputs and better results.

In 2011, the Commission will be reporting on progress as requested by the European Council. But already this year, we will draw up an evaluation report. To this end, we have requested reports from the Priority Area Coordinators by 30 June. The first Annual Forum in mid-October will be a good opportunity to take stock of events and get input from regional stakeholders. The first Annual Forum will be organized back to back with the BSSSC annual event in Tallinn 14-15 October. For the second Annual Forum the intention is to organize it in Warsaw together with the Baltic Development Forum.

The Annual Forums will be organized as large, open and frank exchange of views on progress, good practice, and obstacles. It is important to hear the views of those active on the ground. Everyone should feel they have their part to play in the development and implementation of the strategy, and make their contribution by reporting on what works, and what does not.

The Member States, regions, private sector actors, NGOs etc in the Baltic Sea Region are working together in this new way to find out how far the new macro-regional approach can overcome obstacles to cooperation. Expectations are high. However, it will not be the Commission that determines how far this new approach can take us. The Commission will not and cannot implement any macro-regional strategy – it does not have the resources, nor, crucially, the local knowledge. It is for others – the administrations, agencies, regional authorities – to transform ambitions into facts.

3.2.2 Selected Flagship Projects

SPIN (sustainable production through innovation in SMEs)
By Daniel De Graaf, German Federal Environment Agency

SPIN combines environmental issues with economic ones in line with the EU Baltic Sea Region strategy's interdisciplinary perspective. The idea is not only to increase business activities but also push them onto a sustainable track by exploiting the innovations already available. It is exactly this thematic crossroad where the SPIN project focuses its activities on. SPIN was awarded a Lighthouse Project by Baltic 21 and is considered a "fast track" flagship project within priority area 8 of the BSR strategy. The project is part-financed by the Baltic Sea Region Programme 2007-2013 and was approved in the first call.

Helping companies to operate more profitable and to reduce their environmental burden by applying eco-innovations developed in SMEs within the Baltic Sea Region is the key issue of the initiative lead by the German Federal Environment Agency. Matchmaking, i.e. bringing together demand (elicited by certain EU directives related to environment) with supply of eco-innovations, is addressed by different instruments of SPIN. Production processes are made more sustainable, while at the same time business opportunities are being created. This goal is expressed by the slogan of the project: "Private profits, public benefits".

In order to enable SMEs to determine their needs that result from compliance with EU legislation or out of competitiveness reasons, tools, which have demonstrated their added value in practice, are collected for application. Satisfaction of specific needs is achieved by implementation of eco-innovations which are provided by the SPIN database, which will be officially launched at the 3rd SPIN partner meeting in Vilnius in May 2010. Companies offering eco-innovations are encouraged to provide a description for a database entry.

The SPIN partner countries Finland, Estonia, Lithuania, Poland, Denmark, Sweden and Germany have set up help lines in order to provide practical information for interested companies and to assist with the application of tools. For introduction and promotion of eco-innovations, innovation workshops addressing certain industry sectors are organized. The results of the project, including the outcome of the country studies on SME needs as well as studies on barriers and incentives of the implementation of eco-innovations, are put together in a BSR policy strategy on how to enhance the application of innovations supporting sustainable production.

The project, which started in January 2009, intends to connect 200 institutions in the field of sustainable production throughout the Baltic Sea Region. It is through this network of agencies, ministries and other institutions that SPIN aims to promote and foster the idea and implementation of sustainable production.

BEMIP (Baltic Energy Market Interconnection Plan)
By Nina Egebjærg Clausen, Danish Energy Agency

The EU's Baltic Sea Strategy's strategic action in the field of energy focuses on establishing an integrated and well functioning market for energy by implementing the Baltic Energy Market Interconnection Plan (BEMIP). The three priority objectives of the EU's energy policy - competitiveness, security of supply, and sustainability - can only be achieved through a well-interconnected and well-functioning internal energy market backed up by coordinated action by Member States to enhance their solidarity. Therefore one of the priorities in the EU's energy policy is to connect "energy islands" with the internal market. The Baltic region has, in this context, been identified as the target for the first major infrastructure projects. The integration of the Baltic States into EU energy networks is seen as one of the main objectives that will contribute to the stability and economic growth of the Baltic Sea Region. Following the agreement of the Member States of the Baltic Sea Region, EU president Barroso decided in 2008 to set up a High Level Group chaired by the Commission on "Baltic Interconnections". The High Level Group agreed by July 2009 on a comprehensive plan on energy interconnections and market improvement in the Baltic Sea Region, also called "The Baltic Energy Market Interconnection Plan (BEMIP)".

In terms of priorities, BEMIP's focus was first put on the electricity sector, then gas, making reference to other topics of high importance (oil and clean energy). BEMIP, coordinated by Denmark and Latvia, brings together, in a coordinated way, the projects involving all countries around the Baltic Sea – namely Finland, Estonia, Latvia, Lithuania, Poland, Germany, Denmark, Sweden, and as an observer, Norway - for the development of the internal market for electricity and gas; electricity interconnections; new electricity generation capacity; diversification of routes and sources for natural gas; and oil.

The first progress report on the implementation of BEMIP was presented in November 2009. The main conclusions showed that progress in the electricity sector has so far been successful in that it generally delivered on the agreed actions and timeline. Some progress in the gas sector has also been achieved and work is now intensifying in this field.

The 2nd progress report will be presented by June 2010. So far, results show that there is continued political support towards effective implementation of the BEMIP and towards further work in gas from all participating countries, as well as the Commission. Coordination with the EU's Baltic Sea Region Strategy is also ongoing. In this respect, the members of the BEMIP High Level Group have agreed to act as the steering group for the priority area on energy. Underneath is listed a short overview of the main achievements in electricity and gas:

Main achievements to date in electricity:

- Internal electricity market roadmap is considered the critical path for the success of the BEMIP. This is a 4-step plan, where step1 identified preliminary political and business decisions that needed to be taken still in 2009, e.g. offering free capacity of Estlink1 to the market is one of these. This step1 is finalized.
- Step 2 of the roadmap will require a lot of effort from the member states (abolition of regulated tariffs, free movement of subsidized renewable electricity (RES) without losing subsidies, etc.). The action on the abolition of regulated prices is smoothly progressing. The three Baltic States set up a taskforce in order to discuss renewables feed-in tariff policy, and other related topics in order to fully adopt step2 of the Roadmap.
- Electricity interconnection projects are on schedule. It has been highlighted that the existence of the European Energy Programme for Recovery (EEPR) support has a positive impact on the projects by providing incentives for their timely implementation, e.g. Estlink2 and NordBalt. First interconnections are planned to come into operation from 2014 onwards.

Progress in gas has also been achieved The focus of the High Level Group has now turned to further developing common actions and projects in this field. The main approach and objectives have been agreed.

- The first of the four priorities in the work on gas is to identify a minimum set of infrastructure projects that would end the isolation of Finland, Estonia, Latvia and Lithuania: Polish-Lithuanian gas link, BalticConnector (Estonia-Finland) and a regional LNG terminal. Studies on the viability of the BalticConnector are already being prepared, and the Polish – Lithuanian gas link has recently received political support from Lithuania and Poland.
- A second objective linked to the first priority is to identify one regional LNG terminal for the East Baltic Sea countries. While still several potential locations exist, studies are ongoing to provide with conclusions on comparing these options. Discussions for both objectives will now continue with a focus on the need to align regulatory frameworks to allow regional infrastructure investments.
- Third and fourth objectives are to contribute to enhanced security of gas supply in the West-Baltic region, including Poland, Germany, Sweden and Denmark through diversification of routes and sources of supply, as well as through addressing the issue of Danish gas field depletion. These topics are now discussed within the so called West Baltic Taskforce launched within the BEMIP as a working group for which we have seen a proactive interest from the region's stakeholders. The taskforce is driven by the Baltic Gas Association and will present an action plan to the HLG by the end of 2010.

In the 1st BEMIP progress report, the proposed regulation on the security of gas supply was identified as an important factor that will have a strong impact on the region's infrastructure needs, especially in the three Baltic States. The ways of accommodating these requirements through regional cooperation has been examined, and the three Baltic States are now working together within the BEMIP framework to prepare Preventative Action Plans and Emergency Plans both on national and regional level by the end of the year.

Assessment

The level of regional collaboration remains high, despite the crisis. Neither the strain public budgets are under nor the financial pressure on companies have had a visible negative impact on the plans and activities of regional networks. This resilience is a positive indication of the broad-based interest in regional collaboration across the Baltic Sea. But it might also be a reflection of the financing through EU-and other public funds being unaffected by the crisis and by the lack of company involvement. It seems at least prudent for organizations involved in regional collaboration to critically assess how the crisis has affected particularly the private sector interest in participation.

The EU Baltic Sea Region strategy is clearly getting under way, with large interest across the many parts of the Region to get involved in projects under its umbrella. The strategy is providing orientation that regional organizations clearly take seriously in their own planning. And it has encouraged a new level of cooperation between these organizations on many issues where they have a shared interest. However, there is sense that the strategy has mainly led to a better integration of existing regional efforts, not to the coordination or integration of national policies in the broader context of the Baltic Sea Region. This leaves many potential policy levers unused and limits the potential impact of the regional efforts. The implementation and governance structures for the strategy are still evolving. Based on the (limited) experience so far, there might be a need for a different mix of bottom-up and top-down elements in the governance structure of the strategy. The current set-up does not seem to give sufficiently clear strategic direction and fails to align national policies. Both of these cannot be achieved in a bottom-up process - they require the top-down engagement of national leaders.

4. Implications

The global economic crisis has clearly hit the Baltic Sea Region hard. Prosperity has gone down in all but one country across the Region, sharply in some cases. The downfall in demand has been accommodated through both lower employment and a drop in productivity. Exports have fallen sharply and the Region was disproportionally affected by the reduction in global trade. Investment activity, traditionally an Achilles heel of the Region, has slumped after some improvements in the run-up to the crisis.

The drastic slowdown of the Baltic Sea Region economy reflected in these figures is to a large degree the natural result of a global crisis hitting a group of small open economies. Accordingly, the regional business climate has improved markedly as soon as the global economy has shown signs of stabilization and a return to slow growth. This quick return of sentiments to the pre-crisis level of mid-2008 is surprising: the return to growth is still fragile and driven by the willingness of local consumers to spend. Exports are still weak, despite more encouraging recent signs. Investment activity, too, remains low. And if the Greek crisis leads to a serious setback for the main economies in Europe, it will not leave the Baltic Sea Region unaffected. There are also more long-term concerns: the loss of market share in global trade could herald a more permanent loss of position versus Asia. It is too early to tell whether this is the case. There is no reason for pessimism but it is too early to call the crisis over.

The longer-term outlook for the Region depends on its level of global competitiveness. While there has been little new data since the last State of the Region Report was published in October 2009, there is no evidence of an erosion of the Region's strong competitiveness. In some areas, particularly in macroeconomic policy, there are even signs that the Region has weathered the crisis better than most peers in Europe and the OECD.

Most of these improvements are driven by short-term economic trends. The future path of the Region's competitiveness will instead depend on the policy decisions made in response to the crisis. The tighter budget conditions in many countries in the Region will also play a role. So far, there are few signs of a fundamental review of competitiveness policies across the Region. In countries with solid competitiveness this might be justified; reforms in specific policy areas might be enough. But there is a real danger that either more pressing macroeconomic challenges or overconfidence after a quick recovery will stop a more fundamental review of growth strategies elsewhere in the Region as well.

Whether the regional level can make a contribution to competitiveness upgrading depends on the nature of collaboration across the Baltic Sea Region. Collaboration remains high and is becoming more integrated across the different networks and projects. The EU Baltic Sea Region strategy has made a significant positive contribution to this process. But it has not been the step change in joint action that many in the Region had hoped for, at least so far. To reach the next level, it will require the further engagement of political leaders from the Region to create an effective institutional architecture for action. This does not require new organizations but a more systematic alignment of regional efforts with the much larger set of activities pursued at the national (or EU) level. For this to happen, political leadership from within the Region is critical. It is too early to let the public administrations take over from the elected officials.

A topic that in this context will gain in importance is the connection between the EU Baltic Sea Region strategy and the Europe 2020 strategy. The Lisbon agenda, the predecessor of the Europe 2020 strategy, has been an important orientation and benchmark for the Baltic Sea Region. The content and process improvements of the new strategy, agreed upon by the European Council in March 2010, take up many issues that that have long been advocated in the Region, not least the focus on green growth. The new EU strategy does not have an explicit regional dimension. But, as was discussed in previous Reports, this does not preclude the EU member countries across the Baltic Sea Region to design a regional 2020 action plan to supplement the national commitments. Such a regional 2020 action plan could and should be tightly integrated with the action plan of the EU Baltic Sea Region strategy.

This is not an easy time for deepening regional collaboration and linking national policies closer to a regional agenda. The focus of economic policy remains strongly on macroeconomics. Politically, this raises the importance of the national and the EU/global level. There is little that cooperation at the Baltic Sea Region level can do in terms of macroeconomic policy coordination. In addition, the crisis has increased the heterogeneity across the Region in terms of economic conditions, competitiveness, but maybe most importantly also of attitudes and perceptions. The crisis in Stockholm, Warsaw, and Hamburg has been quite different from the crisis in Reykjavik, Riga, and Moscow. The EU Baltic Sea Region strategy and the strong existing networks across the Region have provided much needed robustness to regional collaboration. But it is critical to again make the argument for regional collaboration for the broader public. This is not easy at a time when there are debates about the role of foreign banks, about fiscal rescue packages for countries in need, and about competitive devaluation. Without convincing the public at home, it is futile to expect politicians across the Baltic Sea Region to make decisive steps towards further integration.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Section B: The central European shore of the Baltic Sea Region – competitiveness trends over the medium term

- The last decade has been a period of impressive overall performance for the Baltic countries, despite the current deep and costly crisis; they have been remarkably resilient in the difficult adjustment progress
- The crisis is, however, a clear signal that the economic policy approach now needs to be fundamentally reviewed to get on a new, more sustainable growth path
- Macroeconomic policy has been too narrowly focused on meeting the legal requirements for Euro-zone accession, neglecting the medium-term sustainability of financial markets and, in some countries, public finances
- Microeconomic upgrading has been effective in market opening and (mostly) in the adoption of EU rules and regulation; it has largely failed in building distinct competitive strengths and especially in leading to the fundamental upgrading of local companies.
- The combination of success in macroeconomic stabilization and market opening, but failure in increasing the competitiveness of the local business sectors creates a significant potential for macroeconomic overheating
- While EU policy tools (rules and regulations; projects) have been formally adopted, effective implementation is often seen as lagging; this is an area where more technical support through instrument like JASPERS could help
- Poland's better performance during the crisis is not a reflection of higher or more robust competitiveness, but the result of country-specific factors (size, location, less consistent economic policies)
- Poland is not a role model for the Baltic but its strong current position gives it a clear opportunity to upgrade its competitiveness

This part of the State of the Region Report takes a closer look at the developments in the Baltic countries and Poland. While the State of the Region Report usually looks at the current trends in the Region to draw implications for the future, here the perspective is more long-term and covers the last decade. The global crisis has raised questions about the development path in the Baltics and Poland. The Baltics were for a long time the growth champions of the region, while Poland was a relative laggard. Over the last two years, their positions have been reversed. What does that imply for the assessment of the last decade, and what are the lessons to be drawn for the policy approaches needed now in the aftermath of the crisis?

1. Introduction

The global economic and financial crisis has hit the Baltic countries particularly hard. EU member countries in Central Europe in general have suffered significantly. This section will aim to provide some more insights into the lessons that policy makers in the central European parts of the Baltic Sea Region should draw from the painful experience of the last 2-3 years.

There is general agreement on how the global crisis entered the Region. The key transmission channels were global trade and global capital markets. The slow-down in global trade, essentially in demand in key export markets, hit exporters. The rapid drying up of international capital markets and sudden explosion of risk aversion hurt everyone reliant on external finance. The Region, including the Baltic countries and Poland, were not meaningfully affected by the direct exposure of local financial institutions to the US capital markets at the epicenter of the crisis, the third potential transmission channel.

The intensity with which economies in the Region reacted to the negative shocks coming through these two first transmission channels had little direct relation to their competitiveness. Export-orientation is often associated with higher levels of competitiveness. To export, one needs to produce goods and services that are attractive on global markets. And if one exports, there are almost inevitably benefits from the exposure to foreign competition and foreign ideas on global markets. Dependence on external financing is a normal feature of countries in a rapid catch-up process. It is not a sign of competitiveness but it is fully consistent with efforts to upgrade competitiveness by improving the capital stock of an economy.

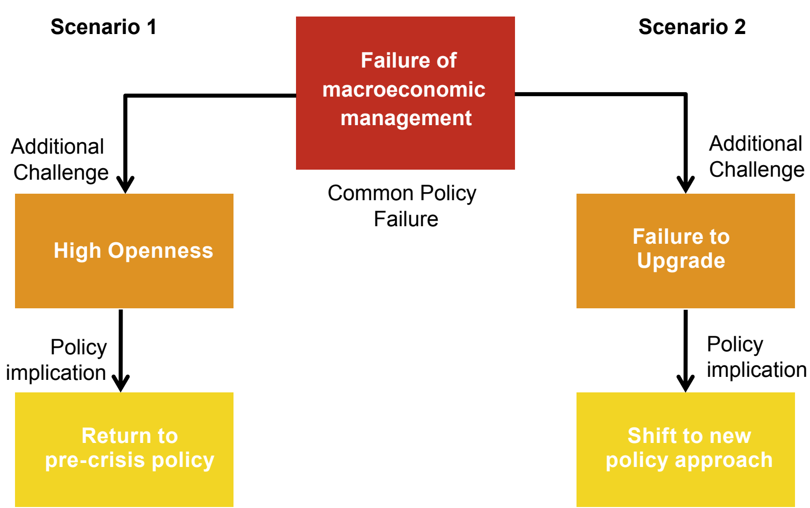
In addition to the shocks coming in from the global economy, the Baltic countries in particular were also struggling with their own home-grown problems. Already prior to the crisis, all three showed classical signs of macroeconomic overheating, i.e. rising inflation, rapid growth in the construction sector, and a strong increase in the debt position of the private sector (companies and households), much of which fuelled by foreign capital inflows. When the global crisis hit, its direct effect quickly multiplied when it led to a collapse of the domestic overheating. The result was a dramatic fall in GDP, following right on the heels of the very high growth rates prior to the crisis.

What are the lessons to be drawn from this experience? How should policy-makers in the Baltic countries take account of these lessons in designing a growth strategy that moves beyond dealing with the short-term management of the crisis? The answers to these questions depend on the interpretation of the turn of events that are described above.

At one extreme, the following interpretation can be heard: the Baltic countries did suffer as small-open economies in catch-up mode. The failure to avoid macroeconomic overheating prior to the crisis, not untypical in countries in similar circumstances, added to the depth of the downturn. But otherwise the fundamentals are positive. EU accession, the programs of the EU, and the activities of the EIB, the NIB, and other international financial institutions have led to a significant improvement in the underlying competitiveness of the Baltics. And local policies have by and large made a contribution to gradually developing the competitiveness of their economies. As the global markets return to normal, the Baltics will be able to recover and eventually return on their previous growth path. The return to normal will take some time because the severe macroeconomic imbalances that had build up prior to the crisis first need to be worked out. And the normality will see somewhat lower growth rates because the pre-crisis growth rates were clearly unsustainable and not a reflection of the growth in potential GDP. For policy makers, this suggests that their focus should be on overcoming the immediate consequences of the crisis and instituting better macroeconomic management. But for their competitiveness strategy, it is continuity that is the best advice.

At the other extreme, the following interpretation is argued for: the Baltic countries did suffer as small-open economies in catch-up mode. The macroeconomic overheating prior to the crisis was not just a failure in macroeconomic management but a reflection of the failure to upgrade microeconomic competitiveness. While wages and demand increased, the capacity of local companies remained largely unchanged. Productivity growth slowed down after the large, but ultimately one-off benefits of first the economic transition and then the preparation for and ultimate accession to the EU. The efforts of the international organizations as well as domestic governments were unable to

The Baltic Countries in the Global Crisis



move beyond creating normal market economy legislation, openness to trade and investment, and providing some infrastructure investment. These efforts supported the growth in demand but were insufficient to upgrade the productivity of the existing company base. As a consequence, imports grew while exports and FDI did not grow with the same dynamism. The global crisis made the problems more visible and acute. But the problems were there already. As the global markets return to normal, the Baltics will be able to recover somewhat, overcoming the cyclical component of the current crisis. But without any changes in economic policy, the growth outlook is bleak. The one-off effects from EU accession are largely gone. The pressure from other countries, ranging from Bulgaria and Romania to Turkey and the Ukraine, is inevitably increasing. And demand from the major markets in Western Europe is likely to remain subdued for a significant period. For policy makers, this suggests that, beyond overcoming the immediate consequences of the crisis and instituting better macroeconomic management, they need to adopt a new growth strategy.

Reality is somewhere between these two scenarios. To better understand where, a number of different perspectives will be introduced in the remainder of this chapter. First, four teams of authors will in the next section review the experience of their respective countries following a common structure. This will provide different perspectives on where individual countries in the Baltics stand. Through the inclusion of Poland, a country that has experienced a different path of economic development over the last few years – more subdued growth prior to the crisis but much higher resilience in the face of the global shocks, further insights into the relative advantages of a different growth model might be gained. Second, contributions from the European Investment Bank (EIB) and the Nordic Council of Ministers (NCM), two of the international organizations that have been active in the region over the last decade, will reflect on the impact of their activities on the region and the lessons they draw in view of the current crisis. The chapter will then close with a reflection on what these different perspectives suggest regarding the two scenarios and their radically different policy implications outlined above.

2. Country chapters

In this set of country-specific articles, leading researchers from the three Baltic countries and Poland have been invited to discuss the economic development of their countries throughout the last decade. All of them have been asked to organize their chapters in four sections: first, describing the economic trends over the last decade, following broadly the framework used in the first part of this Report to look at economic outcomes; second, discussing competitiveness trends, covering both changes and the current profile of strengths and weaknesses; third, followed by comments about the main directions of government's economic policy since 2000; and finally, providing their perspective on possible implications to be drawn.

2.1 Estonia

By Marek Tiits, Dorel Tamm, and Rene Tõnnisson (Institute of Baltic Studies)

The general hope and perception emerging from recent international media coverage is that the global financial and economic crisis is nearly over. The employment figures remain sluggish but financial markets enjoyed extraordinary gains last year and a number of economies have started to demonstrate again quite reasonable growth rates.

In the Baltic Sea Region, the situation also seems to have started to improve after the crisis. The quarterly GDP growth for the countries in the Baltic Sea region in Q4 2009 was not negative anymore but close to 0% or even slightly positive. Estonia is preparing for the adoption of the euro in 2011 - the European Commission has on March 12th given its approval - and the budget crisis in the Southern Europe has overshadowed the woes in the Baltic States. The view that the crisis is nearly over and everything will continue as previously represents a rather comforting outlook. This is a very tempting yet a dangerous way of thinking.

Economic trends, 2000–2009

It could be argued that in general the global financial and economic crisis hit small export led economies harder than bigger nations. In terms of the contraction of GDP in 2009, the economies of the three Baltic States were among the worst hit in the world. The real GDP of Estonia, which grew in 2005-2006 by nearly 10% annually, contracted in 2009 by 14.1%. The very rapid GDP experienced in mid-2000s was accompanied by ballooning current account deficit, which reached 17-18% of GDP. In 2009, in the midst of the deepest crisis, the current account balance turned positive for the first time since the early 1990s.

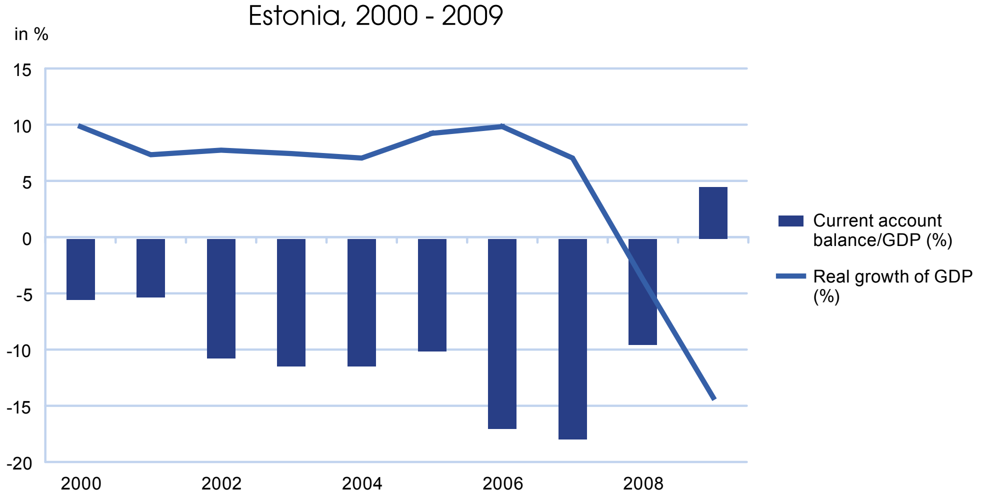
The very rapid economic growth of the Baltic States over the last years was based on the massive inflow of foreign capital. The record low interest rates in Western Europe and in the United States, in combination with the process of EU enlargement, led to a significant inflow of foreign direct investments to the Central and Eastern Europe. In per capita terms, Estonia proved to be one of the particularly attractive locations for foreign direct investment.

In Estonia, the majority of the foreign capital came in form of the reinvested profits rather than new export oriented Greenfield investments. In addition to the inflow of foreign direct investments, there was a remarkable inflow of debt financing. A significant share of the inflow of the debt financing was provided by the Scandinavian banks, which were fighting for their market shares in the Baltic States.

This led to a rapid increase in the gross external debt of Estonia. Almost all of external debt was built up by the private sector while public sector debt remained virtually non-existent. In fact, the public sector ran a budget surplus from 2001 to 2007. Yet, this surplus still proved too small to compensate for the massive inflow of

GDP Growth and Current Account Balance

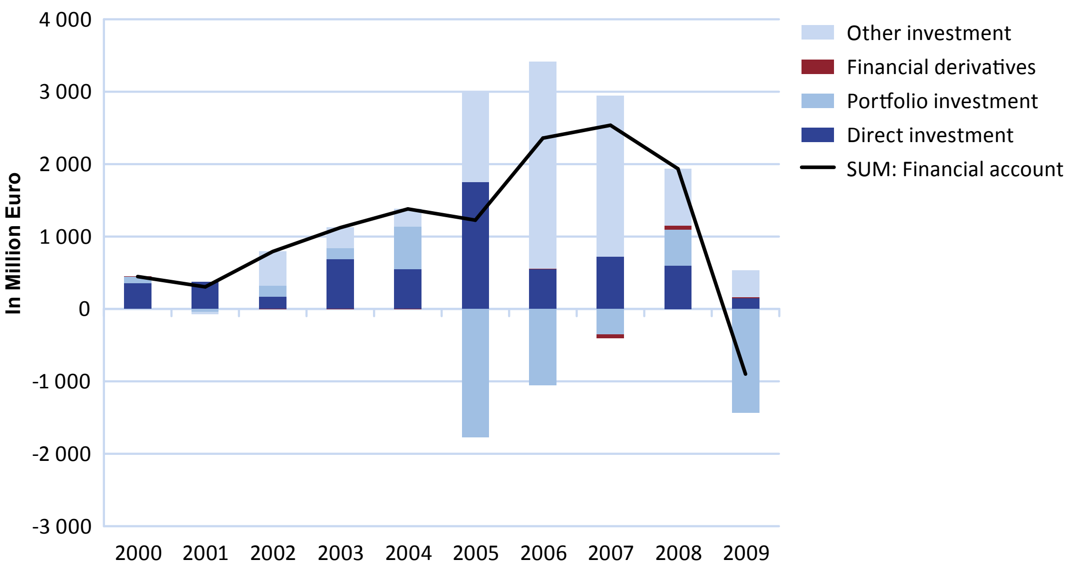
Estonia, 2000 - 2009



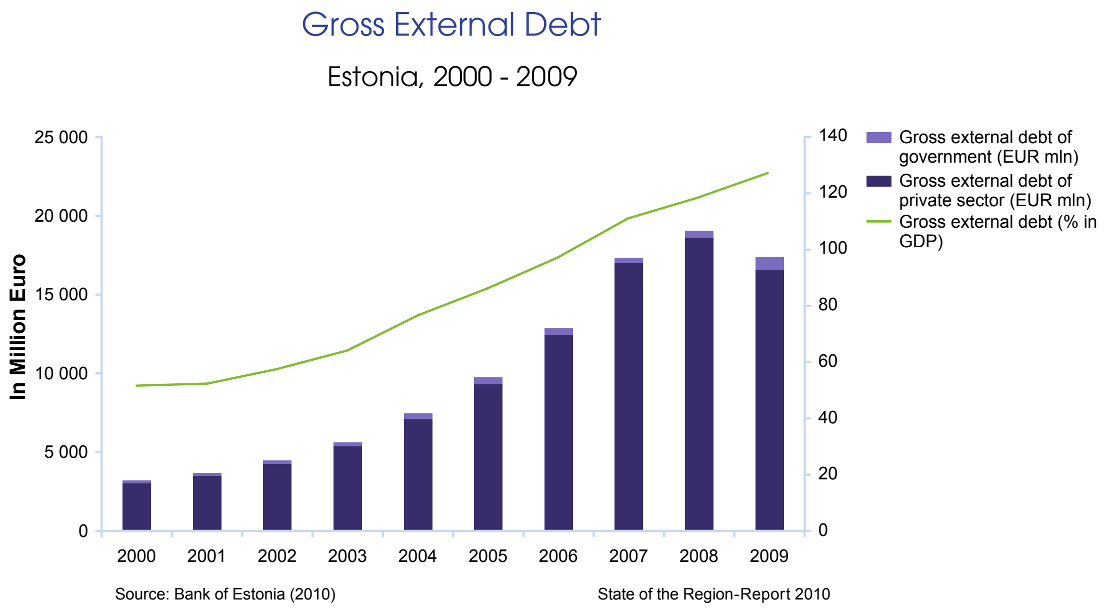
Source: Bank of Estonia (2010) State of the Region-Report 2010

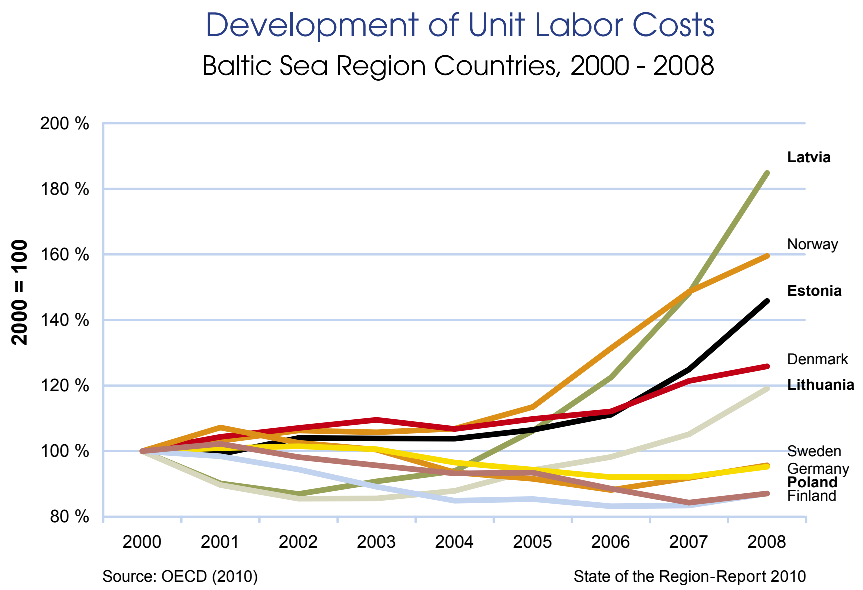
Structure of Foreign Capital Inflows

Estonia, 2000 - 2009



Source: Bank of Estonia (2010) State of the Region-Report 2010





debt financing and to cool down the increasingly overheated economy.

The inflow of capital, which came at record low interest rates, triggered major asset and consumption booms in Estonia that led to large current account deficits reaching 17.8% of GDP in Estonia (in 2007). The domestic consumption fuelled growth that triggered a very rapid asset and wage inflation. In 2008, consumer prices grew more than 10% and the average annual growth of gross wages and salaries was 12.6% during the period 2000-2008, reaching 20% in 2007 compared to 2006.

One might argue that this was a time of record high fuel prices and this might have externally triggered inflation. Yet there were also very influential domestic factors, as especially after 2005 wage growth had outpaced significantly the productivity growth in industry. Unit labor cost (ULC) increased by 37% from 2005 till 2008 in Estonia. The increase in unit labor cost was in all three Baltic States remarkably more rapid than in Germany where ULC increased 7% or in the Euro area in average where the increase was 4% during this period.

In 2008, the earlier rapid GDP growth turned into a severe crisis. For Estonia and the other Baltic countries, the global financial and economic crisis was a perfect storm, hitting their weakest spots. In the Q4 2008, the global financial crisis led suddenly to the reversal of the flows of foreign capital. The earlier inflows of finance to the Baltic States suddenly turned into outflows, while the demand on the export markets contracted as well.

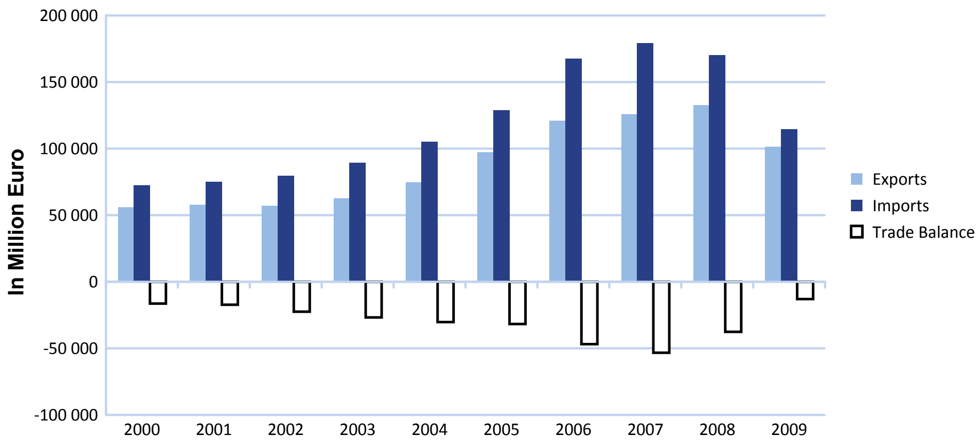
Throughout the 2000s, Estonia has had difficulties closing its trade deficits. For a country in catch-up mode, a modest trade and current account deficit is perfectly natural if it is driven by imports of new technologies and machinery. The associated increase of export capacity will then ultimately turn the trade balance into surplus. For Estonia and its Baltic peers, unfortunately, this never happened. It could be therefore argued that the Estonian industry was never strong enough to cater fully for the imports of the investment and consumption goods. When the domestic real estate and consumption boom started in the mid 2000s, it became even harder to earn sufficient export revenues. This way, the Estonian economy was pushed to a highly vulnerable position. Overheating domestic demand and an eroding cost position of exports contributed to a trade deficit of between 30% and 40% of GDP in the period between 2000 and 2008. During the crisis, the currencies of the neighboring non-euro-based economies depreciated by 20-25% and global export demand slumped. Estonia's exports declined in 2009 compared to 2008 by about 25% but the simultaneous drop in domestic demand led trade deficit shrink to 12.8% of GDP.

In order for Estonia to sustain in the course of the crisis its 2007 level of GDP and to compensate for the previous inflow of capital, its export revenues would have needed to increase twofold overnight. This would have been, obviously, an unachievable target for any country to actually meet. In reality, the decrease of exports led also to the decreased domestic demand for imported inputs and goods. With this, the negative trade balance diminished and the external shock was transmitted to the domestic market.

The gap between wage and productivity levels became even more visible and severe during the economic crisis. Normally, it would be preferable to close the gap between revenues and salaries by increasing the productivity of the existing businesses. In the fixed exchange rate regime, broadly based wage cuts throughout the economy would be an alternative way out of such situation. Yet, the 20-25% wage deflation, which would have been needed, takes a lot of time to actually start and to roll out throughout the economy. Also, the employers are normally keen to sustain at least their best personnel during difficult times. Therefore, the hourly wage costs declined even in 2009 very little, while the enterprises cut their labor costs primarily by decreasing their personnel numbers. The latter led to a very rapid increase of unemployment.

External Trade Values

Estonia, 2000 - 2009



Source: Bank of Estonia (2010)

State of the Region-Report 2010

Table. Wages and Unemployment in Estonia, 2000-2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Annual change of average gross wages, %	.	12.3	11.5	9.4	8.4	10.8	16.5	20.5	13.9	-2.9*
Unemployment among aged 15-74	**13,6**	**12,6**	**10,3**	**10,0**	**9,7**	**7,9**	**5,9**	**4,7**	**5,5**	**13,8**

Source: Statistics Estonia, authors' calculations

The economic crisis led to major decline of the export revenues, consumption and government revenues. To avoid a huge public deficit, the government was forced to reduce the annual budget of 2009 several times, and the total cut in the expenditure reached 10%. To present the above massive cuts in a positive light, Estonia was said to have become a "World Champion" in cutting the state budget. Yet this also meant that the decline of the government spending was to foster the decline of the GDP even further.

The economic crisis led to an increasing economic, regional and societal polarization in Estonia. The situation is better in the capital city and bigger regional centers as they have always had a larger role in the international trade and services but also in the provision of public services. The more remote regions, which lack a strong exporting industry, are in deep trouble. The decline in domestic consumption and increase in unemployment have hit these parts of Estonia harder than other parts of the country.

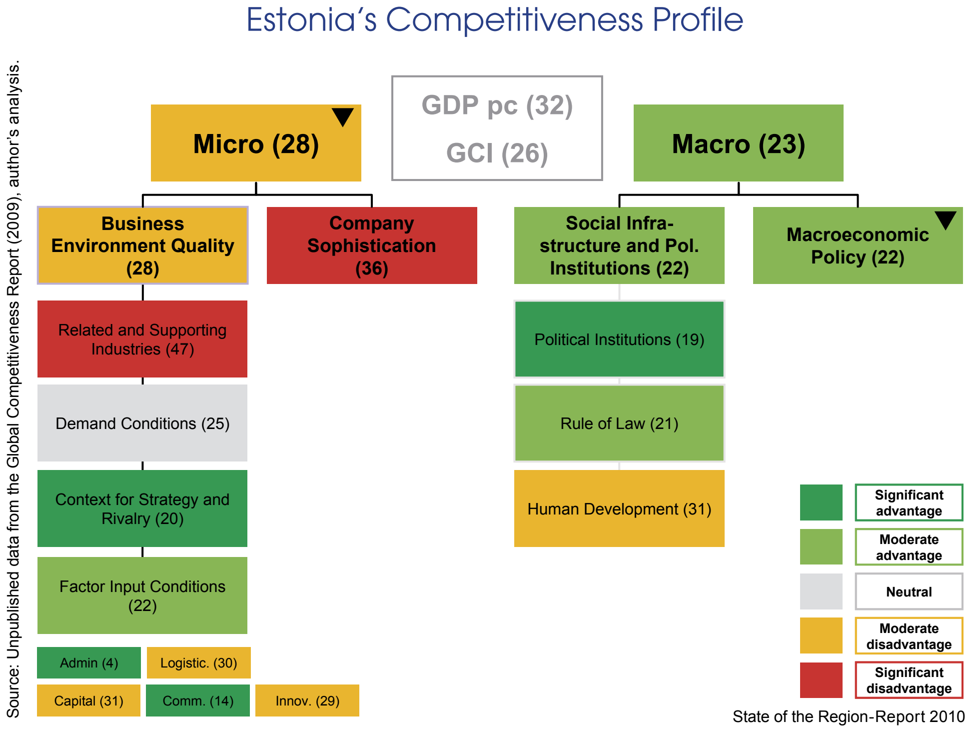
The current hardship in Estonia, especially in the more remote parts of the country, is just a part of a much broader pattern across the peripheral Europe from the Baltic States or Greece to Spain or Ireland. All these countries have faced a similar externally fuelled consumption booms that have now went bust. The earlier period of excessive consumption was in some countries public deficit led, in other cases private debt led. The commonality is, however, that the exporting industries of these economies were not strong enough to earn enough export revenues. Now that there is no way for an excessive domestic consumption led growth to come back, the future job creation and economic growth will depend fully on the increase of the competitiveness of these economies.

Competitiveness trends, 2000 - 2009

In the Global Competitiveness Index (GCI), which covers the competitiveness of individual economies among more than 130 economies, Estonia has throughout the decade retained a relatively stable position on the borderline of the 25 most competitive economies. Estonia's relative strongholds have been the low burden of government regulation, low level of corruption, ease of starting new businesses and the success of government in promotion of ICTs.

Estonia scores high for its political institutions. Variables such as rule of law and national business environment have moved side-by-side with the GCI. The rule of law and the generally favorable business environment is a prerequisite but not a sufficient condition for a continued economic growth and the increase of living standards. Economic development entails normally for a gradual increase in the sophistication of the business strategies, technological innovation and the evolution of clusters around major exporting industries. This is what makes an economy truly dynamic and prosperous.

Broad take-up of ICTs, both in the public and private sector, is an area where Estonia has really excelled. Estonia's R&D spending has increased very rapidly in recent years thanks to the increase of government appropriations but also due to the rise of wages. The growth in the number of personnel dedicated to R&D has been much more modest. The limited availability of qualified labor, including scientists and engineers, remained one of the most significant impediments to development throughout the decade. Estonia's industry is dominated by low and medium-tech industries, which are by their very nature not very R&D intensive. Even if the increase in R&D investments will not bring an immediate positive impact on the GDP growth, the continued investment into R&D remains crucial



for maintaining and increasing the quality of higher education, further upgrading of the competitive advantages of the industry and supporting economic development in the long run.

One of the most important weaknesses of the Estonia's business environment has been the rigidity of labor markets and especially the insufficient availability of qualified labor, including scientists and engineers. A number of reports highlighted the mismatch between the supply and demand of the education and skills. The situation has slightly changed during the economic crisis, which provided enterprises with the opportunity to choose employees from a wide pool of applicants instead of operating in an economy with almost full employment.

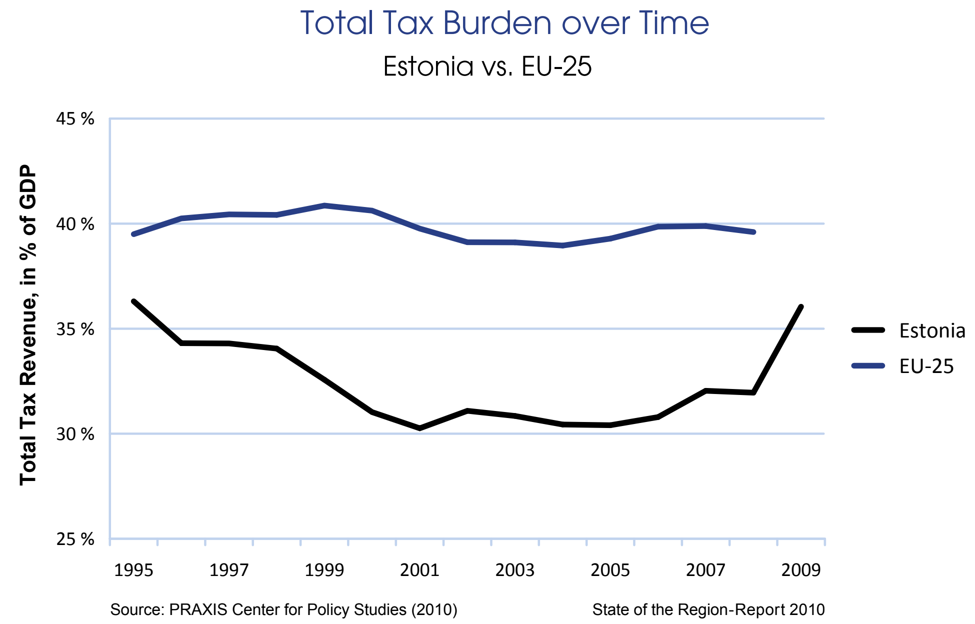
The extent of domestic clustering in Estonia remains low. This has partially to do with the low specialization of the existing enterprises and partially with a very small size of the economy. Also, a substantial number of earlier supply relationships were significantly changed or even ceased to exist entirely as the economic crisis triggered a major restructuring of the economy.

The business strategies of Estonian companies, which were not very sophisticated in the early 2000s, degenerated even further during the recent boom years. Domestic demand supported sales of products and services, which did not require a lot of knowledge intensity and R&D to develop and produce. The incentives for conquering foreign markets were, during the boom years, not as important as they are now. But now, enterprises lack the advanced scientific and technological knowledge and the management skills needed for successful entry into the foreign markets.

Policy trends, 2000 - 2010

The preparation for the EU membership was clearly the dominant theme of Estonia's public policy in the first half of the 2000s. Rapid adoption of the acquis communautaire was an important part of this process. The harmonization of laws and standards brought about the need for new investments and upgrading the existing competitive advantages. This effect was, for example, very visible in relation to the food safety and environmental standards, which necessitated and continue to necessitate major investments in the adoption of new technologies.1 Unfortunately, it sometimes this also led to overinvestment as shown by the currently existing, but unused, capacities in several food industry enterprises. So technological upgrading alone did not necessarily lead to higher competitiveness in foreign markets.

1 See also: Marek Tiits *et al*, *Made in Estonia*, Institute of Baltic Studies, Tartu, 2005, http://www.ibs.ee/MiE.



In 2000, a new tax regime was put in place. It relieved enterprises' reinvested earnings from corporate income tax as the corporate income tax was applied only to profits distributed to shareholders. The decrease of the already relatively low taxation rate also continued to be a prominent policy objective. This was a major incentive to foster investment and capital accumulation in Estonia, perhaps with some inspiration from US economic policies at the time. The increase of the attractiveness of Estonia to indigenous and foreign investment was an important consideration. It is, however, clear that in the current economic situation, where Estonia does not have a significant cost advantage anymore, other factors besides taxes start to play a more important role in attracting foreign investments.

During the 1990s, Estonia had a relatively modest number of public support programs for entrepreneurship, technological development, exports, etc. In parallel to the launch of the EU Lisbon Agenda in early 2000s, innovation and economic development policies gained a lot of importance in Estonia. A full range of business development programs has been put in place. Both the EU Lisbon Strategy and the introduction of the EU Structural Funds were instrumental in changing the mentality and introducing relatively stable policy programs. These programs operate on the basis of multi-annual budget allocations and are directed at enterprises to support the development of more knowledge-based products. Overall, perhaps even too many different new incentives have been put in place in a rather short period of time, and it seems that not necessarily all of these function in a most effective way.

The above objective of capital attraction was met very well. But the combination of the above tax cuts, fixed exchange rate regime, massive inflows of foreign finance and the annually balanced state budget, produced for the mid 2000s, a strongly pro-cyclical economic policy regime.

When the global financial crisis hit, the public sector response varied very significantly from country to country. Some countries were very slow to take any action. Some countries were trying deliberately to use the government spending for preserving the industrial capacity and employment. Estonia prioritized, driven by the transition experience of the early 1990s, the stability of the financial system foremost. At its heart is the planned adoption of the euro in 2011 to avoid any future exchange rate risks. Accession to the Eurozone also has a political dimension as it would come as a major achievement ahead of the general elections scheduled for spring 2011.

Driven by these considerations, re-balancing the state budget to meet the Maastricht criteria became the single most important policy objective in 2009. In parallel, the longer-term budget strategy, which includes the strategy for the use of EU Structural Funds, was revised to be able to meet the crisis. The budget allocation for (re)training, development of technology and exports was increased in the situation where almost all other public spending and costs were cut.

One might ask if the response to the crisis could have been different. Maybe the government should have taken stronger contra-cyclical measures. Perhaps even the Maastricht criteria at the European level could have been modified to allow temporarily for a greater public deficit. The pro-cyclical economic policy of Estonia, applied prior to the global crisis and the excessive dependence on foreign finance, made the economy very vulnerable to external shocks. When the global financial and economic crisis hit, room for maneuvering proved to be very limited.

Implications

The main challenge for Estonia today is how to regain its competitiveness through finding new competitive advantages to reduce unemployment and regional disparities instead of relying on cost advantage as previously.

The prospective of introducing the Euro in Estonia at the beginning of 2011 could certainly be viewed as an important step towards economic recovery as this will increase investors' confidence, overall financial stability, reduce transaction costs, etc. However, it is clear that it will not be a panacea and will not automatically solve the fundamental problems of the Estonian economy described above. It should be viewed as necessary but not a sufficient condition for progress in the next economic policy planning framework.

The key to long term competitiveness of Estonian economy lies in the capacity of Estonian companies to compete on innovation. Innovation capacity provides central input for increasing productivity and competitiveness of Estonian industries. While individual firm strategies will of course constitute a crucial part, the role, which the public sector could and indeed should play in this process, should not be underestimated.

One of the key challenges that have hampered the competitiveness of both Estonian companies and the public sector is access to qualified human capital. This will, without a doubt, remain a key challenge for the next years to come, also considering the current demographic trends. Development and reform of the education and lifelong learning system has to be one of the core pillars of Estonian public policy. This is key for unleashing the entrepreneurial spirit and laying the grounds for bringing new products and services of Estonian origin successfully to various foreign markets.

The measures which have been taken by Estonian governments during the last years to stimulate the microeconomic competitiveness of its companies, in particular its exporting industries, should be further developed and adapted to the changed economic realities. Even more importantly, the co-ordination and effectiveness of the existing entrepreneurship, technological development, and export support programs should be improved considerably. A thorough evaluation of the effectiveness of these efforts needs to be undertaken, analyzing the impact of the existing policy programs from the perspective of the needs of the existing major industrial clusters. Better understanding of the challenges faced by the enterprises operating in the main exporting industries will, in turn, allow a better focus of the various public actions from education and labor market policies to entrepreneurship and innovation.

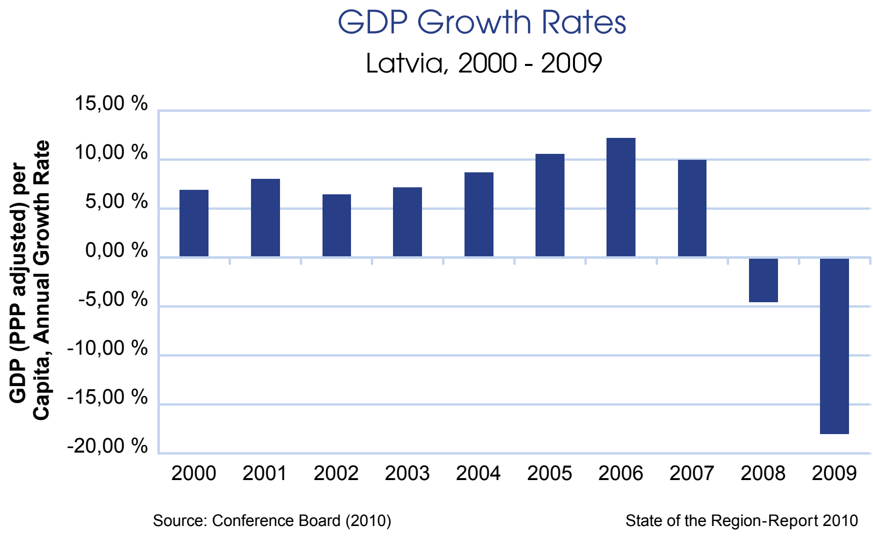
Finally, we would like to stress that the process of integrating Estonian economy into global value chains, as well as into the cross-border clusters in the Baltic Sea Region, should continue. The economic development policy of Estonia should focus on enabling the process of upgrading Estonian industries and helping them participate in more sophisticated and higher value added economic activities than the current subcontracting role that many industries in Estonia have played so far.

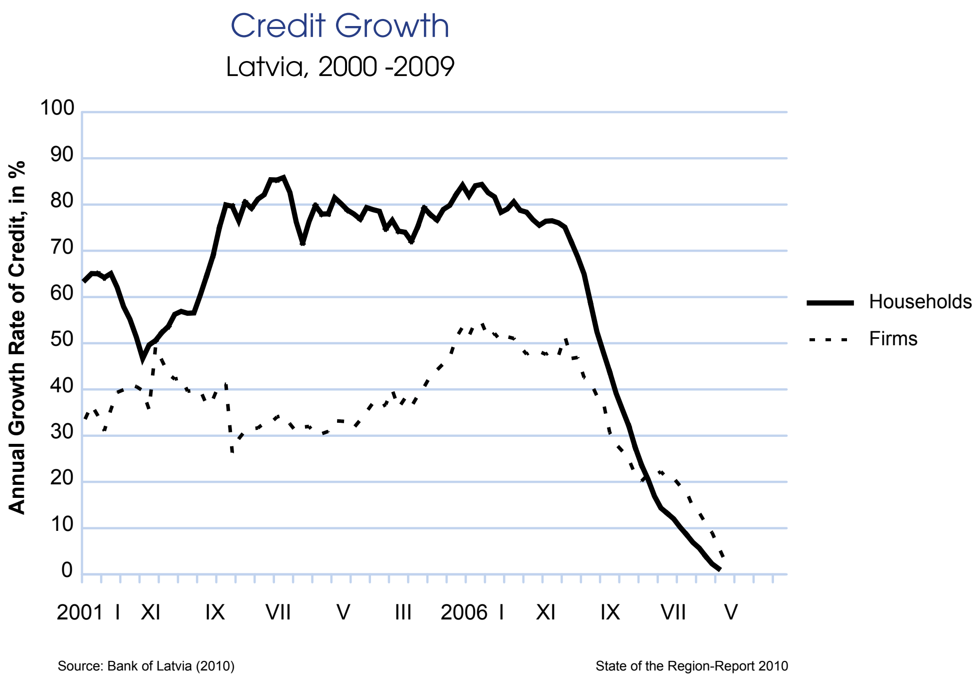
2.2 Latvia

By Alf Vanags and Morten Hansen (BICEPS, SSE Riga)

Economic trends, 2000 – 2010

At the macro level, Latvian economic developments have been dominated by the most spectacular boom/bust episode in the European Union. Until the financial crisis, the country saw the





highest growth rates in the EU in 2004, 2005 and 2006. The situation is now reversed, with a major decline in economic activity in 2008 and 2009 and some of the worst indicators in the EU.

The boom brought about a quite substantial degree of convergence as Latvian GDP per capita rose above 50% of the Union's average with Latvia surpassing Poland but remaining relatively poor as the Union's 24th richest economy on a per capita basis. With the massive GDP decline of 2009, Latvia will again find itself below Poland and only ahead of Bulgaria and Romania.

The boom was associated with substantial productivity growth, both in terms of productivity per worker and productivity per hour worked, but, with the onset of the crisis, productivity has declined sharply – more so in terms of productivity per worker than per hour. This is common everywhere and reflects the fact that even in the face of massive demand declines, firms' fixed costs have to be covered. However, in Latvia, this may also be the result of labor hoarding in the face of high firing and hiring costs and, we suspect, may partly reflect a move from the official to the grey economy.

The high GDP growth rates were also the result of increased employment and a steadily declining unemployment rate. At its peak, at the end of 2007, employment was almost 25% above its 2000 level and the unemployment rate had dropped below 6%. As can be seen, the subsequent bust has resulted in a dramatic rise in unemployment. Employment too has fallen and, in 2009, fell below one million for the first time in many years.

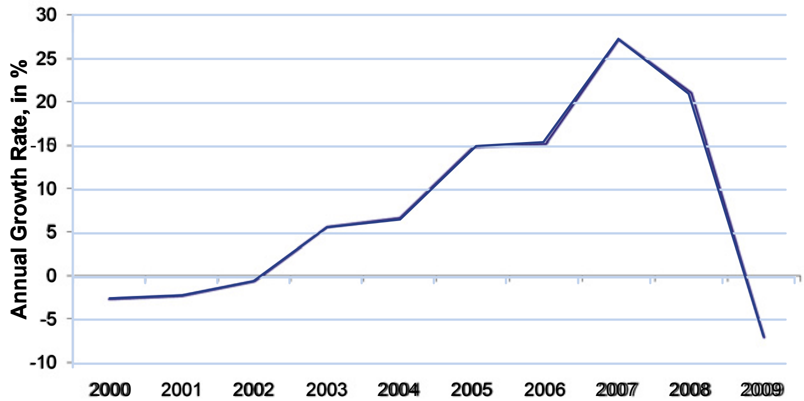
The boom was largely a credit-driven demand side phenomenon with staggering growth rates in bank lending. The first decade of this century gave birth to a banking system, saw it mature and eventually get into a deep crisis as the world financial crisis turned into also a domestic financial crisis. The consumption and real estate features of the boom can be seen in the evidence that credit growth to households was for several years twice as high as it was for businesses.

Productivity growth was significant but possibly driven more from catching up effects and less from innovation. R&D spending, as a share of GDP, has always been low by EU standards and, although government policy planned for an increase to 1.5% of GDP by 2010, this seemed optimistic even in the boom years when it remained below 1% and in 2008 was 0.61%. The government now has 2015 as the target date for this indicator.

As the labor market tightened during the boom, wages, and thus costs, increased dramatically and the growth of labor costs soon outstripped productivity gains resulting in rising unit labor costs (ULC). Combined with developments in exchange rates, this resulted in an appreciation

Unit Labor Cost Growth

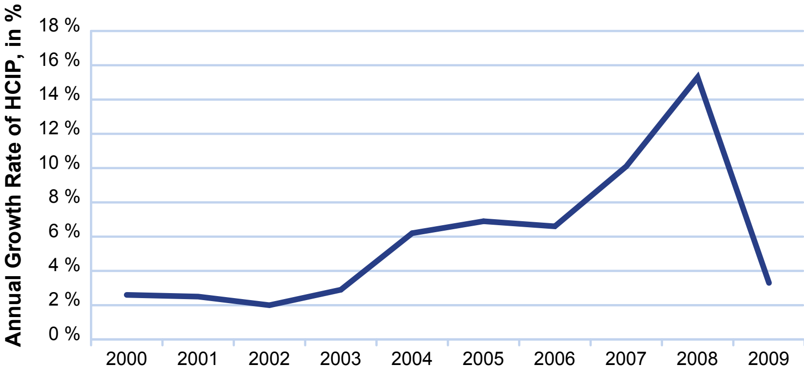
Latvia, 2000 - 2009



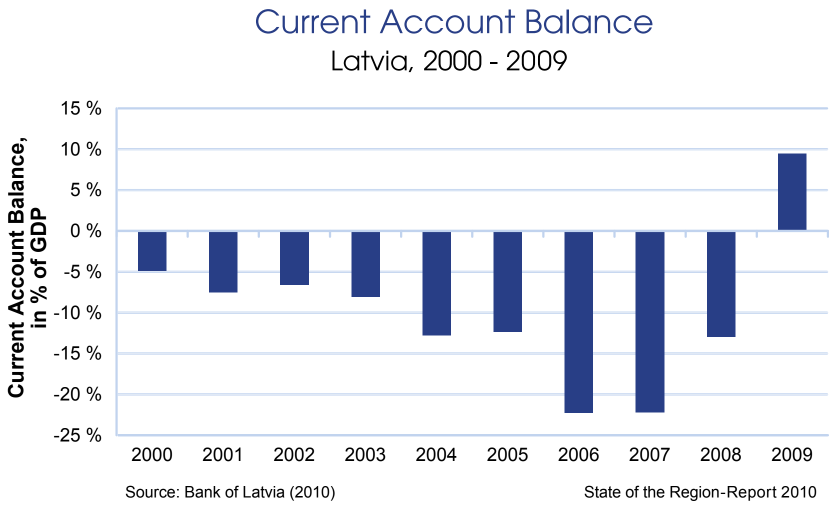
Source: Bank of Latvia (2010) State of the Region-Report 2010

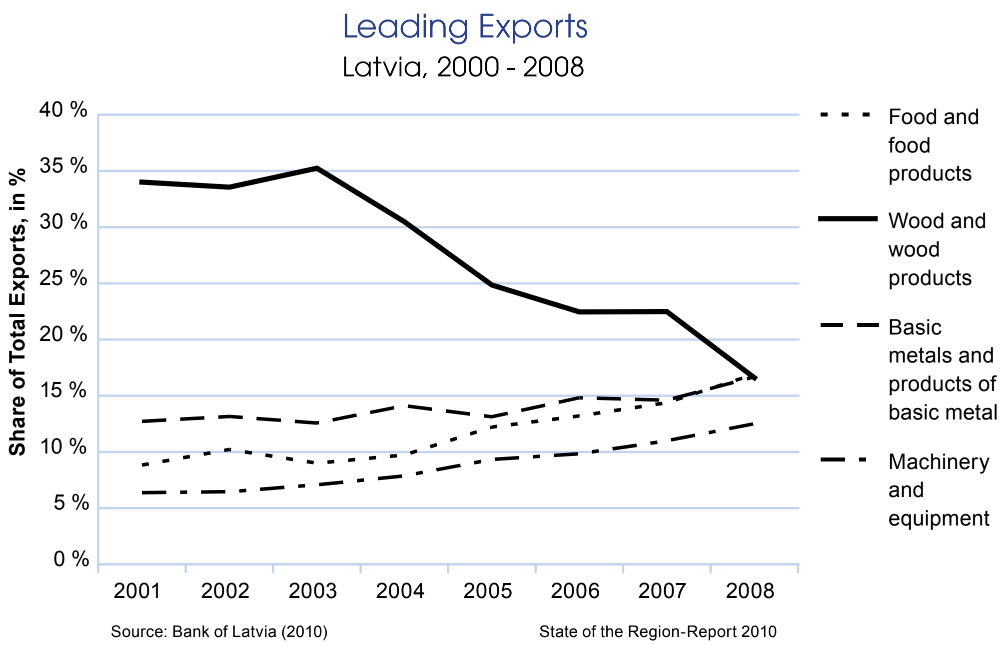
Inflation

Latvia, 2000 - 2009



Source: Bank of Latvia (2010) State of the Region-Report 2010





of the real effective exchange rate by over 60% between 2000 and the second quarter of 2008. In the current situation of high unemployment, wage growth has reversed with Latvia on a path of 'internal devaluation', which has resulted in a depreciation of the real effective exchange rate by about 10% from the 2008 peak.

During the overheating period, the tightness of the labor market was exacerbated by outward migration due to still higher wages and a high demand for labor abroad. A mitigating factor for the labor market in the current downturn is continuing outward migration. On the other hand, the migration gives rise to concern that Latvia will permanently lose some of its best young people.

The tight labor market and the subsequent increases of ULC had a spillover effect to inflation just as now falling ULC contribute to deflation.

The massive credit boom was associated with a housing boom and also a consumption boom with the latter leading to a dramatic worsening of the current account. Again, the reversal of the situation has seen an import collapse, which has improved the current account. However, it should be noted that the current account surplus of 2009 still contains a deficit on the goods balance.

The composition of foreign trade did not change much over the post-2000 period with the same commodity groups occupying the top places in exports and imports. However, it is notable that the Latvian economy now relies much less on wood and wood products in its exports than it used to and this is one major result of the loss of competitiveness plus a general decline in wood prices. At the same time, the share of other traditional exports has increased – most noticeably for food products whose share in total exports has doubled.

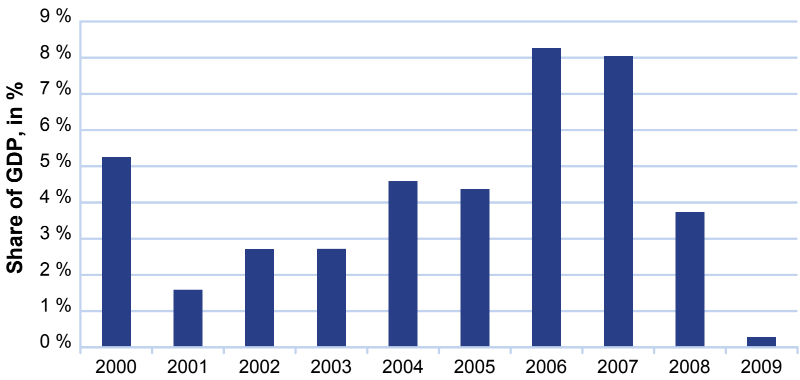
Leading Destinations for Exports

Latvia, 2000 - 2008

Source: Bank of Latvia (2010) State of the Region-Report 2010

FDI Inflows

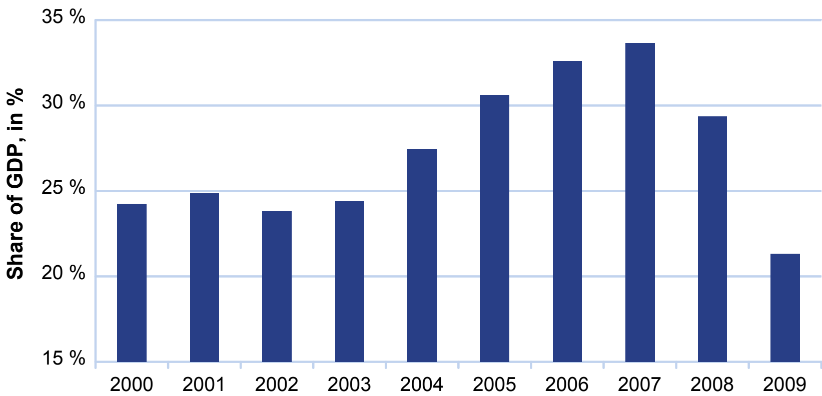
Latvia, 2000 -2009



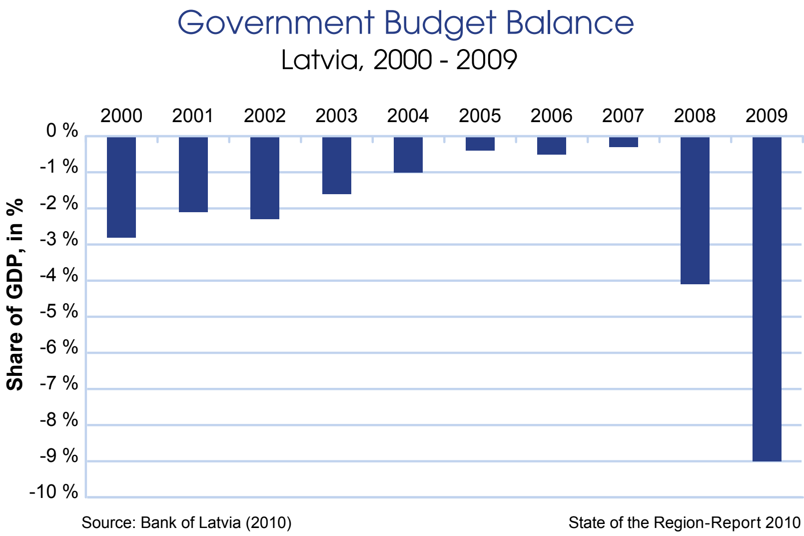
Source: Bank of Latvia (2010) State of the Region-Report 2010

Gross Fixed Capital Formation

Latvia, 2000 - 2009



Source: Bank of Latvia (2010) State of the Region-Report 2010



In terms of trading partners, the changes have been more noticeable. In particular, it is notable that Latvia trades substantially more with its Baltic neighbors, especially with Lithuania, which is now Latvia's main trade partner both for exports and imports. This should be seen as a (successful) EU integration story: with EU membership, trade with the neighboring Baltic countries has become easier and thus more widespread. The UK is now a much smaller export destination than it used to be which reflects the relative decrease in wood exports.

The boom brought increases in both FDI and fixed capital formation whereas the recession has seen both virtually dry up.

Lastly, a look at fiscal policy: the boom years saw diminishing but continuing budget deficits. Given the patterns of GDP growth, this reflects highly pro-cyclical fiscal policy In fact, Latvia was running increasingly large structural budget deficits, reaching 8% in 2007, according to calculations by the Latvian central bank, Bank of Latvia.

Summing up, Latvia enjoyed a massive boom, the Union's biggest, up to 2007-08 but it also experienced the biggest imbalances. The boom was associated with a spectacular property price bubble fuelled largely by credit, much of it borrowed in Euros. Thus, it is not surprising that the economy was hard hit when the world financial crisis struck.

In December 2008, a 27-month Stand-by agreement was agreed with the IMF, the EU, the World Bank, EBRD and individual donor countries. At around 35% of 2008 GDP, it is one of the largest of such agreements and its purpose is to stabilize the financial sector and to finance fiscal deficits while the government consolidates the budget. The agreement supports the Latvian commitment to the fixed exchange rate and the exit strategy is seen as euro adoption by 2014.

Competitiveness trends, 2000 – 2010

The Global Competitiveness Index (GCI) compiled by the World Economic Forum offers the most comprehensive coverage of international competitiveness developments. On GCI indicators, Latvia is often ranked in the 40s or 50s[2]. In discussing Latvia's performance, it is of interest to identify a) areas where this is different, b) areas where Latvia's ranking has changed significantly and c) areas where rankings are diverse.

According to the rankings, Latvia has seen its microeconomic as well as its macroeconomic competitiveness ranking deteriorate in 2009 and this is not strange given the rather tumultuous events of 2009, politically and economically.

Overall the development of the past decade has not been disastrous for Latvia but certainly does not contain many success stories either. In a sense, the development of Latvian GCI indicators reflects rather well the nature of the boom – the rapid rise

2 Latvia's GCI performance for 2003 should be treated as an outlier – it consistently provides 'much better' rankings than in previous or subsequent years.

of Latvian GDP was not associated with any meaningful improvement in the underlying economic fundamentals. Some interesting observations are:

- Technology-oriented indicators such as FDI and technological transfer have deteriorated and, although the link to internet users (high and improving) may not be strong, one may still question why they move in opposite directions
- Internationalization of firms is down and all scores regarding clusters have deteriorated
- In education, Latvia scores well on secondary and tertiary enrolment and has consistently done so (rather typical for Eastern Europe) but going up a level or two (Quality of research institutions, Quality of the educational system, Quality of management education etc.) rankings are markedly lower, suggesting that while quantity does very well (enrolment), quality remains a problem

It is also worth noting the rather low ranking of rigidity of employment, which contrasts with the otherwise flexible Latvian labor market in terms of wage bargaining and trade union density.

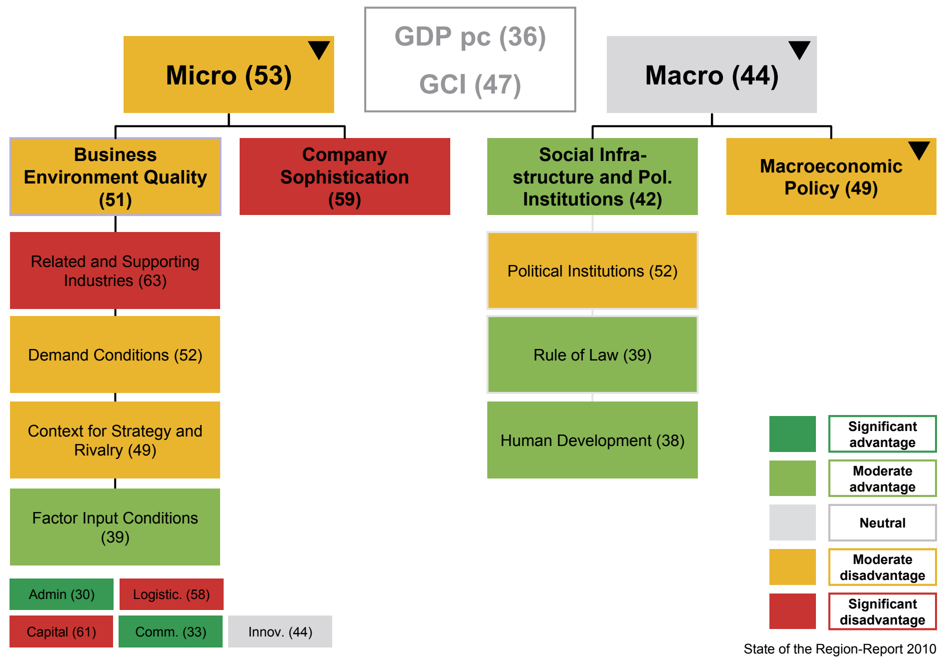
As 2009 was, to say the least, a very special year, one should perhaps not put too much emphasis on what seems to be significant deterioration of rankings related to political institutions. Given the magnitude of the recession, it is obviously difficult for the government to improve its score on an issue such as Government effectiveness in reducing poverty and inequality. But one should obviously be concerned if this temporary deterioration becomes permanent.

Other evaluations of competitiveness and its constituent parts are also available and here the evidence often complements or reinforces the GCI indicators. For example, in terms of the composite indicators of the European Innovation Scoreboard (EIS), Latvia has always performed poorly and in the latest edition, from 2009, only Bulgaria is ranked lower among all EU countries. At the same time, Latvia's rate of improvement is above the EU27 average, though we are entitled to doubt if this will continue since two of the main drivers of improvement are identified as strong growth in 'public R&D expenditures' and in 'private credit'.

One interesting performance measure is the World Bank Logistics Performance Index (LPI) where Latvia, at 37, is ranked above both Estonia (43) and Lithuania (45). This is good news for Latvia since, with a share of total value added in excess of 10%, transport and logistics is in the economy as large as the entire manufacturing sector.

In summing up we have to conclude that overall Latvia ranks very much like its GDP per capita: Low.

Latvia's Competitiveness Profile



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

State of the Region-Report 2010

Policy trends, 2000 – 2010

Economic policy can be thought of in terms of two dimensions: macroeconomic and microeconomic or structural. At the macro-level, an irresponsible and highly pro-cyclical fiscal policy contributed significantly to Latvia's boom and subsequent bust. The imbalances were striking: at various times during 2005 – 2007, Latvia had the European Union's highest GDP growth rates, highest wage growth rates, highest inflation, largest credit expansion, biggest house price increases, biggest current account deficit as well as the highest private sector debt to GDP in Eastern Europe. Currently, on the contrary, Latvia faces the biggest drop in GDP, the Union's most severe wage and price deflation, the biggest housing price collapse as well as a forty percentage point change in the current account balance in just a little over three years.

This section tries to highlight some of the major features of economic policy that led to this rollercoaster macroeconomic development.

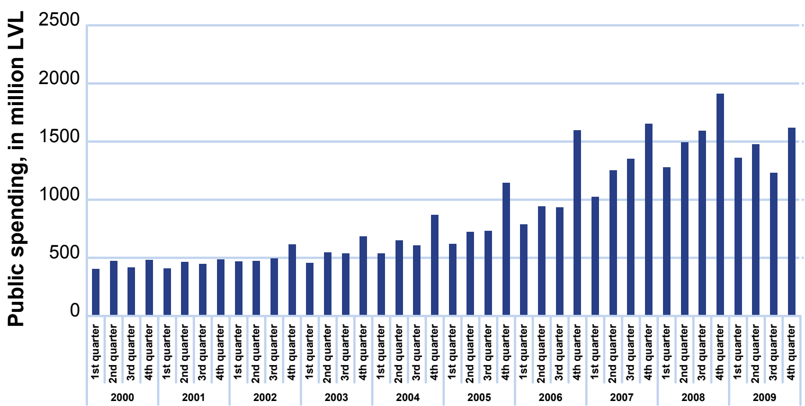
Latvia's fiscal policy was not only highly pro-cyclical but suffered also from 'budget seasonality'. During the years of high growth, windfall tax revenues appeared but as the graph shows these windfall revenues were hastily spent. Already from 2002, it is apparent that fourth quarter spending is abnormally high and for 2005 – 2008 this reaches absurd levels. This seasonality reflects two undesirable features of Latvian politics and policy making. Firstly, the nature of coalition politics in Latvia meant that in the boom years, the windfall revenues resulted in a series of annual supplementary autumn budgets that funded a political dividend for ministers in the coalition. And secondly, the rigid annual budgetary framework meant that allocated expenditure had to be spent by December 31st.

There were warnings from the IMF, the EU Commission, the Central Bank and some economists but this advice was largely ignored and the 'Plan to Combat Inflation' of March 2007 was correctly referred to by Danske Bank as 'Too little, too late'.

The tax structure, with no capital gains tax, heavily supported the move from traded to non-traded (mainly real estate) economic activity and, in general, the tax windfalls helped mask a very narrow tax base that had no tax on interest income, no serious tax on real estate, as mentioned no capital gains tax, no tax on dividends and relied on a (virtually) flat tax on income as well as on social taxes.

Latvia could not have avoided the whole credit boom – low interest rates were imported from abroad. But had a credit register been created earlier than 2007, some of the worst excesses might have been avoided.

Government Spending by Quarter
Latvia, 2000 - 2009



Source: Bank of Latvia (2010)

State of the Region-Report 2010

We would also, partly from personal experience, put some of the blame for the overheating on a poor debate climate where negative comments were often perceived as 'unpatriotic'.

At the microeconomic level a key national policy document since 2005 has been the National Lisbon Programme of Latvia (NLP), originally defined for 2005-8 and then updated to 2008-10. The key policy directions of the NLP are:

- securing macroeconomic stability
- stimulating knowledge and innovations
- developing a favorable and attractive environment for investment and work
- fostering employment
- improving education and skills

This is not the place for a comprehensive evaluation of the Latvian NLP but needless to say there have been some spectacular failures, most notably the failure to secure macroeconomic stability despite persistent formal recommendations by the Commission to address this issue. Targets have frequently been overoptimistic e.g. the aim to achieve R&D expenditures at 1.5% of GDP by 2010; implementation has been weak e.g. Latvia has persistently lagged in implementation of a modern system of lifelong learning and more recently in terms of developing a flexicurity approach to the labor market; and, in some areas, there has been an unwillingness to take meaningful action e.g. in reducing the prevalence of undeclared work.

Implementation of microeconomic/structural policy has been left largely to the structural funds and, in fact, more than 56% of the expenditures of the 2007-13 programming period are aimed at expenditure supporting the NLP and, in the case of innovation and entrepreneurship ,95% of expenditures are aimed at NLP targets. How effective have the funds been and how effective will they be in the new programming period? The experience of the 2004-6 programming period (which in practice ended in 2008) is still subject to ex-post evaluation and the impacts still have to be fully realized. Here, it is unfortunate that the recession will cloud the analysis of impact. Macro-modeling suggests that the funds had a significant impact on the economy though this depends on the degree to which the funds crowded out private investment. At other levels interpretation is less certain. For example, in terms of innovation, the 2009 Summary Innovation Index of the European Innovation Scoreboard places Latvia in second last place in the EU27 – only Bulgaria is ranked below Latvia. Another indicator is venture capital – Latvia quite promisingly included funding of venture capital in its European Regional Development Fund programs. Nevertheless, in terms of outcome in 2007/8, venture capital intensity in Latvia was one eighth of that in Hungary in terms of venture capital as a share of GDP, and one ninth in terms of venture capital per capita. In terms of the latter, the Latvian figure was just one thirtieth of the Finland indicator. So, there is a long way to go.

Lastly, as a very crude indicator, one may question Latvia's commitment to and focus on long term development by noting that during the first decade of this millennium Latvia had no fewer than seven economic ministers.

Implications

If the Baltic countries, as a whole, have been the hardest hit in Europe by the recession, then as has been shown, on all indicators such as GDP, unemployment, or property price decline, Latvia has been the hardest hit of all. The discussion of policy developments such as 'benign fiscal neglect' (or alternatively just plain 'fiscal irresponsibility') together with the inability to take Latvia from close to the bottom, in terms of innovation indicators, or the very modest development of venture capital financing suggests that as the general recovery takes hold, as it surely will, Latvia may not be well placed to resume a path of rapid catch up. Indeed, the boom years may well come to be regarded as the 'lost decade' in terms of real structural progress. In other words Latvia appears to be closer, perhaps dangerously close, to the second of the extreme scenarios discussed in the introduction. Thus, Latvia needs to adopt a new growth strategy. But is this happening? Or is it happening effectively? Effectiveness is the operative word here – Latvian policy history is littered with strategies, action plans and the like that have remained for the most part unimplemented.

Today, in the spring of 2010, the major policy concern remains to bring down the government budget deficit to within the Maastricht limits in order to enable entry to the euro zone by 2014.

While sound fiscal policy is surely desirable in and of itself[3] it is debatable whether the aim of early euro adoption represents the most powerful argument for fiscal responsibility. In truth, the desirability of fast euro adoption is seen as axiomatic by key policy makers and is not something that has yet been subject to any serious public debate. Arguably, going into the euro at the current exchange rate may subject Latvia to years of 'internal devaluation' and make it more difficult to identify and adopt the real structural reforms that may put future growth on a better foundation than was experienced in the boom years. It is to be hoped that this is a debate that will emerge in the election campaign leading up to the October 2010 parliamentary election, so that voters are better informed about the full implications of early euro zone entry.

Although there has been much talk of structural reforms since the IMF and European Commission were invited in late 2008, there is little evidence of measures that will really improve long-term productivity. Thus, closing country schools does not constitute 'educational reform' and cutting wages and employment in the government institutions does not constitute 'public administration reform'.

In education an urgent priority is firstly to acknowledge and then to act, on the problems in Latvian higher education, which is 'diploma oriented' at the expense of developing real analytical skills. A recent study of innovative firms shows that higher education received after 1990 is not as effective as Soviet education in promoting innovativeness as measured by both product innovations and patent applications. What is needed is to 'open up' higher education by developing programs in English and attracting faculty from abroad.

In public administration, key priorities are to improve quality and evaluation and analytical capability. Currently, for example, the Latvian government has inadequate capacity to evaluate and analyze the economic and distributional impacts of the tax reforms (much needed) that are currently under discussion. In effect, they rely on technical assistance from the IMF and the World Bank to do this for them.

3 In this context the proposed *Law on Fiscal Discipline* which would set the budget deficit level corresponding to the forecast changes of GDP and other macroeconomic indicators and constrain expenditure fluctuations to within a range determined by these indicators is a welcome initiative.

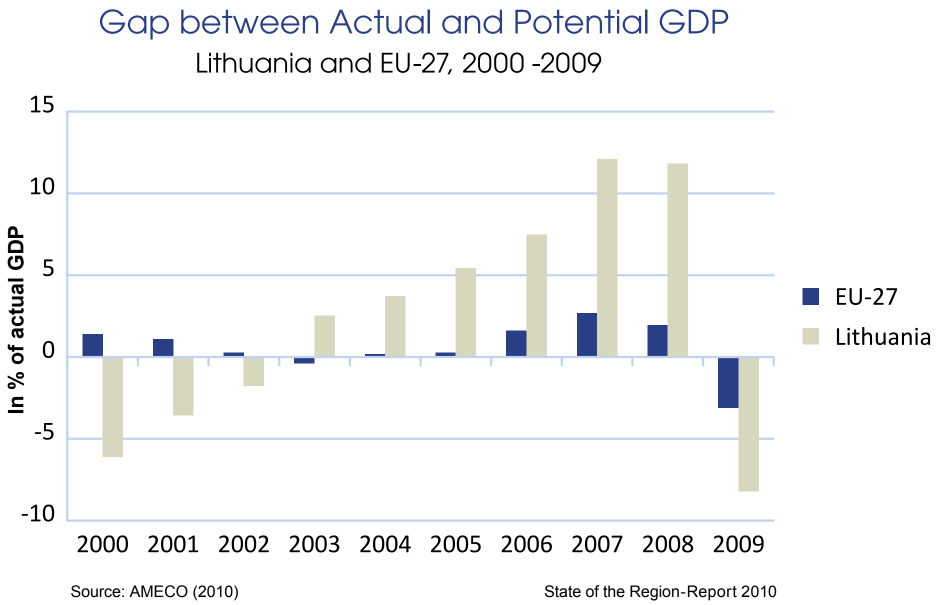
It is these kinds of reforms that will genuinely improve human capital and that can take Latvia forward rather than the kind of 'picking winners' industrial strategy that has been proposed by the Economics Ministry and the World Bank.

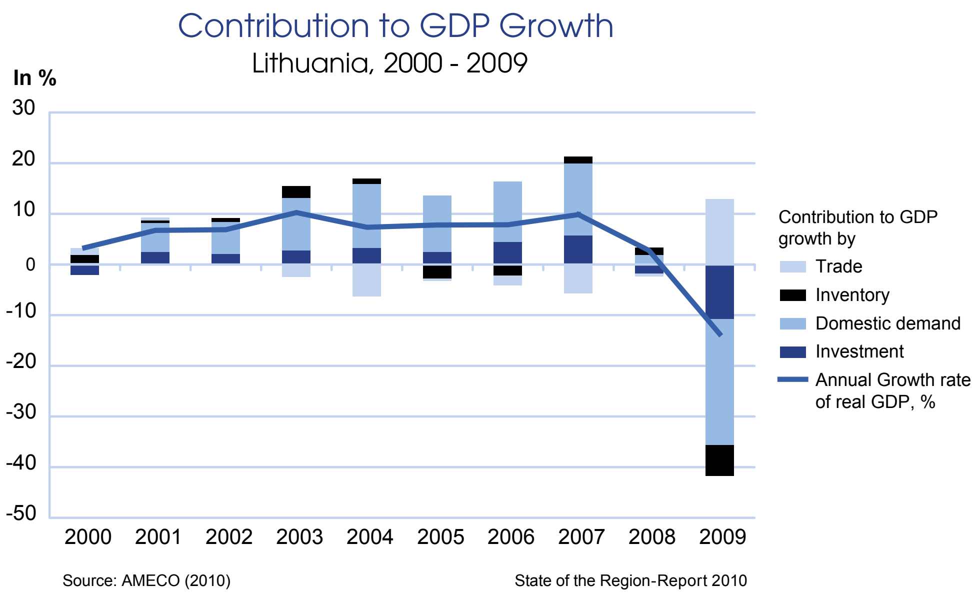
Lastly, perhaps a rather 'utopian' proposal: many foreigners perceive the Baltic states as a single undifferentiated unit and when they come to visit or invest they are surprised that this is not the case. So, instead of fiercely trying to promote individual identities, why not make a strength out of an apparent weakness? Why not go for the promotion of a Baltic identity and also for deeper integration than has been achieved within the EU? The benefits of integration achieved in the region as a result of EU accession can be clearly seen in the Baltic States but many barriers remain. For example, the tax systems are quite similar but very different from those of say Scandinavia. Why not go for an explicit Baltic harmonization?

And as a postscript one may ask: which lessons the Latvian experience of 'internal devaluation' might provide for e.g. Greece, which is forced on to such a path due to its inability to devalue externally? We would argue that the situation looks bleak for Greece and any other country forced to take this route. Latvia has displayed tremendous (if perverse) economic flexibility: inflation was brought down more than twenty-two percentage points in less than two years on the back of wages that saw annual increases of up to 35% turn into decreases of 5 – 25% (private vs. public sector). All this was facilitated by GDP turning from 12% growth to an 18% decline and unemployment from 6% to around 20%, the latter without serious social unrest. We find it hard to see Greece or indeed any other 'old' EU country replicate this. Indeed, if internal devaluation fails in Latvia, it does not bode well for Greece and others.

2.3 Lithuania

By Algirdas Miškinis (Vilnius University)
Lithuania, like most of the eight new EU members from Eastern Europe, has recorded very rapid economic growth over the past several years before entering the current crisis. Real GDP growth in 2000-07 averaged over 8%, much higher than growth in potential GDP.





Exports had helped to spearhead the recovery following the slump induced by the Russian financial crisis in 1998. Most experts agree that more recently the credit-fuelled domestic demand has been the main driver of GDP growth. A large fraction of credit-fuelled domestic demand automatically fed into higher incomes, especially in the non-tradable, pro-cyclical sectors, and contributed to higher capital and labor utilization rates. The associated irrational exuberance eventually resulted in bank losses, excessive and inefficient investments, excessive indebtedness of the private sector, and overly optimistic projections of tax revenues. Thus excess growth of domestic demand provided a powerful stimulus for overall economic activity but it collapsed dramatically along with the burst of the house price bubble and the onset of the global economic crisis and local credit crunch.

How has the boom occurred? What are the reasons?

...with no rock-solid evidence of imminent threats to macro-financial stability it was difficult for policy makers and individual decision takers to collectively agree on unpopular precautionary measures, which would have implied foregone political popularity and short-term economic gains. With the benefit of hindsight, it is getting obvious that the role of the convergence process was grossly over-stated and the inefficient over-borrowing for non-productive purposes was one of the reasons for the hard landing.

The strong credit expansion started at the beginning of this decade when Lithuania began to recover after the Russian crisis and economic prospects improved considerably with the highly successful reorientation of Lithuanian exports to the stable and promising western markets and with the EU accession prospects.

One could argue that the credit market processes could be rightly regarded as financial deepening ("credit democratization"), which shared many attributes with the peer countries of Central and Eastern Europe. Credit supply was boosted as a result of the banks' privatization, financial liberalization, the advent of foreign (mostly Scandinavian) resource-affluent banks, new lending and risk management practices, and the environment of low nominal interest rates due to the credible peg of the national currency to the euro.

Credit demand was fuelled by rosy income prospects, in particular after the accession to the EU, rising profits and wages, declining unemployment and the tax code, which favored housing loans and external financing of corporate investment projects. The combination of credit supply and demand factors plus favorable global economic environment, which emerged on the back of global credit easing, helped to pull the economy out of the stagnation in the aftermath of the Russian crisis.

In terms of financial convergence, Lithuania was traditionally regarded as a "late riser" (after a term coined by Cottarelli et al., 2003). At least until 2004 its credit-to-GDP ratio seemed to be well below the level justified by fundamentals (see, e.g., Backé et al., 2006, and Ramanauskas, 2007). Some studies, e.g. Kiss et al. (2006) and Sebastian (2005), claimed that fast credit growth in Lithuania could be fully explained by convergence. Some concerns related to strong credit growth were raised by Ramanauskas (2006a, 2006b) as he discussed the growing evidence of the strengthening financial accelerator and credit cycle.

Some authors, e.g. Ahmed and Bakker (2007), also pointed to the resemblance of the Baltic boom to the unsustainable Portuguese scenario due to possibly inefficient use of borrowed funds. *However, it was generally perceived that risks to macro-financial stability were contained mostly due to low initial indebtedness, vested interests of reputable Scandinavian banks in Lithuania, banks' adherence to regulatory requirements, a well-developed institutional setting and the lack of clear indications of overheating* (Bank of Lithuania, 2008).

...the first signs of the credit boom in Lithuania surfaced as early as in 2003, and starting from 2005 they were becoming more and more evident. Credit growth was becoming partly self-induced through the financial accelerator effect. Easing credit constraints and the associated surge of liquidity in the economy had a profound effect on asset prices. Steeply rising housing prices in turn spurred housing acquisition and development, and rising equity values via Tobin's q channel provided incentives to invest into the pro-cyclical sectors. All of this further simulated borrowing and created overheating pressures ...

It is important to note that the booming real estate sector was the main gateway for the credit to pour into the real economy. At the end of 2008, the loans directly related to real estate acquisition and development constituted around half of outstanding bank loans to the private sector. However, despite this concentration of credit, its stimulating effects propagated throughout the whole economy and fostered seemingly broadly-balanced growth of output and incomes.

Large injections of "imported" liquidity into the economy simply could not leave wage and profit levels unchanged. The grave problem with this is that the vast majority of economists, decision makers and foreign observers failed to take the interdependence between the real activity and incomes on the one hand, and the housing and credit boom on the other appropriately into account.

Yet these assessment errors were not trivial, as the discussion of credit endogeneity was basically underpinned with the presumption of economic convergence. There were many analyses attempting to rationalize the strong economic growth accompanied by large external imbalances with the help of the neoclassical growth theory (see e.g. Bems and Jonsson, 2006, or Bems and Schellekens, 2007). These analyses suggest that active borrowing and large external imbalances are justified in the context of strong economic convergence provided that capital inflows raise productive capacity and expected future incomes.

It turned out that in the Lithuanian case the largest part of incoming capital flows were financing consumption and nonproductive, non-tradable activities thereby invalidating the initial premise of convergence.

The whole boom-bust period was largely determined by compounded risk assessment errors made by various economic decision makers. But banks do stand out in this respect. Given the strong dependence of the economy on credit conditions and bank lending policies, the banks exerted immense influence on actual economic developments, and their risk assessment errors were detrimental for the overall economy. Individual borrowers and even companies acquiring bank financing for their business projects usually do not have sufficient expertise for the well-rounded assessment of micro- and macro-economic risks – banks' as financial intermediaries' primary function is therefore to resolve asymmetric information problems, assess and monitor investment risks and thereby ensure the efficient allocation of financial resources. In contrast, during the whole boom episode banks underestimated various risks, most notably credit risk.

Possible reasons for such inadequate assessments were rather standard in the regional context. They included overestimation of the role of collateral for ensuring portfolio quality, overestimation of the speed and sustainability of economic convergence, inadequate assessment of capital crowding-in, down-playing local risks from the foreign banking group perspective, market share buying, principal- agent problems in bank employee remuneration schemes, excessive profitability requirements set out by share-holders, etc.

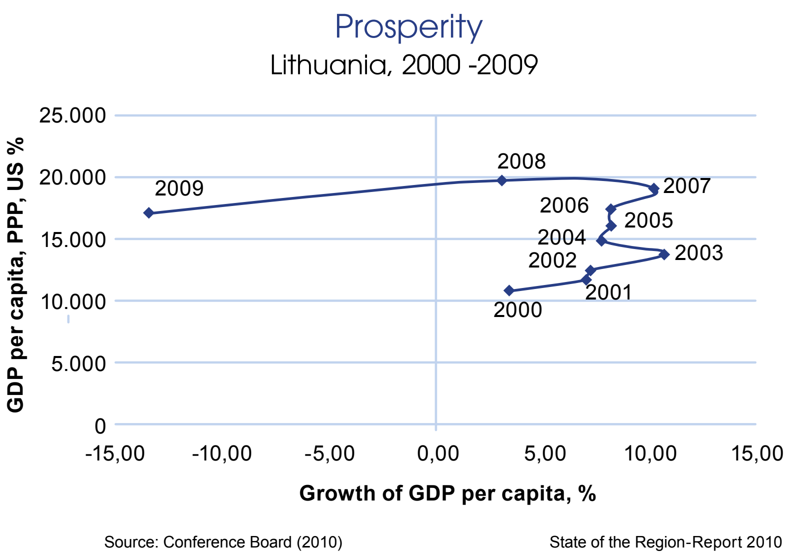
Kuodis, 2009, p.p. 104-108

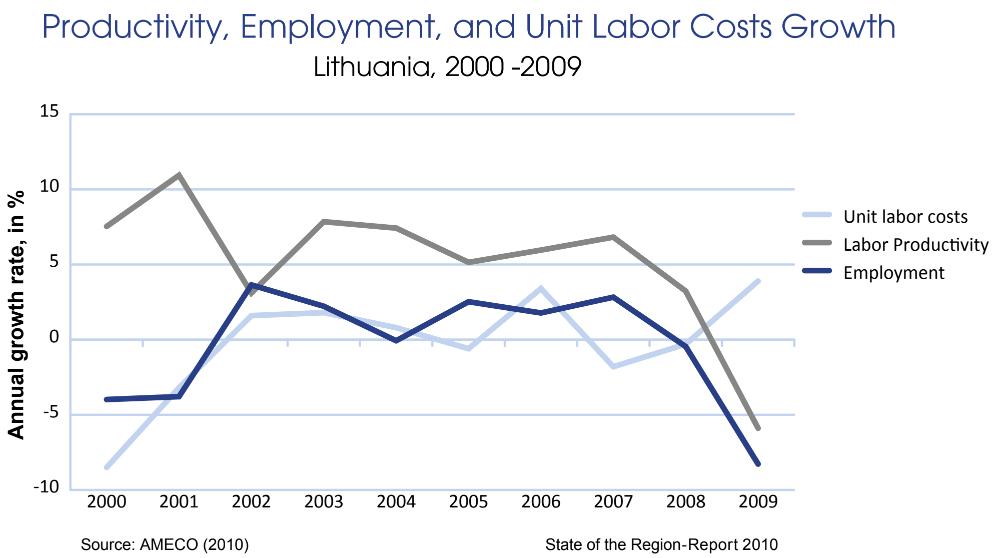
The contraction started slightly later than in other Baltic States in 2008, while annual export and industrial output indicators remained solid - which is partly explained by the return to full production of the Mazeikiai oil refinery, and consumer spending so far remained robust. Such a situation compared to the other Baltic States, where the slowdown has been really marked, has led to expect that these factors are likely to have helped the Lithuanian economy to avoid the very rapid slowdown. Unfortunately, exports of goods and services have dropped significantly in 2009 as exports of all major product groups shrank vastly. In summer 2009, domestic demand became weaker due to a contracting real estate market (that had a huge impact on GDP, with the construction sector being large as a share of GDP), deteriorating expectations and tightened lending policies by the banks. Although the bank portfolio of loans issued to businesses and individuals was still growing in 2008, net credit flows continued to shrink. By the end of 2008, they had fallen to the level of 4–5 years ago, this figure subsequently went into the red in 2009. The non-performing loans reached 8.7% of the total during 2009 – more than double the percentage in the previous year. The government has increased deposit insurance in an effort to stabilize the banking system. Capital outflows reached 12% of GDP in 2009. Some companies, unable to adapt to a dramatically changed economic environment, faced collapse. The depth of the recession during 2009 (15 % drop of GDP), puts Lithuania among the worst hit countries in the EU.

Economic trends, 2000 – 2010

Lithuanian economy continued to report solid prosperity growth till 2007. After higher prosperity growth in 2007, the recession period deepened by financial crises and internal and external blatancies started.

The contraction in Lithuanian GDP per capita in 2009 was much sharper than in EU-15 or EU-27. The decrease in GDP per capita has turned prosperity levels for Lithuania back to the level of 2006. In general, the CAGR (compound annual growth rate) in the period 2000-2009 was 5%, which allows for significant catch up to aver-





age EU-15 and Lithuania reached 55 percent of EU-27 average (GDP per capita at current market prices, PPS).

Over time, Lithuania increased productivity (per person employed and per hour worked) significantly to reach the same level as Estonia (per hour worked) and a little bit lower if consider the productivity per person employed. The sectors with the highest productivity per hour (estimated as gross value added per actual hour worked, at current prices) in 2008 were financial intermediation, transport, renting and business activities, storage and communication, real estate. The biggest increase in productivity compared to 2000 was in agriculture, hunting and forestry (+236.5%) and electricity, gas and water supply (+201%). For a sustained period, wage growth has exceeded productivity growth by far, thus weakening the country's competitiveness. Nevertheless, the growth of unit labor cost was less rapid than in Latvia and Estonia.

Lithuania's employment rate falls behind Latvia and Estonia (in 2008 the rates were 64.3%; 68.6%, and 69.8% respectively) despite being close to the EU -27 average. The hours worked per capita increased by 15 percent between 2000 and 2008. The sharp rise in unemployment in 2009 pressed the labor mobilization to the level of 2005/2004.

Unemployment jumped to 13.8% in 2009 (up from just 5.8% in 2008) and is expected to rise further to 16.5% in 2010. This growth in unemployment is fuelling a new wave of massive emigration. Approximately 300,000 people have left the country since it regained its independence. Both the skilled and unskilled have departed. The list includes university graduates and IT specialists as well as agricultural workers and unskilled laborers. Official statistics show the increase trend of emigration but not the whole picture.

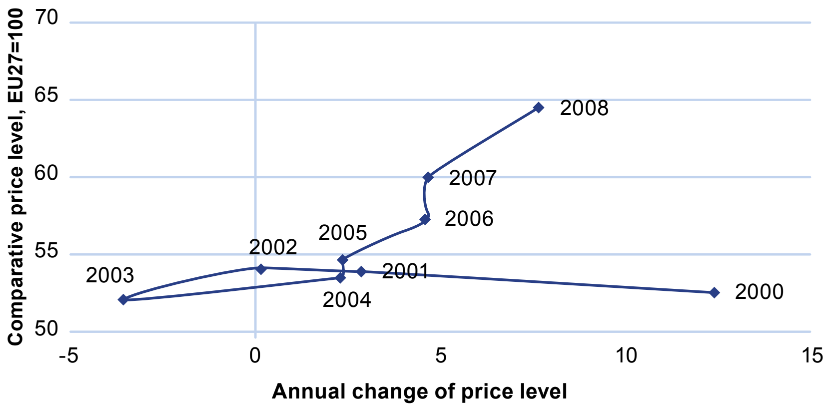
In the period 2000-2006, the rising productivity and the increasing employment was followed by increasing growth of price level on the local market. Starting in 2006, Lithuania became an increasingly expensive country, measured by price levels relative to the European average (there is no comparable data available yet for 2009). The slowdown in inflation will be one of the few bright signs for Lithuanian consumers in 2009.

Between 2000 and 2008, Lithuania increased its market export share by more than 2.6 times but due to the recession in 2009 the market share could shrink to the 2007 level (being twice as big as in 2000). Lithuania remains focused on exporting goods instead of services, while the more advanced economies increasingly shifted to services and outsource production. Lithuania continuously increased the export of high technology products and the share of these products in 2008 increased twofold compared to 2001 but it still remained too small. Exports plummeted during 2009 and no recovery is expected in the medium term. The first data from 2010 gives grounds for some optimism as during the first months of the year, export indicators were better than during the same period in 2009, driven by exports of mineral products.

During the period 2000-2009, the Lithuanian trade flows became increasingly oriented towards the EU (with average shares around 75% of total exports). But trade with Russia and other CIS countries remains also relatively significant (around 24%). Main export partners in 2010

Price Level

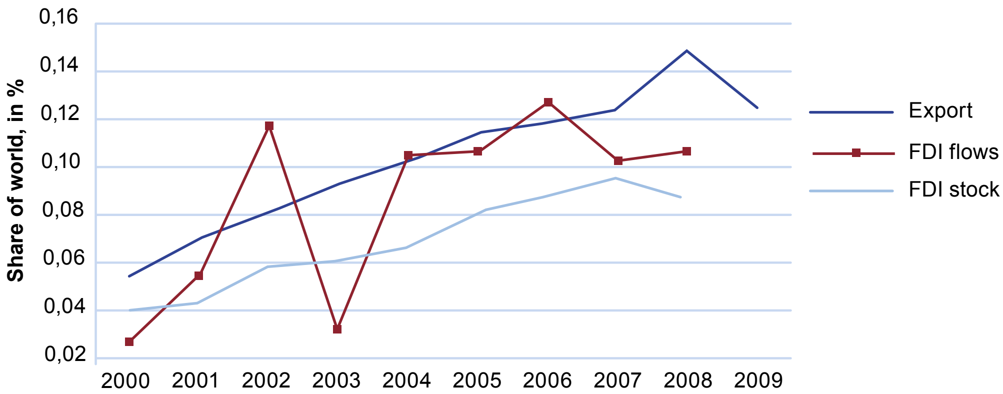
Lithuania, 2000 -2009



Source: Eurostat (2010) State of the Region-Report 2010

Exports and Inward FDI

Lithuania, 2003 - 2009



Source: Lithuanian Statistical Office (2010) State of the Region-Report 2010

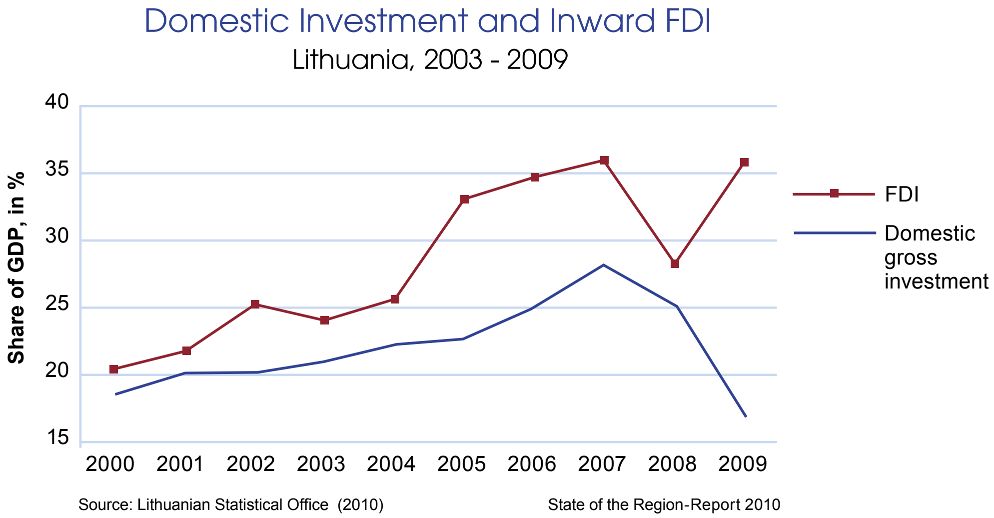


Table: Foreign direct investment by economic activity

	Foreign direct investment (inward stock)				
	2000	2006	2007	2008	2009
Total	100	100	100	100	100
Manufacturing	29	40	35	23	28
Utilities	3	11	9	7	8
Services	66	48	51	63	60
Other	2	1	5	7	4

Source: Lithuanian Statistics Department, Calculated by author

are the EU countries (the largest share goes to Germany with 12.4%) and Russia (11%). Main import countries are Russia (39%) and Germany (9%) with Poland and Latvia following.

Domestic gross fixed capital investment increased in the period 2000-2007 but is slightly lower than in Estonia and Latvia. Lithuania's investment rate is comparable with most of the rest of the EU-10. In 2007, gross fixed investment amounted to 28% of GDP, in 2008-2009 the investment ratio deteriorated and is at 17%, which is worse than in 2000. This could be explained by the rather high share of construction in the overall number, much of which contracted during the recession period.

Lithuania always was consistently behind Latvia and Estonia on inward FDI, being considered a less attractive country for foreign investors. During the period 2000-2009, the FDI share to GDP increased significantly - almost twice - and the stock grew up 3.6 times, the outward FDI during the same period increased by 47 %. The main investors between 2000 and 2009 were EU countries (Sweden, Poland, Denmark and Germany). At the end of 2009, the FDI stock from EU-27 made up 78 percent of total stock.

Compared with neighboring countries, Lithuanian FDI inflows continue to be less biased towards real estate and financial institutions and reflect 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. After rising in the first half of the 2000s, the share of manufacturing in inward FDI dropped in the run-up to the crisis before recovering somewhat in 2009.

The average value of Lithuanian inward and outward FDI flows divided by GDP is very close to the EU-27 and EU-15 average. Nevertheless, the Lithuanian Bank expert Raimondas Kuodis emphasized:

"… that in the Lithuanian case the largest part of incoming capital flows were financing consumption and nonproductive, non-tradable activities thereby invalidating the initial premise of convergence."

Competitiveness trends, 2000 – 2010

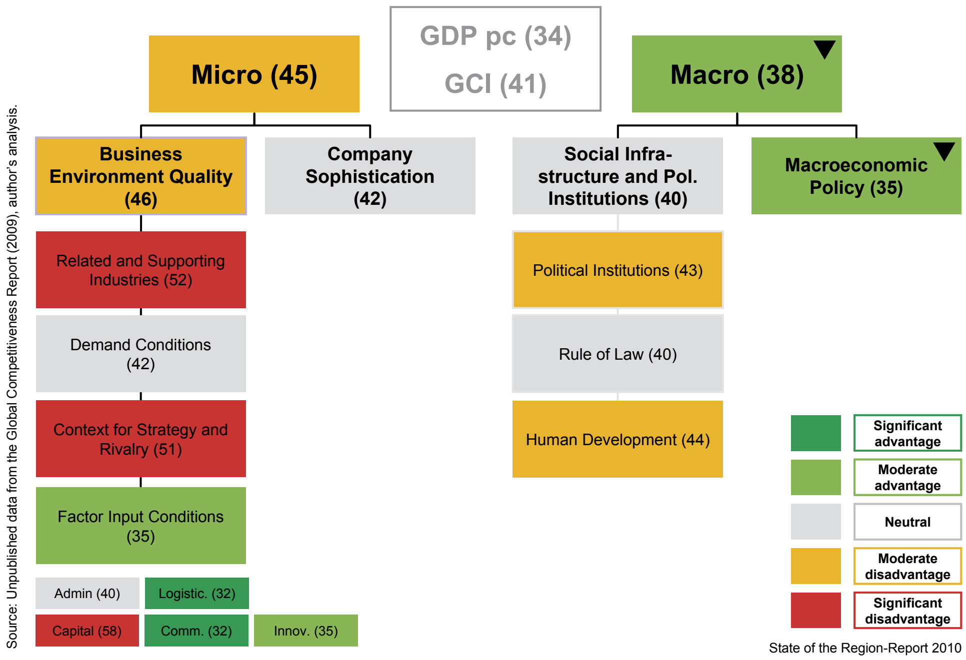
The business environment in Lithuania is rather favorable. Lithuania was among the top 20 countries on the measure of ease of doing business (World Bank, 2005). Lithuania also remains highly competitive. In 2006 – 2007, Lithuania was more competitive than Hungary, Italy, Greece, Poland and Croatia among EU countries. However, according to the GCI, Lithuania lacks clear advantages compared to other countries. Additionally, compared to the EU average, labor costs in Lithuania are five times less expensive. Although Lithuania may lack the financial capital of "old Europe," it has a skilled and educated workforce, and low labor costs. Its population is well educated: the literacy rate of Lithuanians aged 15 and older is 100% and 30% of the population aged 25 - 64 have completed higher education. This is twice as many as the EU-15 mean and the highest among the Baltic countries. This makes it an attractive place for foreign firms that want to also "out innovate" the competition.

Lithuania ranks 26th out of 183 economies in the 2010 Doing Business ranking. There are only two procedures involved to register property in Lithuania compared to the OECD average of 4.7 and it takes an average of 3 days to register property (OECD average: 25 days). However, the country ranks near the bottom (119th) in the ease of employing workers. Low wages have been causing a brain-drain, and prior to the crisis many highly qualified workers emigrated to the United Kingdom and Ireland. Emigration is a serious problem for the economic development of Lithuania as highly skilled labor moves abroad, while the Lithuanian government has been paying for their education. The scarcity of skilled workers has driven up the wages for highly qualified employees. Paradoxically, during recent years, the Lithuanian government has been issuing working permits for Belarusian and Ukrainian immigrants in order to fill the vacancies.

Lithuania has very weak legal rights, which weakens the business environment in Lithuania. High restrictions are placed on capital flows and difficult access to loans further impairs company sophistication. However, Lithuania scores higher than the average of EU-8 countries in terms of business sophistication.

Lithuania has been a parliamentary democracy since independence from the Soviet Union with a stable political system that endured Europe's first impeachment of a sitting president without political upheaval. Political institutions, as a whole, improved their standing from a rank-

Lithuania's Competitiveness Profile



ing of 46 in 2001 to 43 in 2009. Effectiveness of law making bodies decreased their rankings from 46 in 2002 to 50 in 2009. Public trust of politicians additionally decreased during the period from 48 in 2002 to 51 in 2009. Other noteworthy developments were favoritism in decisions of government officials: a ranking of 28 in 2001 to 35th place in 2009. There was, however, a significant increase in the transparency of government policymaking. The country had a ranking of 43 in 2002 and this improved to 33rd place in 2009. Another improvement was in the area of decentralization of economic policymaking: 36th place in 2003 and 27 in 2009.

PERCEPTIONS ON COMPETITIVENESS, RULE OF LAW AND CORRUPTION

Vilnius, 23 June 2008

...Lithuania had a lot of room for improvement. I said that Lithuania was able to compete in the globalised world and that Lithuania had very good cards to play. I gave two specific examples: One that Lithuania was a real competitor to China when it comes to production, and one that in IT-services Lithuania was a real competitor to even India.

The two examples? The Danish owned furniture factory in Kaunas by the name of Theca Furniture is producing for one single customer, the Danish furniture chain BoConcept, having furniture stores in most markets globally but not yet in Lithuania. The factory in Kaunas is now, thanks to a good financial sector and a good logistics business in Lithuania, exporting the entire production to many countries where BoConcept has stores, primarily in Europe. That is today profitable rather than servicing those stores from the very huge factories in China close to Shanghai also producing furniture exclusively for BoConcept.

The other example was IT-services. The big American company CSC has recently opened a service center in Vilnius and the Embassy of Denmark has assisted them because the operation in Lithuania has been planned and implemented by CSC Denmark. I mentioned that CSC had already hired app. 80 Lithuanian IT experts and were planning to hire as many as 200, not to service the Lithuanian market but to serve and support customers in Scandinavia.

Then I added that a few years ago Lithuania would probably not have been considered a possibility at all because most investments of this type at that time would have gone to India. Today, I said, time zone closeness is considered more important than it was a few years ago. And that's why Lithuania has some very strong cards to play even in the wider globalised world. ...

Then it is correct that at the end of my remarks I mentioned some perceptions. A previous speaker had said that it made no sense for Lithuanian business to have a dialogue with Government and politicians about the deteriorating competitiveness of Lithuania. I said that in Denmark the IMD World Competitiveness Report was closely studied by businesses and the Government to analyze where improvements could be made.

I recommended a dialogue between Lithuanian business and Lithuanian politicians ... it was necessary also to be aware of the fact that international business people had some perceptions about Lithuania that might reduce foreign investment in Lithuania.

One such perception had to do with rule of law. Was it always the case in Lithuania that a citizen or a company was able in a clear, predictable and transparent way to establish what are his or her rights and obligations? Having said the word "transparent", I said, I have to say, as a friend of Lithuania, that there are also perceptions of corruption.

Back to the competitiveness issue: Did you notice that the Bank of Lithuania reported on 17. June that inflow of foreign direct investment in Lithuania fell 29% in the first four month of this year compared to last year? Especially the month of April was week. I do certainly not hope that this will be a trend for Lithuania. If so, this is another reason for the timeliness of a dialogue between Lithuanian business and Lithuanian politicians.

Laurids Mikaelsen
Ambassador of Denmark

Rule of law generally increased during the 2001 - 2009 period. Lithuania had a ranking of 46 in 2001 and, in 2009, had an improved ranking of 40. Several notable changes during the period will be noted below. Reliability of police services decreased from a rating of 65 in 2001 to 47 in 2009. Another notable decrease in ranking occurred with a low occurrence of irregular payments by firms: 18th place in 2001 to 35th place in 2009. Lastly, in the category of negative trends, Lithuania's ranking on low business costs of corruption decreased from 43rd place in 2001 to 64th place in 2009. There are several areas of positive improvement that should be highlighted. The rating of low business costs of crime decreased from 47rd place to 28th in 2002 and 2009 respectively. The low impact of organized crime improved from a rating of 62 to almost a half (29th place) in 2009. The efficiency of the legal framework also improved from a ranking of 64 in 2001 to 47 in 2009.

On innovative capacity, Lithuania is rated as a moderate innovator, with an innovation performance well below the EU27 average and a rate of improvement above that of the EU27. One area in which Lithuania appears to have a competitive advantage is in terms of cluster strength and innovation in the biotechnology sector. In this area, it is a regional leader. According to the Lithuanian Biotechnology Association, the biotechnology sector in Lithuania has been growing by about 22% yearly for the past five years. Two companies, Fermentas and Sicor Biotech, were sold in 2007 for more than 28 million Euros. Biotechnology firms are clustered about Vilnius, and have ties with business and research centers at Vilnius University. Therefore, there was momentum in the development of the Lithuanian biotechnology sector that other regions did not have. Building on this momentum, the Vilnius City municipality and two major universities (Vilnius University and Vilnius Gediminas Technical University) are building a major research park, the Saulėtekio slėnis (Sunrise Valley).

Another positive development of the biotechnology industry in Lithuania is related to immigration and the "brain drain" phenomenon. As an example, seventeen advanced Lithuanian experts who had previously emigrated have decided to return to the Vilnius Institute of Biotechnology. Dr. Daumantas Matulis from the Institute of Biotechnology has stated that

"The growing importance of life sciences and biotechnology in Lithuania is being recognized with ScanBalt Forum 2008 to take place in Vilnius. This is a chance to promote Lithuania as an attractive place to work, live and invest. We intend to further strengthen our position as a strong player within life sciences and biotechnology in the Baltic Sea Region."

Although information about the biotechnology sector in Europe is incomplete, Ernst and Young find that the Lithuanian biotechnology market is one of the largest in the region. 99% of biotechnology products are exported to 86 countries. In 2006, the biotechnology industry had sales in excess of 90 million Euros. Among former Communist countries, Lithuania follows only Hungary in sales volume. The Lithuanian government has been increasing biotechnology research funding during the last five years.

Policy trends, 2000-2010

Fiscal policy, during the period 2000-2008, did not prevent the real estate bubbles. In Lithuania, deductions of mortgage interest payments from personal taxable income on housing loans were in place. Lithuania abolished the deductibility of interest payments for new loans taken after 1 January 2009.

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 but not on the stimulation of economic recovery. The Bank of Lithuania reduced banks' reserve requirements (minimum reserve requirements are currently at 4%) 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.

In fiscal policy, main measures on the revenue side were a cut in the personal income tax rate from 24% to 21% (from it levying a 6% tax to the health insurance fund), an increase of the profit tax from 15% to 20% and the VAT from 18%

to 21%, and substantial increases in excise duties on tobacco, fuel and alcohol and the abolition of most existing tax exemptions. On the expenditure side, the budget includes significant cuts in current expenditure but also reflects higher social transfers and wage increases for certain categories of public sector employees. Furthermore, the contribution rate to the second pillar pension funds was temporarily reduced from 5.5% to 3%. On 7 May 2009, Parliament approved further substantial fiscal consolidation measures to limit the government deficit to 2.9% of GDP, mainly in the form of expenditure cuts (including public sector wage and staffing levels) and investment. Contributions to the second pillar pension funds were further reduced to 2%.

Not all of these decisions had the intended effect. A high tax burden, faced by small enterprises in particular, and inefficient actions against excessive red tape in the business environment contributed to the rising unemployment and deteriorating situation of companies. Delays in implementing public sector structural reforms made it impossible to cut already swollen budget expenditures. With treasury revenues falling well short of the target, the fiscal deficit of Lithuania, over 3% of GDP in 2008, rose to 9% of GDP in 2009, with little hope of reduction in 2010[4]. So far, to cover this deficit, the government has been forced to use rather expensive loans (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.), which are only adding to the rapidly growing costs of government debt servicing and increasing the burden to the national treasury. The Lithuanian debt-to-GDP ratio was decreasing until 2008, mainly due to strong GDP growth and was equal to 15.6% of GDP in 2008.

A major problem is the rapid increase in unemployment, which could become structural, nevertheless, pose major risks to long-term convergence. This has raised a new emigration wave, which will have long-term negative consequences, especially given Lithuania's aging demographic trend. Also, the country faces an increasing 'brain drain', which adds to the shortage of highly skilled professionals. This, coupled with an inefficient public sector in serious need of reforms, and a high level of corruption, make it difficult to attract FDI, despite the fact that the current Government appears to be paying more attention to the latter. The high foreign trade deficit of previous years all but evaporated in 2009. However, inflation has eased off and the current account deficit has turned positive in 2009.

Selected Macroeconomic Policy Indicators

Lithuania, 2000 -2009

Source: Eurostat, IMF (2010)

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4 In February 2010, the Lithuanian Ministry of Finance revised the general government deficit target down to 8.1 percent of GDP in 2010.

The government has launched major structural reforms in the fields of education, healthcare and social security. Lithuania has revised labor legislation to enhance labor market flexibility, facilitating the adjustment of the economy. The initiatives of creating better conditions for growth in the years ahead were taken as follows:

- Profit tax exemptions for scientific research and experimental expansion – Established by Parliament in April 2008. Further revisions of profit taxation so as to increase R&D are being discussed.
- Productivity and competitiveness enhancing measures in the framework of the Investment Promotion Programme co-financed by EU structural funds (physical infrastructure, human resources developments) – Adopted by the Parliament in December 2007, the Investment Promotion Programme is co-financed by EU Structural Funds.
- Education system reform aiming at intensifying competition in the higher education sector and at reforming governance of higher education institutions – Politically agreed in 2007 and the object, in 2009, of a presidential resolution for a reform as of the school year 2009/2010 – in the updated National Reform Programme, part of the Lisbon process.
- Concession allowing companies investing in substantial technological renewal to reduce their payment of profit tax by 50% – Adopted by the Parliament in December 2008. (Cross-country study, 2010, 96p.)

Lithuanian authorities adopted a comprehensive package of measures aiming at business support by reducing administrative burden, improving access to finance, and facilitating exports and investment. As energy dependency is high on the agenda, the government passed measures to improve energy efficiency. The use of EU structural funds is also planned to be simplified and enhanced.

The Convergence Programme reiterates Lithuania's strive for joining the euro area immediately after the country meets the convergence criteria. The key strategic objective of the medium-term policy is to further public finances consolidation and essential improvements in the areas that can ensure economic breakthrough.

Growth in 2010 depends on a strong recovery in external demand and recovery in fixed investment, mainly supported by accelerated absorption of EU structural funds. Lithuania can also boast of a lower average indebtedness level of businesses and households compared to the other Baltic States, and older EU members. Domestic demand is expected to contribute positively to growth from 2011. For 2010, GDP growth is expected to remain negative, reducing the size of the economy by another -3% to -4.5%, and driving unemployment up further to 17%. The most recent estimates are, however, somewhat more positive.

Throughout the crisis, the economy has proved to be highly flexible as a significant adjustment has occurred via decreases in prices and wages. Nevertheless, the outlook for the Lithuanian economy remains challenging. Raimondas Kuodis from the Lithuanian Bank emphasizes that

"… there are significant risks that due to the inefficient allocation of capital and labor and due to the excessive debt burden the long-term economic potential of the country may have been dented."

Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. The high initial imbalances could impede the recovery process after the global economic environment begins to revive.

Corporate Governance as a Competitive Driver in the Baltic countries

By Arminta Saladžienė, Chairman of the Baltic Institute of Corporate Governance and Winner of the 2009 Swedbank Baltic Sea Award

In the face of an unprecedented economic decline, the Baltic governments and companies have focused on addressing short term "survival" measures. As the worst is hopefully behind and the economic fundamentals start to consolidate, the key challenge becomes finding sustainable ways towards more competitive and balanced economies.

It is obvious that ability of the Baltic companies to compete on the global arena for capital, resources, markets, and talents becomes a decisive factor largely determining the future of the Baltic economies. In this context, governance standards in the private and public sectors are an unutilized driver which can positively contribute to the competitiveness of the Baltic region and lead to a faster and more sustainable economic growth, job creation and welfare.

Since accession to the European Union the Baltic countries have made a considerable progress in adopting the principles of good governance. However, the gap between the international benchmarks and the current state, especially in the area of government-controlled enterprises and private unlisted companies, remains wide. In addition, general awareness of the value of sound governance as well as established principles is vague in the Baltic societies. The case for change was evident.

So in mid 2009, a small group of individuals sharing commitment to the welfare of the Baltic countries founded the Baltic Institute of Corporate Governance (BICG). This non-governmental initiative pursues global class competitiveness and transparency of Baltic public, private and state owned companies through promotion of leading corporate governance practices. It is founded on the belief and evidence that:

- well-governed companies attract premium valuations; they are much better positioned to get external financing and do so at a lower cost;
- such companies achieve more efficient allocation of resources, which leads to higher performance;
- due to robust control mechanisms, they become more resilient to crises and management failures;
- transparency and accountability help well-governed companies earn trust and respect of their investors, employees, partners, and the general public.

The BICG started its activities by launching the only Professional Board Member Executive Education in the Baltics. The curriculum of the BICG Executive Education is based on the Directors' program from the Stockholm Chamber of Commerce and Corporate Governance Leadership Resources from the International Finance Corporation/Global Corporate Governance Forum. The program, targeted at business owners, board members, senior executives, and decision-makers from the public sector, is delivered by distinguished experts and practitioners in the field of governance. Best corporate governance practices like recruitment of independent professional board members, separation of management and steering roles, empowerment and accountability of boards are discussed. By June 2010, two classes of 70 high level graduates from all three Baltic countries were certified as Professional Board Members.

Another important field of activity for the BICG is development of guidance on corporate governance for the Baltic companies of different size and ownership structure. In addition to the expert work on drafting and debating the recommendations, advisory role of the Corporate Governance Council composed of nine Baltic business leaders is essential in this undertaking.

For a number of reasons, the first guidance was developed for the state- and municipality-owned companies (collectively referred to as government-owned enterprises or GOEs). In spite of extensive privatization processes in each Baltic country, GOEs still represent a significant share of economic activity and thus have an important impact on the overall performance of the national economies. These enterprises play a significant role due to their size, economic and social impact, and importance of sectors in which they operate, like utilities, energy, transport, financial services. They are often referred to as "national treasures", however, seldom are treated as such. Yet, inefficiencies in governance of such enterprises come at a high public cost. Moreover, the state as the owner of public assets sets the tone at the top and has influence over the public sector governance in general.

The Baltic Guidance on the Governance in Government-owned Enterprises (Guidance) by BICG was developed during January-May 2010 and represents a considerable team effort involving international experts, policy makers and civil servants from the Baltic governments, municipalities and public agencies as well as practitioners from both government-owned and private companies. The consultation process included national field-studies and in-depth personal interviews with key stakeholders in all three Baltic States. Ensuring an inclusive and transparent process, the Baltic Summit was held on March 19 which summoned international corporate governance experts and leaders from the Baltic governments and business and provided an excellent forum for sharing experiences, discussing governance issues and debating the draft Guidance.

The Guidance provides best practice recommendations regarding the ownership function exercised by the state, separation of ownership, industry policy and regulatory functions, transparency of objectives, empowered boards, clear roles of the shareholders, board, and management, and other relevant aspects of GOE governance. Next step is adaptation and application of the Guidance in each of the individual countries. BICG applauds to the leadership of the Lithuanian Government, which has already undertaken the project to reform governance of the state-controlled enterprises.

This is just the beginning. There are a number of tasks and challenges ahead of BICG but the movement for better governance and commitment from so many stakeholders will yield significant returns. Effective corporate governance practices are critical in fostering jobs, stimulating investment, combating corruption, creating prosperous societies, and building wealth. And all of these are high on the agenda of the Baltic countries.

2.4 Poland

By Marzenna Anna Weresa (WERI, Warsaw School of Economics)

The relative macroeconomic performance of Poland in 2010 and the outlook for its economy compare favorably with other countries in the Baltic Sea Region. Positive real GDP growth, moderate inflation, and a shrinking current account deficit distinguish Poland from other countries in the Region. This optimistic view is supported by the latest GDP data for the fourth quarter of 2009, showing a considerable increase of GDP growth. It might be a first sign of the recovery of Poland's economy and the beginning of a new, upward phase of the growth cycle.

Economic trends, 2000 - 2010

Poland is one of the largest countries in the Baltic Sea Region in terms of area and population. But it does not belong to regional leaders in terms of prosperity, despite significant catch-up over the last decade. Poland's GDP per capita (in 1990 US$ PPP adjusted) has been growing by 40% between 2000 and 2009 to reach US$10.259.

Throughout this period, Poland remained on its convergence path towards the highest developed countries from the Baltic Sea Region, i.e. Germany and the Nordic countries. Polish GDP per capita rose from 40% of the German level in 2000 to 54% in 2009. Similar convergence processes with regard to prosperity have been observed between Poland and other developed countries from the Baltic Sea Region, such as Sweden, Finland, Denmark and Norway. However, Poland has been losing ground relative to Estonia, Latvia, Lithuania, and Russia. The three Baltic countries overtook Polish prosperity levels, while Russia remained behind, slowly catching up. This trend changed in 2008 as a result of the global crisis. Poland's prosperity increased compared to all these countries and it managed to overtake Lithuania and Latvia, while the prosperity gap toward Estonia narrowed to 4.7 percentage points.

The assessment of Poland's prosperity based on broader gauges of socioeconomic development and standard of living yields a brighter picture. Using the UNDP Human Development Index (HDI), Poland was ranked 41st among 182 countries worldwide, just behind Estonia (40th position in this ranking), outpacing three countries from the Baltic Sea Region, namely Lithuania (46th), Latvia (48th), and Russia (71st). Furthermore, Poland had the highest medium-term annual growth rate of this index in the Baltic Sea Region.

In labor productivity measured by GDP per hour worked (measured in US$, PPP adjusted), Poland saw its performance grow during the whole period of 2000-2009. Growth was at an average annual growth rate of 4%, much higher than that in the Nordic countries and in Germany, but lower than in all three Baltic States. Poland was the only country in the Baltic Sea Region that experienced productivity increase during the crisis. The level of labor productivity in Poland vis-à-vis the Nordic countries and Germany remains relatively low: in 2009 it ranged from 36.9% of the Norwegian level, through 53.1% of German, to 75.9% of Icelandic one. GDP per hour worked (in 2009 US$) in Poland was, however, 122.2% of its level in Estonia, 124% of Lithuania's performance and 145.4% of that in Latvia. The analysis of labor productivity measured using as an indicator GDP per person employed (in 2009 EKS$) brings similar conclusions.

Starting at the end of 2008, the global financial crunch caused Polish unemployment rates to rise. Unemployment has been a serious problem during the whole decade. After the highest level was reached at 19% in 2004, unemployment had been slowly declining to 7.1% in 2008. It reached 8.2% at the end of 2009, a rise that was not that severe as in the Baltic States, where unemployment rate reached double-digit level in 2009. In 2009 the largest wave of layoffs in Poland was observed in the manufacturing of base metals, wearing apparel, and motor vehicles, trailers and semi-trailers, i.e. sectors that had been strongest hit by the crisis also globally. Furthermore, according to the research conducted by the National Bank of Poland, in Q4 2009 enterprises continued to lay off rather than recruit employees (the ratios were 41.7% vs. 24.6%) but these ratios improved throughout 2009 (for Q1 to 48.7% and 20.1% respectively).

The Polish labor market has been suffering from a relatively low employment rate, i.e. small number of working people as a percentage of the overall population aged 15-64. This ratio stood at 55% in 2000, went down to 51.2% in 2003, and before growing to 59.2% in 2009. Despite this improvement, it remained the lowest in the Baltic Sea Region, more than 20 percentage points lower than in the Nordic countries and Germany, and over fifteen percentage points lower than in Estonia, Latvia and Lithuania.

For the last decade, Poland experienced a negative net migration rate. The number of temporary emigrants started to increase strongly in 2004, after Poland's accession to the European Union. At the end of 2007, the number of temporary emigrants doubled compared to 2004 and reached 2.27 million Poles. The most popular countries for Poles seeking temporary emigration were the UK, Germany, and Ireland. The crisis contributed to a reduction of temporary emigration. In 2008, the number of Poles that lived abroad on a temporary basis fell to 2.21 million, and in 2009 it went down further as a larger percentage of emigrants decided to come back. Nevertheless, this shift coupled with the positive demographic trends that originated in 2008 and continued throughout 2009, slowed down the shrinking of Poland's population.

All different dimensions of the labor market situation are captured in labor mobilization, i.e. number of hours, which is worked per an inhabitant during the year. During 2000-2009, labor mobilization in Poland strongly fluctuated. At the beginning of the 21st century, it was similar to that in Germany (689.7 hours per capita versus 699.3 hours per capita), the lowest in the Region. In 2003 it started to fall, touching the bottom of 639.8 hours per head in 2005 before rising again. Poland continued to catch up all countries in the Region, overtaking Germany already in 2008, and significantly bridging the gap towards Lithuania, Finland, Sweden and Norway.

Poland experienced significant swings in unit labor costs over the last decade. After a rise in 2001, unit labor costs fell, albeit at a decreasing rate since 2004. Despite a temporary rise in unit labor costs in 2008 – already reversed in 2009 -, hourly labor costs (PPP adjusted) are less than half of the levels in Germany or the Nordic countries. They are, however, somewhat higher than their levels in Estonia, Lithuania and Latvia.

In 2009, the openness of Poland's economy, measured as a ratio of goods and service exports to GDP was around 41%. Both exports and imports have been growing strongly at double-digit rates. Poland increased its share in world exports from 0.5% in 2000 to 1.0% in 2008. Despite the sharp decline of trade in 2009, Poland defended its market position. Since 2000, Poland's exports have grown by more than 2.5-fold, reaching its peak of €115.9 billion in 2008 before dropping by 16% to €96.4 billion in 2009. The decline in exports in 2009 was not that dramatic as in the Baltic countries, where exports shrank by more than 20%. In the first months of 2010 Poland saw some recovery in export value but export values were still lower than in 2008. A significant feature of Poland's merchandise trade was a high trade deficit. In the pre-accession period this deficit gradually declined before rising again when Poland joined the EU. The deficit shrank to under €-8.7 billion in 2009.

Over the past three years, the Polish zloty has appreciated substantially against the euro, the U.S. dollar and other currencies. A sharp depreciation of the zloty (by over 35%), which started in the autumn of 2008 and continued through the first half of 2009, had a significant impact on the trade balance.

Poland had a relatively low level of current account deficits in recent years. While in the three Baltic States this indicator has been rising since 2003 achieving two-digit levels after their accession to the EU, in Poland it has been swinging around -2% or -3% in 2001-2006 before reaching a peak of -5.5% in 2008. The crisis brought the deficit down to -2.2% in 2009, largely as a result of a significant decrease in imports.

The geographical structure of Poland's foreign trade has been relatively stable throughout the whole period of 2000-2009. Poland's key commercial partners were other member countries of the European Union, in particular Germany. The share of the EU countries in Poland's merchandise exports, at nearly 79% in 2009, has been growing over time. Especially, Central European EU member countries gained in importance. The composition of Poland's total foreign trade by sector was relatively stable, with a predominant position of manufacturing. Poland's exports are dominated by machinery and transport equipment, a pattern that has been stable over time. Services have been slowly gaining to account for 17% of all exports in 2009.

In the beginning of this decade, Poland registered low and declining investment rates but has shown considerable improvements since 2004. After double-digit investment growth in 2006-2007, there has been a substantial drop in the investment rate in 2008-2009. A factor that adversely affected investment in Poland in 2008-2009 was a lower level of foreign direct investment (FDI) inflows. The inflow of FDI to Poland amounted to US$16.5 billion, decreasing by 27% from the previous year. Preliminary estimates for 2009 show that FDI inflows dropped further, decreasing by nearly a third to just under US$12 billion. In the 1990s, privatization was a major source of capital inflows to Poland. Since 2002, an increasing number of Greenfield projects have begun to compensate for privatization-related FDI inflows.

Competitiveness trends, 2000 – 2010

The data from the Global Competitiveness Index offers a comprehensive assessment of basic determinants of competitiveness comparing them for 133 countries. Poland's overall competitiveness in 2010 was better than Latvia's and Lithuania's but still lower than Estonia's. The main strengths of Poland's competitiveness in 2010 were company operation and strategy (ranked 32nd), context for strategy and rivalry (ranked 33rd) and the rule of law (33rd). A relatively low rank Poland achieved in macroeconomic policy (ranked 42nd), as well as some elements of microeconomic competitiveness, such as supporting industries and clusters (45th) and factor conditions (43rd), in particular insufficient infrastructure development.

Poland moved up nine places in 2009 to 35th position on social infrastructure and political institutions. But a closer look at governmental institutions in Poland continues to reveal relatively low transparency of government policy making (which even deteriorated slightly in 2009), low government effectiveness in reducing poverty and inequality, poor effectiveness of law-making bodies, low public trust in politicians, and wastefulness of government spending. All these elements improved in Poland in 2009. One exception was transparency of government policy making, which not only was the worst in Poland compared to other countries in the Region but slightly deteriorated in 2009, making the gap in transparency towards the three Baltic States even higher.

Similar changes have been observed with regard to rule of law. Poland gained 10 positions, outpacing Latvia and Lithuania (that went down by six and five positions respectively) and diminishing the gap toward Estonia. Poland's strengths were the low occurrence of irregular payments by firms as well as correct diversion of public funds. Main weakness was the inadequate efficiency of the legal framework. The perception of Polish corruption had worsened in 2005 and was relatively stable since then. In 2009, Poland started to improve its position moving to 35th place, ahead of Lithuania and Latvia.

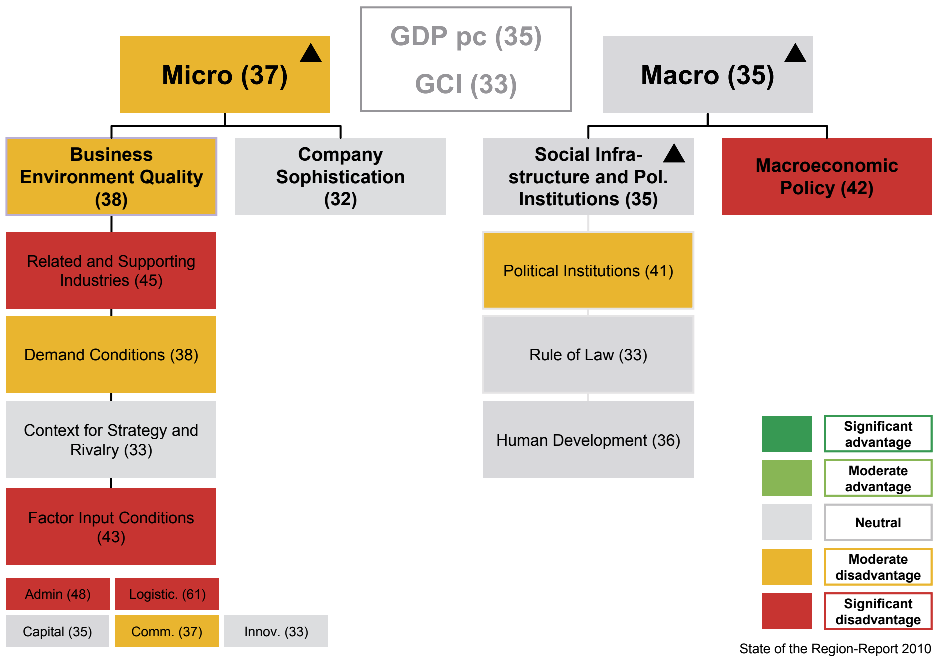
As a measure of monetary policy, Poland experienced significant fluctuations of inflation rates over the last decade. Before EU accession, the annual average rate of inflation decreased strongly from 10.1% in 2000 to 0.7% in 2003. Inflation then rose to 3.6% in 2004 before stabilizing around 2% during the next three years' period. Since 2007, the inflation rate has increased to close to 4%, even during the current crisis.

Following a period of high budget deficits, Poland reduced the shortfall to -1.9% in 2007. An expansionary budget in reaction to the crisis pushed the public finance deficit back to -7.1% in 2009.

On the quality of the business environment Poland was ranked 38th in 2009, higher than Latvia and Lithuania but somewhat lower than Estonia. Poland made huge progress in this respect moving up from 51st place in 2008 but still not back at the 36th position, which it had in 2000. The improvement in Poland's position was a result of changes in demand conditions (up from 58th to 38th place) and in the context for strategy and rivalry (up from 51st to 33rd place).

The aspects of demand conditions that showed the highest advancements were growing stringency of environmental regulations (ranked 36th in 2009 compared to 59th in 2008) and laws relating to ICT (46th versus 65th in 2008). The regulatory changes in environmental protection introduced in Poland in 2009, included in particular, the revised national environmental policy, new law on environmental protection and the National Emission Allocation Plan 2008-2012. These changes in environmental protection regulations went in line with an assumption that after 2015, Poland has to be a country fully compliant against all environmental standards mandatory in the EU Member States. The activities planned in the field of environmental protection in Poland correspond with the

Poland's Competitiveness Profile



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

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priorities of the 6th Community Environmental Action Program such as sustainable development, adaptation to climate change, and protection of biological diversity. They are being implemented at a national level under the Infrastructure and Environment Operational Program, the Rural Development Program for 2007-2013 and the Operational Program "Sustainable Development of the Fisheries Sector and Coastal Fishing Areas for 2007-2013". At a regional level, environmental policy is being accomplished under 16 Regional Infrastructure and Environment Operational Programs. These programs are co-funded by the EU budget. According to Poland's Ministry of the Environment, total combined donations to environmental protection programs will amount to €6.3 billion, which constituted no more than 20% of eligible environmental investment. The remaining resources will be supplemented by the Polish side.

The most important latest change in regulatory framework related to ICT development in Poland was a new broadband law which eliminated barriers to investments in telecommunications and development of internet infrastructure, approved in April 2010. It has regulated the involvement of authorities of municipalities in building an internet and telecom infrastructure. Furthermore, the bill has also regulated the procedures related to permits necessary for this type of investments, which should shorten the time required to obtain them. Therefore, it is expected that these new regulations will have a great impact on internet expansion and the development of e-administration in Poland.

Among factors that are grouped into the category 'context for strategy and rivalry', Poland experienced significant improvements in the index describing pay and productivity ratio (ranked 31st in 2009 versus 54th in 2008) as well as in the field of market disruption from state-owned enterprises (ranked 19th compared to 45th in the preceding year). However, in many other contextual aspects, Poland's position remained relatively weak.

As far as factor conditions are concerned, logistical infrastructure was the weakest element of Poland's performance (ranked 61st, about 30 notches behind the Baltic States positions) in 2009, in particular the quality of roads, rails, ports and other transport infrastructure. After Poland's accession to the European Union in 2004, EU funds have been used to modernize the infrastructure, leading to a significant improvement in the road quality. These positive changes have not been reflected in the GCR assessment yet, as Poland's road infrastructure was ranked 72nd, far behind the positions of all three Baltic States. Though Poland has a relatively well-developed railway network (the railway density is about 6.5 km/100 sq km, while the EU15 average is 4.6 km/100 sq km) but its quality is not sufficient. In 2009, about 37% of Poland's rail lines were in poor condition and nearly a half of the total length of the railway network was not prepared for high speed trains. In 2008, a railway modernization program and a plan for the development of high-speed rail transport in Poland were launched by the Polish Ministry of Infrastructure. A significant increase of investment in railway infrastructure is planned.

Administrative infrastructure, despite a positive change, remained relatively poor (48th). The relatively weak level of the Polish administration infrastructure is also confirmed by the World Bank's Doing Business report. A more disaggregated presentation of the qualitative aspects of Poland's administrative infrastructure reveal that after a significant drop in 2008, the country recently has improved its position on the burden of government regulation, starting a new business and burden of customs procedures. A special package of more than 20 laws was prepared in 2009 to ease conditions for doing business (introduction of a one-stop shop to start business, reduction of administrative barriers, improvements of access to financing).

In contrast to existence of relatively high administrative barriers for doing business in Poland in 2009, capital market infrastructure should be positively distinguished. While in the Baltic States it deteriorated due to the financial crisis, in Poland it improved significantly (ranked 35th in 2009 compared to 50th in 2008). A Financial Stability Committee, consisting of the president of the National Bank of Poland, the chairman of the Polish Financial Supervision Authority and the Finance Minister, was created in 2008 to monitor domestic and international financial developments and propose regulatory measures to maintain financial stability in the country.

Some developments can be also observed in Poland's innovation infrastructure (ranked 33rdin 2009, up from 39th in 2008). In this area there have been measurable improvements in availability of scientists and engineers as well as the quality of math and science education. The share of public and private R&D spending in the GDP known as GERD, or gross expenditure on R&D is a commonly used indicator for the assessment of a country's capacity to produce new knowledge. Even though expenditures on R&D show an upward trend in Poland in terms of absolute value, their share in the GDP fluctuated over the last decade. It dropped from 0.64% in 2000 to 0.54% in 2003, growing again since 2004 to 0.61% in 2008. Comparing Poland with other countries from the Baltic Sea Region, Poland spends a relatively small part of its GDP on R&D, similar to Latvia (0.61%) and Lithuania (0.80%). The public sector accounts for 60% of Polish R&D spending. This relatively stable share indicates that the R&D sector has not been restructured so far. Similar to Poland, the share of public spending on R&D was relatively high in Lithuania, Estonia and Latvia (in 2008 it was 55.6% 50.0% and 47.3% respectively) while in the Baltic Sea Region average private share in R&D was much higher.

Poland, similar to the three Baltic States, had a very low percentage of researchers in the total labor force compared with 1.03% in the EU-27. For instance, in Lithuania, the share of researchers in the labor force was only 0.54% and it was somewhat higher in Estonia (0.72%). Encouragingly, the number of researchers in Poland has grown in 2000-2008 by over 10%. Poland also has a relatively young science and technology (S&T) labor force. Since 2000, the number of new science and engineering graduates in Poland has increased considerably. The share of tertiary S&T graduates in the 20-29 age class doubled to 13.9‰ and the growth trend of this indicator has been much higher than the EU average. Moreover, this share was among the highest in the Baltic Sea Region. Poland outdistanced not only Latvia (9.2‰) and Estonia (13.3‰), but also Norway (9.3‰), Germany (11.6‰) and Sweden (13.6‰). The number of Polish patent applications per million inhabitants has tripled since 2000 but despite this growth it remained very low. The 2010 edition of the European Scoreboard placed Poland among the group of "moderate innovators", with an innovation performance considerably below the EU27 average but at an above average rate of improvement.

To sum up, with regard to business environment, Poland's position significantly improved in 2009. Despite many imperfections, Poland can rely on a relatively sophisticated business environment and it compares favorably with Lithuania and Latvia and has been closing the gap toward Estonia in this respect.

On company operation and strategy, Poland moved up in the GCR ranking from 46th position in 2008 to 32nd place in 2009 after many years of deterioration, outpacing Latvia, Lithuania and Estonia. Poland's strengths laid in the widening extent of marketing and relatively good value chain breadth as well as rising companies' R&D spending along with increasing capacity for innovation. Main weaknesses of Polish companies' operation and strategy in 2009 included low level technology absorption and nature of firms' competitive advantage, which was mostly low cost-based.

Clustering has been initiated quite recently in Poland. Therefore, Poland's position in state of cluster development was rather low in 2009 and furthermore, it even deteriorated. Ranked 71st Poland lags behind Estonia (57th), Lithuania (63rd) and Latvia (69th). The recent emergence of many cluster initiatives led by companies, research institutions or sometimes also by local authorities might change this. According to the European Cluster Observatory database in 2009, there were 147 clusters in Poland, of which only 10 clusters obtained the highest, three-star, rating, 39 clusters had a two-star rating, and the remaining 98 clusters were at the early stage of their development.

The reasons for the relative weakness of cluster development in Poland lay in insufficient expansion of supporting and related industries. This expansion has been hampered by limited availability of latest technologies (Poland dropped 5 places to 59th in 2009) and weak collaboration in clusters (ranked 64th, 2 positions down from 2008).

These problems, to some extent, have been addressed by the Polish cluster policy. The GCR positioned Poland at 64th place with regard to cluster policy development (lower compared to Estonia and Latvia but higher than Lithuania) but such policy is currently being introduced, becoming a part of Poland's regional and innovation policy.

Policy trends, 2000 - 2010

Throughout the whole period of 2000-2010, economic policy priorities were influenced by Poland's membership in the European Union and attempts to address main internal challenges that Poland faced at that time. There have been two phases with regard to policy priorities: before Poland's accession to the EU (2000-2003) and in the period of EU membership (since 2004).

In the beginning of the 21st century, Poland was adjusting its economy to the EU regulations and preparing to the EU accession and at the same time trying to foster economic growth (which was relatively low due to a slowdown in the global economy) and speed up structural reforms. Therefore, at that time, apart from efforts to introduce EU rules, the focus was on two components of economic policy: stabilization policy and structural policy. As Poland experienced relatively low GDP growth rate in 2000-2003 (around 1.5% on average), the main goal of the stabilization policy was to foster recovery in the Polish economy and create foundations for a return to a path of self-sustaining GDP growth. This goal was addressed by measures aimed at boosting private investment spending and attracting FDI. They included gradual cuts in the corporate tax rate, which was reduced from 30% in 2000 to 19% in 2004 and since then remained unchanged. In 2004, the Polish competition law was also adjusted to the EU regulations. Furthermore, in 2003, changes in Poland's system promoting FDI were implemented. As a result of a merger of the State Foreign Investment Agency and the Polish Information Agency, the Polish Information and Foreign Investment Agency (PAIiIZ) was established. The main tasks of this Agency were to help foreign investors to enter the Polish market and guide them through all administrative and legal procedures that were necessary to start a business as well as to support foreign firms that already invested in Poland.

In the first half of the decade, the Polish government was also concerned about the reduction of the scope of macroeconomic imbalances. It particular, main goals were to reduce inflation and keep it under control, curb unemployment, which was rapidly growing at that time (up to 20% in 2002-2003) and deregulate the labor market. To attain these goals, the government had planned to use stabilization policy mix, involving some tightening of the fiscal policy and loosing of monetary policy.

In practice, however, the monetary policy was effectively made more expansionary but the government failed to make fiscal policy more restrictive at the time. As a result, some goals were achieved (e.g. economic recovery, control of inflation, improvement of Poland's attractiveness to FDI) but some were not (e.g. fiscal discipline, decrease of unemployment rate).

Another range of policy priorities in the first half of 21st century was connected with structural changes. Market-oriented institutional transformation had not been finished in the 1990s therefore speeding up privatization and restructuring lagging sectors (e.g. mining, metallurgy, power generation, rail transport, etc.) were among structural policy priorities. Some of these goals were strictly connected with the process of the EU accession as well as Poland's stabilization policy. For instance, restructuring of metallurgy was negotiated with the EU, devised under its pressure, and eventually privatization of the largest steel mills was carried out with foreign investors' involvement.

Since its EU accession, Poland, to a greater extent, has included European policy framework in setting its economic policy goals. Apart from policy priorities related to internal Poland's economic situation, such as reduction of unemployment or control of the budget deficit, there were other goals connected with the EU strategy. In order to implement the fundamental objectives of the renewed Lisbon Strategy, the National Reform Program for 2005-2008 (NPR 2005-2008) was designed. It was based on the National Development Plan, which was approved by the Council of Ministers in January 2003 and on the Action Program of the Prime Minister entitled "Solidarity State" adopted in 2005. There were two main policy goals indicated in the NPR 2005-2008: creation of new jobs as well as reduction of imbalances in the public finances. In particular, in macroeconomic area policy priorities were to consolidate public finance and improve public finance management. In the microeconomic and structural policy area the government put particular attention to boosting entrepreneurship and innovation, and developing infrastructure together with reforms of network industries. Third component of governmental plan was to boost employment and upgrade human capital.

In practice, the government achieved only some of these goals. In 2006, the government succeeded in bringing down the budget deficit but this was attained thanks to the new method, which was used for calculating the deficit. Poland, similar to the other EU member states was allowed to include private pension fund transfers into the general government sector for the purposes of evaluating its deficit. The reduction of the budget deficit in 2007 was the result of faster-than-expected GDP growth coupled with windfall tax revenues and strengthened budget discipline when it comes to expenditure, but comprehensive public finance reform was not implemented.

In the field of employment policy, some actions were taken in order to improve work incentives. The huge problem in Poland at the time was high share of people who received disability benefits. This was due to so called "disability trap", which appeared because the net disability incomes were higher than minimum wages. This problem was partly solved in 2005 by introduction of new rules concerning disability, which introduced the obligation of re-evaluation of disability pensioners in order to direct social transfers to those people who really need them. However, some problems such as high youth unemployment, and high tax wedge remained unsolved at the time.

The latter issue was addressed by policy actions in 2007. The tax wedge decreased substantially in Poland for two basic reasons. First, the disability premium was gradually reduced from 13% to 6%. Second, a tax break was introduced for families with children. Moreover, in 2008, the eligibility criteria for early retirement schemes were tightened and some cuts in personal income taxes were introduced (in 2009 three-tier scale tax system, i.e. 19%, 30% and 40%, was replaced by two tax rates, i.e. 18% and 32%). These new regulations were in line with the National Reform Program for 2008-2011 (NPR 2008-2011) aimed at implementing the revised Lisbon Strategy adopted by the Polish government in 2008. The NPR 2008-2011 was based on the Strategic Plan of Governing of the Prime Minister Donald Tusk's Government being also consistent with the Strategy for the Country's Development 2007-2015, the National Strategic Reference Framework 2007-2013 as well as Convergence Program 2007 Update. There were three priority areas recognized by the government: (1) creating conditions for favorable development of the Polish society; (2) developing innovative and value-added sectors and branches; (3) increasing efficiency of institutions.

The first priority area was covered by six policy measures such as changes in education system, social security modernization, active labor market policies, development of institutions that support the citizens' participation in public life, information society development and improvement of health care system. Some actions have been recently undertaken in these areas. As far as education system is concerned, the amendment to the laws regulating higher education as well as the academic degrees and titles is currently going through the legislative process (2010). Furthermore, the Bologna Process has been implemented in the Polish higher education system. It facilitates free movement of Polish students in the EU.

With regard to employment reforms, the early retirement schemes have been reformed but the special farmers' social insurance program has not yet been changed. In order to support employment of people aged 50 and more, in 2009, the amendment to the Labor Code was made. It introduced incentives to employ and maintain at work people over 50 years old (these measures were for example: shorter period of sickness allowances covered by employers or extended training funds). Another strand of governmental actions related to the Polish labor market was connected with upgrading of qualifications and skills of employees. Many actions have been implemented in this area under the Human Capital Operational Program 2008-2013, which is co-funded by the state budget and European funds.

Innovation was another priority of the Polish government for 2008-2011. The Lisbon agenda had been included into policy priorities since Poland joined the EU in 2004 but the process of the implementation of its renewed version speeded up in Poland after 2006, with the increase in the inflow of the EU structural funds. Since 2007, innovation and entrepreneurship were regarded as the key issues in all economic programs of Poland's government (e.g. introduction of the Operational Program "Innovative Economy"). Some changes in the research system were initiated such as, for example, creation of national coordinating institution for research, i.e. the National Centre of Research and Development. Furthermore, National Foresight Program was implemented and priorities for Poland's technological development up to 2020 were defined.

Innovation and entrepreneurship were also boosted thanks to the amendments to the law on freedom of economic activity, which were introduced in 2008-2009. For instance, these regulations facilitated suspending of business activity for a limited period (without financial costs or face any administrative measures such as social and health insurance premiums, income tax withholding or monthly and quarterly VAT declarations), simplified financial settlements of small and medium size enterprises with tax authorities, and clarified the way of law interpretation and introduced one-stop shop for start-ups. Programs supporting the development of clusters were also initiated including internationalization of clusters activity within INNET program.

Development of transport infrastructure and restructuring of network industries became other primary issues in the Polish economic policy in 2007-2009. In order to speed up freeway projects, in 2009, the government revised the law on public tenders and made it more flexible.

Furthermore, the market for electric power was opened in 2007 and elaboration of privatization plan was initiated. In 2008-2010, privatization was accelerated in order to boost corporate profitability and encourage investment. Privatization projects carried out during 2008-2010 included, among others, initial public offering by energy group PGE, partial privatization of PKO Bank Polski, selling state share in Polish Insurance Company (PZU). However, due to the crisis, the Ministry of the Treasury became cautious about privatizing financial institutions and postponed some privatization projects (for example the privatization of the Warsaw Stock Exchange originally scheduled for 2009 was postponed to autumn 2010).

In the third priority area mentioned in the NPR 2008-2011 regarding the efficiency of institutions, only a little progress has been made so far. The reorganization of public finance sector has not been implemented but in 2009 first steps were made. The government approved a Strategy for Public Finance Management for 2009-2011. Under this strategy, public debt should be reduced from around 45% to 41.9% of the GDP over three years. This measure is related to Poland's preparations to meet the Maastricht criteria, which have been described in The Convergence Program Update approved by the Polish parliament in January 2010. According to this document, the public deficit will increase slightly but will not exceed 60% of GDP. Under this Convergence Program Update, in 2010, the public finance deficit is expected to account for 6.9% of the GDP, 5.9% in 2011, followed by 2.9% in 2012. These goals seem to be rather optimistic and they can be achieved only on the condition that deep structural reforms of public finance are implemented.

Finally, in 2008-2010 the focus of economic policy has been shifted to mitigating the global financial crunch and its negative effects. In the case of Poland, the most severe consequences of the crisis included rising unemployment, strong depreciation of the Polish zloty, and growing general government deficit and public debt. They have become the center of economic policy. The government addressed some of these issues, introducing in November 2008 the Stabilization and Development Plan. It was followed by the Anti-Crisis Pact, which was launched in August 2009, which brought the temporary relaxation of labor regulations at a time of crisis in order to increase the adaptability of enterprises. The Polish government decided not to inject any special packages of state intervention but, in fact, some effects of anti-crisis stimuli introduced in other countries were transmitted into Poland through international market.

Poland's membership in the European Union was, during the whole decade, a key factor influencing economic policy goals. In the beginning of the decade, the main aim was to adjust to the EU market through restructuring, liberalization and deregulation, while after EU accession, implementation of European common policies, boosting employment, innovation and infrastructure development were at a center of the governmental actions. There were also some issues related to macroeconomic performance that remained among policy priorities throughout the decade but the goals set up by the government have been met only partly in these areas. These were relatively high unemployment and in-depth reform of public finance.

Implications

The global financial crisis triggered an economic downturn or even recession in many countries and induced many changes in the economic landscape in 2009. In this turbulent time Poland managed to upgrade its overall competitiveness, boosting it in many dimensions. Poland's relatively good performance and better than its counterparts resilience to the crisis was reflected in its positive GDP growth, which reached 1.7%, making Poland the only economy in the Baltic Sea Region as well as in the whole EU that did not shrink last year. However, it does not mean that Poland has been bypassed by the crisis and this positive growth in 2009 has not been a guarantee of success in the coming years.

The crisis has had a greater impact on some countries than on others due to different levels of internationalization of individual economies and sectors (including the financial sector) and varying resistance to external shocks. Poland as a relatively big country (compared to three Baltic States) relatively easier adjusted to this external strike. There are several reasons for Poland's relative resilience to the global crisis. In particular, these include Poland's relatively large domestic market and high internal demand as well as the moderate openness of the Polish economy, measured by the ratios of trade and FDI to GDP (40% and 33% respectively). Other factors include a flexible exchange rate of the Polish currency, an increased absorption of EU structural funds, and sound rules for supervision over the financial sector coupled with a relatively low level of its internationalization (low share of foreign banks in total bank assets). Furthermore, paradoxically, the lower sophistication of Poland's export pattern, which was always regarded as a sign it was lagging behind in the manufacturing sector, at this time of crisis became a factor that facilitated adjustments as exporters were less sensitive to swings in external demand and could thereby switch to supplying the domestic market. This coupled with the depreciation of the Polish zloty, facilitated adjustments in the export sector. It should be stressed that in this brief overview of factors that have mitigated the impact of the global financial and economic crunch on Poland's economy, the active role of government economic policy is not included as there was no special fiscal policy in Poland aimed at counteracting effects of the crisis in 2009.

In view of the analysis conducted in this chapter, it seems that Poland is closer to the first scenario outlined in the introduction than to the second. In general, microeconomic foundations of country's competitiveness have been gradually developing. This process is confirmed by the elasticity and adaptability of Polish enterprises, notably small and medium-sized firms in coping with the negative effects of the current external shock. Another indicator is Poland's foreign trade performance, in particular, Poland's growing share in global exports and imports and increasing flows of intra-industry trade. Furthermore, Poland, step by step is moving to an innovation-driven stage of competitiveness as a significant improvement was noted in the growth rates of innovation performance indicators (European Commission, 2010). These positive signs allow concluding that Poland has been upgrading its microeconomic competitiveness but the pace of it is unfortunately relatively slow. The missing elements in Poland's microeconomic competitive ability are, in particular, transportation infrastructure and cluster development. In these areas the gaps dividing Poland from other countries in the Region are the highest. There are some hopes for bridging the gap in the first area as many infrastructure projects are currently being carried out but these projects will be accomplished in the medium-term. Closing the gap in cluster development will take much more time as nearly all existing clusters in Poland are still an in immature stage.

Having concluded that microeconomic foundations of Poland's competitiveness are developing in a proper direction, it seems that macroeconomic management should be blamed for Poland's relatively low competitive performance as it sets the overall context in which companies operate. One cannot deny that also in this area huge progress has been made during the last decade. The good examples include positive impact of the central bank, which was running appropriate monetary policy or high quality of financial supervisory regulations. Nevertheless, some structural problems remained unsolved. The reform of public finances, including the restructuring of government spending, was declared as one of policy priorities by all Polish governments that ruled the country during this decade. However, this reform has not been introduced yet. Another key macroeconomic policy issue is the country's exceptionally low level of labor participation and relatively high unemployment rate. Some reforms have been already initiated such as, for example, the termination of the generous provisions for early retirement but further changes in disability pensions, and a redesign of the farmers' pension system are necessary to increase labor mobility and its participation rate. Other key challenges for government policy include human capital development through more active educational policy. Furthermore, reforms are also needed in health care and the science sector. Upgrading the stock of human capital through education and better health care seems to be a crucial factor for further development, and a strategic driver of Poland's competitive position in the long run. In the short run, however, a stringent budgetary policy aimed at curbing the growth of the budget deficit and public debt is essential.

In conclusion, in order to improve the competitive position of the Polish economy, policy makers need to pursue not only an appropriate policy mitigating the global crisis but also an active macroeconomic policy in breaking down the internal barriers. Though Poland has been more resilient to global crisis than other countries in the Region and improved its competitiveness in 2009-2010, the country did not avoid some slowdown in economic growth and many economic problems remained unsolved. Therefore, despite relatively good performance, Poland cannot be regarded as a perfect model to follow by other countries in the Region. Positive features, which are worth implementing elsewhere, are sound rules regarding financial sector supervision and effective monetary policy. However, there are also some weak points such as low transparency of public finance coupled with rigidities in fiscal policy, overregulated labor market and insufficient social capital development. Therefore, despite relatively good performance of Poland's economy, adopting 'the Polish model' by other countries seems to be limited as it might not be effective.

3. International financial institutions and the Baltics

The two following articles have been written by representatives of the European Investment Bank (EIB) and the Nordic Council of Ministers (NCM) respectively. They have been asked to profile the activities of their institution across the Baltic countries and Poland, discuss the impact they have seen from their efforts, reflect on the impact of the crisis on their thinking, and give some indications on their plans for the future.

3.1 European Investment Bank (EIB)

By the European Investment Bank (EIB)

The Baltic Sea's 8,000 km long coastline is shared by eight EU Member States plus the Russian Federation. Each country has its own priorities and particularities, its economic imperatives, and political concerns. There has been a long tradition of cross-border cooperation but, despite years of collaborative action to improve the environmental condition of the Baltic Sea, it continues to deteriorate. The response from the EU Commission, the European Parliament, the Member States and concerned stakeholders, to tackle not only the environmental problems but to take a more comprehensive approach to address the over-all sustainability of the Region, has been to adopt a common regional strategy for the whole Baltic Sea Region, the first macro-regional strategy of its kind in the EU's history. The strategy has four key elements aiming to make the Region: environmentally sustainable, competitive, accessible, and safe and secure through risk prevention.

These key elements match closely with most of the priorities given to the EIB by the 27 EU Member States. As the EIB's mandate is to support EU policy, EIB has a special responsibility to contribute to the success of the EU Strategy for the Baltic Sea Region (EUSBSR). The EIB supports the implementation of the Baltic Sea Strategy in various ways. In the past, the Bank has financed several wastewater treatment plants in places that were classified by the Helsinki Commission as hot spots, point sources of massive pollution. Within the framework of the Northern Dimension Environmental Partnership, the Bank has co-financed several high priority de-pollution projects in the St. Petersburg region.

The EIB has, likewise, promoted the upgrading of the necessary infrastructure to integrate the various individual regions into a larger Baltic Sea region. EIB loans have gone to bridges, tunnels, port facilities and railroads. Improved and safer energy production and transmission have also been high on the lending agenda.

The Baltic Sea Region is changing fast and the EIB is alert to the new challenges facing the area. The effects of climate change, sea pollution and the increased number of emergencies at sea as well as inadequate energy interconnections all need to be addressed. The EIB has also supported a large number of research, development and innovation (RDI) projects in the Baltic Sea Region. In some Baltic Sea countries, RDI has become one of the most important sectors for EIB financing. Overall, the EIB has lent more than EUR 20bn to activities in the Baltic Sea Region in the years 2007-2009. In 2009, the EIB's lending in the Region amounted to around EUR 10bn. In the Eastern Baltic Sea Region, including Estonia, Latvia, Lithuania, Poland and the Russian Federation, lending has more than tripled over the past three years, from EUR 2,336m in 2007 to EUR 7,213m in 2009.

Table. EIB lending in the region 2007-2009:

Signatures	2007	2008	2009
EU			
Denmark	209	379	422
Estonia	-	87	842
Finland	613	710	1 145
Germany[5]	110	480	52
Latvia	35	860	285
Lithuania	20	10	1 169
Poland	2 281	2 837	4 784
Sweden	713	1 311	1,135
EFTA			
Iceland	146	-	170
Norway	-	-	-
EASTERN EUROPE			
Russia	-	-	133
Total	**4 127**	**6 675**	**10 136**

5 In the Länder Schleswig-Holstein, Hamburg and Mecklenburg-Vorpommern

Our firm intention, while contributing to the implementation of the new EU Strategy for the Region, is to remain the single most active multilateral financing institution in the area and one of the leading lenders to flagship projects. The flagship projects are a group of projects vital for the implementation of the EUSBSR. The list of flagship projects is a result of negotiations between the European Commission and the EU Member States around the Baltic Sea. One common feature of the flagship projects is that they are crucial for the integration of the different sub-regions into one functioning macro-region. The selection of these projects is carried out by national governments and authorities. The Bank is assisting the Member States in preparing and implementing bankable projects, in many cases also involving co-financing from EU Structural Funds. The EIB has already approved or is in the process of approving financing to roughly one third of the flagship projects in the Baltic Sea Region.

EIB lending in the EU Member States of the Baltic Sea Region

The EU Member States within the Baltic Sea Region represent a microcosm of the entire EU in the sense that well developed countries with intensive RDI activity and a generally well established infrastructure like the Nordic countries (Denmark, Finland and Sweden) are neighbors to the three Baltic countries and Poland, which are economically less prosperous and more recent Member States. Until the economic crisis hit, high growth rates in some of the new Member States allowed for a significant catching up process which has now stalled.

In Denmark, Finland and Sweden, a major part of the EIB's lending is targeted towards the RDI activity of leading private corporations and municipal infrastructure (health, education, transport, water and wastewater). In addition, the EIB has financed key infrastructure projects of national and regional importance, including PPP road projects and railway infrastructure.

In the three Baltic countries and Poland, the main targets of EIB lending are basic infrastructure promoted mainly by publicly owned entities (transport, energy generation, transmission and distribution, environmental protection, and health and education). A particular feature in the new Member States of the Baltic Sea Region is the Bank's co-financing activity with the EU Structural and Cohesion Funds, often through Structural Programme Loans (SPL). These countries (as well as Mecklenburg-Vorpommern in Germany) are classified as convergence regions and have access to significant subsidies from the EU Structural Funds (over EUR 80bn over 2007-2013, of which EUR 67bn is for Poland alone). While

Table. Structural Programme Loans in the Baltic Sea Region and EIB support

2007-2013 programming period

Country	Name of operation	Project cost m EUR	Approved or expected EIB loans m EUR	Signed m EUR	Approved or expected/ project cost %
	Approved programmes				
Estonia	EU Funds Co-Financing 2007-2013 (EST)	4 331	550	550	13%
Latvia	EU Funds Co-Financing 2007-2013 (LV)	5 834	750	750	13%
Lithuania	EU Funds Co-Financing 2007-2013 (LT)	9 564	1 132	1 132	12%
Poland	Mazovia Regional Infrastructure *	400	180	88	45%
Poland	Poznan Municipal Infrastructure *	209	54	48	26%
Poland	Lodz Regional Infrastructure *	323	106	0	33%
Poland	Malopolska Regional Infrastructure *	353	88	38	25%
	Total approved projects	**21 013**	**2 860**	**2 606**	**14%**

(*) Partly co-financed with the Structural Funds regional and municipal investment framework operation.

there is one SPL for each of the three Baltic States covering the co-financing needs for the Operational Programmes in the 2007-2013 programming period, the SPLs in Poland are of a regional character and are, in some cases, also combined with components which are not co-financed with the EU Structural Funds.

In the EU Member States of the Baltic Sea Region, the EIB also offers financing to small and medium-sized companies (SMEs) through intermediary local financial institutions, which it provides with credit lines. The EIB funds are on-lend by the financial intermediaries to eligible SMEs to cover financing needs related to capital expenditure and working capital needs.

Impact/Success of the activities

The economic crisis has had a major impact on the regions' competitiveness. Several major key projects co-financed by EIB and the EU Structural Funds have been downsized, delayed or stopped. The situation in Latvia has been particularly difficult, and progress on the implementation of the three national Operational Programmes, has slowed down considerably due to the austerity measures imposed to bring down the budget deficit and public spending. Estonia and Lithuania have also been hit hard. However, they have managed better to continue their implementation of EU-funded projects. Investments in RDI components in the EU-funded Operational Programmes have come to a halt or been severely delayed due to a lack of private funding, as most RDI projects were planned to be implemented together with the private sector stakeholders.

Comparing the structure of EIB lending in the Baltic States and Poland with lending to other Member States, it is clear that the focus of EIB lending in Eastern BSR remains on basic infrastructure such as motorways, bridges, railways, power plants, power grids, water treatment and waste management, while EIB lending for instance in Sweden and Denmark is focused on RDI, particularly in the private sector.

Consequences following the experience of the crisis

One of the lessons which can be drawn from the crisis is that the Member States benefit from EIB support to keep investment projects and programs on track. The EIB has responded to financial and technical assistance needs of the concerned countries by fast processing of loan applications. Provided that there has been room for doing so, loans to certain projects have been increased, if required, by the underlying investment rationale. There are also ways to improve the quality of the projects, making use of a number of Financial and Technical Assistance instruments available within the EIB, often referred to as the Js: JASPERS, JESSICA and JEREMIE.

JASPERS is a technical support facility for the EU-12 countries, set up in 2006 to help these Member States in preparing higher quality project proposals for EU Structural Fund grant support. Some EUR 354bn is available in grants for the budgetary period 2007-2013. JASPERS is a joint initiative, combining the funding of the Commission with the technical expertise of the EIB (which administers JASPERS) as well as EBRD and KfW. JASPERS activities in the Baltic Sea Region concern the three Baltic States and Poland. Under the Baltic Sea Strategy, JASPERS can offer its support for all flagship projects which are not yet covered.

JESSICA (Joint European Support for Sustainable Investment in City Areas), launched in 2006, is an initiative aimed at supporting a new way to use 2007-2013 Structural Fund allocations, namely to establish revolving investment instruments rather than grant subsidies in favor of urban development projects. In order to use JESSICA, Member States are expected to include an urban agenda in their operational programs and can consider using JESSICA instruments to fulfill this agenda. Member States can allocate part of their Structural Funds to JESSICA financial engineering instruments. The funds are channeled into Urban Development Funds (UDF) that invest through equity, loans or guarantees in public-private partnerships and other projects that are included in an integrated plan for sustainable urban development. UDF may combine funding from the 2007-2013 Operational Programmes with other resources such as those provided by international financial institutions, commercial banks, other public and private investors, as well as the cities concerned.

The Baltic Sea Region also makes use of JESSICA. The EIB's role in the Region is that of (1) assisting Member States and Managing Authorities through JESSICA Evaluation Studies, following their request, to assess the potential for financial engineering instruments dedicated to urban development and assist the authorities in preparing the framework for the implementation of JESSICA (Poland, Lithuania, Finland, Germany, Sweden have so far benefited from such studies), and (2) acting as JESSICA Holding Fund, to channel Structural Funds into Urban Development Funds on behalf of the Managing Authorities in support of urban projects. For example, in Lithuania the JESSICA Holding Fund supports via intermediaries an energy efficiency program in multi-apartment buildings. The total size of JESSICA Holding Funds managed by the EIB in Poland and Lithuania stood at EUR 327m at the end of 2009. In addition, if so requested, the EIB can act as adviser on implementing UDF-type structures also in countries and regions where it does not operate as Holding Fund.

JEREMIE (Joint European Resources for Small and Medium-sized Enterprises) offers EU Member States, through their national or regional Managing Authorities, the opportunity to use part of their EU Structural Funds allocations to finance small and medium-sized enterprises (SMEs) by means of equity, loans or guarantees, through a revolving Holding Fund acting as an umbrella fund. This initiative was developed by the European Commission and the European Investment Fund (EIF), which is part of the EIB Group.

In the Baltic Sea Region, Latvia and Lithuania decided to allocate a part of their resources from the EU Structural Funds into a JEREMIE Holding Fund that is being managed by the EIF. The EIF has signed almost 10 contracts with financial intermediaries that on-lend to and invest in local SMEs in line with the set targets of the respective Holding Funds. The Latvia Holding Fund is for EUR 91.5 million and the amount dedicated to the Holding Fund in Lithuania is up to EUR 290 million. In addition, as a result of regional and national Evaluation Studies conducted by the EIF in Poland, the local authorities are proceeding to implement six different Holding Funds, at present without further EIF involvement.

The plans for the future

EIB lending to the Baltic Sea Region was about EUR 10bn in 2009. The estimated lending volume, for 2010, remains at the same level. The final lending volume will depend on the progress of the projects in the pipeline, the capacity of the countries to prepare new projects and, finally, the state of the economy in the Baltic Sea Region. The most difficult period of the crisis seems to have passed nonetheless, since most of the Baltic economies are rather export-oriented, the situation of the region cannot improve much if the development of global economic environment continues to be sluggish. The EIB will continue to deliver its expertise and financial instruments. However, there is also a proposal under development examining the potential launch of a BSS Trust Fund, which can provide TA in order to further enhance the implementation of co-financed projects in the Region as well as support the development of complex projects.

EIB-financed projects from the Eastern Baltic Sea Region

EU Funds Co-Financing 2007-2013 (LT), Lithuania

The loan, amounting to EUR 1.321bn, supports the implementation of Lithuania's 2007-2013 National Strategic Reference Framework (NSRF), through the co-financing of three Operational Programmes (OPs): (i) OP for the Development of Human Resources 2007-2013; (ii) OP for Economic Growth for 2007-2013; and (iii) OP for Promotion of Cohesion for 2007-2013. The loan also provides financial support for the completion by 2010 of six large water supply and wastewater treatment projects that are co-financed by the Cohesion Fund (2004-2006 programming period). The total project cost is estimated at EUR 9.564bn.

Latvenergo CHP, Latvia

The project involves the design, construction and commissioning of a second combined heat and power unit within the boundaries of the Riga Thermal Power Station no. 2 (TEC-2) power site located in Acone in the outskirts of Riga, the capital of Latvia. The project is the second stage of TEC-2 reconstruction project that was launched in 2005 with the purpose of replacing the old generating units of very low efficiency and extending the power capacity of the power site. The proposed co-generation plant uses state-of-the-art technologies and comprises a combined cycle unit with gas turbine (GT), heat recovery steam generator (HRSG) and steam turbine (ST) with an anticipated electric capacity of 400 MW electrical and heat capacity of 270 MW thermal for district heating. The loan amounts to EUR 100m out of a total estimated project cost of EUR 367m.

Estlink 2, TEN-E, Estonia

The project concerns the implementation of a monopolar HVDC (high voltage direct current) link interconnecting Estonia (Püssi) and Finland (Anttila) across the Gulf of Finland. The proposed project will have rated capacity of 650 MW, terminal voltage of 450 kV and a total length of 165 km. The new link will increase the transmission capacity between the Baltic and the Nordic countries from 350 to 1000 MW and thereby improve diversification and security of supply, and enhance electricity market integration in the Baltic Region. The project has been designated as a flagship project of the EU Strategy for the Baltic Sea Region and as TEN-E priority project of European interest, and was granted a 100 MEUR Community financial assistance under the European Economic Recovery Programme. The project is currently under appraisal at the EIB and subject to approval by the EIB Board of Directors, the EIB loan to Elering OUE, the Estonian State-owned transmission system operator, would amount to up to EUR 75m out of a total estimated project cost of EUR 306m. This project is foreseen to be co-financed with the Nordic Investment Bank.

National Environmental Protection Fund, Poland

The Polish systems of drinking water supply and of waste water collection and treatment services require an important improvement in order to comply with EU standards. The EIB loan of PLN 500 m (approx. EUR 122 m) to the National Fund for Environmental Protection and Water Management will finance 15 water supply and wastewater collection infrastructure projects representing investments totaling EUR 426 million. All these projects have been already approved for financing by EU Structural Funds and they are located in several small-medium sized municipalities across Poland. EIB funds will help Poland to meet the commitment to implement the European environmental legislation, particularly the Urban Wastewater, Drinking Water and Water Framework Directives. This will substantially contribute to the increase of the quality of life of Polish citizens.

Warsaw-Gdynia Rail Rehabilitation TEN, Poland

The Polish railway network is requiring an important support to be modernized. This first TEN-T Priority Project along the Corridor VI is ensuring a fast connection for passengers and goods between Warsaw and the main Polish ports of Gdansk and Gdynia. The modernized line (about 340 km) will compete with road and airlines on the Warsaw-Gdansk route: less than 2h30 will be sufficient to connect by train the capital of Poland with its main ports. The project is an excellent example of high value added contribution offered by EIB in the new Member States. For the first time in Poland, EIB successfully combined JASPERS' Technical Assistance, EU grants and EIB long-term funding in support of the modernization of the railways sector. The loan amounts to EUR 400m out of a total estimated project cost of EUR 3bn.

St Petersburg Vodokanal I, II and III, St Petersburg, Russian Federation

The EIB has supported three environmental investments in St Petersburg. Prior to these investments, the City of St. Petersburg was the biggest single source of phosphorous emissions into the Baltic Sea. The city did not, at the time ,have sufficient capacity to treat all wastewater nor to treat and dispose sludge from wastewater treatment. In 2003, a first loan (Vodokanal I) of EUR 25m was signed to complete the construction of the South West Wastewater Treatment Plant. The project was co-financed with EBRD, NIB and Nordic Bilateral Donors. The plant was successfully completed in 2005 and taken into operation. In 2005, the following loan (Vodokanal II), amounting to EUR 20m, was signed for the rehabilitation of the city's Northern Wastewater Treatment Plant, with a particular emphasis on improving the situation of sludge treatment and disposal. In 2009, a third loan of EUR 17.5m was signed (Vodokanal III), with the aim of financing the (i) completion of the Northern Tunnel Collector (NTC); (ii) pumping station and buildings; (iii) connection of current direct discharges of untreated wastewater; (iv) reconstruction of Central and Northern Wastewater Treatment Plants. All three projects are important projects within the framework of the Northern Dimension Environmental Partnership (NDEP). Through the proposed investment program, the load of nitrogen and phosphorous to the Gulf of Finland/Baltic Sea is expected to be reduced considerably. The implementation of the proposed program will promote the fulfillment of the commitments made under the HELCOM convention. As a result, the City of St Petersburg will comply with the EU recommendations of 94% efficiency in wastewater treatment.

3.2 Nordic Council of Ministers (NCM)

By the Nordic Council of Ministers (NCM)

The Nordic-Baltic cooperation is based on political cooperation and partnerships on equal footing. The cooperation between the Nordic Council of Minister and Estonia, Latvia and Lithuania entered a new phase on 1 May 2004, when the three Baltic countries became members of the EU.

First and foremost, the co-operation between the NCM and Estonia, Latvia and Lithuania is a political co-operation that generates Nordic–Baltic benefit. The Nordic-Baltic co-operation is a partnership based on common values such as democracy, good governance, equality, freedom of speech and tolerance, and allowing cultural cooperation, amongst other things, to serve as a link in Nordic–Baltic relationships.

The Council of Ministers' cooperation with the Baltic countries is based on the Guidelines for Co-operation 2009-2013, which were endorsed by the meeting of Nordic-Baltic foreign ministers at their meeting in Pärnu in September 2008 and were finally adopted by the Ministers for Nordic Co-operation in December 2008. The following areas are prioritized in the guidelines:

- Education, research and innovation
- Business, clusters and the creative industries
- Environment, climate and energy
- Challenges faced by the welfare state
- Cross-border regional co-operation, including partnerships for democracy in Belarus.

The Nordic Prime Ministers have stated that more profound cooperation with the Baltic countries reinforces the competitiveness of the entire Baltic Sea region and increases opportunities to utilize globalization. The Nordic-Baltic cooperation is closely connected to and should underpin EU policies such as the Baltic Sea Strategy and the Northern Dimension. The three Baltic Prime Ministers confirmed in a meeting the 21 January 2010 that Nordic Baltic Cooperation is of outmost importance for the entire region.

The Nordic Council of Ministers' co-operation with the Baltic governments is referred to as NB8, i.e. the five Nordic countries, within the framework of the Nordic Council of Ministers, working with Estonia, Latvia and Lithuania.

EU Baltic Sea Strategy

The NB8 cooperation, in 2009-2010, has a special focus on the EU's Baltic Sea Strategy, where the existing Nordic-Baltic cooperation has been a good basis for development of projects under the Baltic Sea Strategy Action Plan. The Nordic Council of Minister has with its' five offices in Tallinn, Riga, Vilnius, St. Petersburg and Kaliningrad, a unique network in the Baltic Sea Region and a long-time experience of regional cooperation across the Baltic Sea. The Nordic Council of Ministers is strongly committed to the implementation of the EU Baltic Sea Strategy and sees the Nordic Baltic cooperation as an important cornerstone in the realization of the strategy.

Besides strengthening of the Nordic-Baltic cooperation, the Baltic Sea Strategy also forms an important framework for the development of cooperation with partners in Poland and Germany as well as Northwest Russia. Coordination is crucial for the effective implementation of the strategies covering this region. The Nordic Council of Ministers therefore closely cooperates with the other regional organizations and actors cross the Baltic Sea region on different levels.

The Nordic Council of Ministers can play a particularly important role in realizing the objectives of the Baltic Sea Strategy within different areas. A number of concrete NCM projects are included in the Baltic Sea Strategy Action Plan, e.g. in the fields of forestry, genetic resources and veterinary contingency planning.

Examples of Nordic-Baltic cooperation initiatives

The Nordic-Baltic cooperation has been strengthened with the launch of the joint NordPlus Framework Programme in 2007, which is a major program for exchange and cooperation in the field of education. In the field of research, joint principles for Nordic-Baltic cooperation were agreed in 2009, including themes for the cooperation, governance structure and financing.

In 2009, three joint Nordic-Baltic Mobility Programmes, with financing on equal footing, were launched: for Civil Servants, for Business and Industries, and for Culture. The programs are seen as a major milestone for the development of Nordic-Baltic cooperation and have, despite the economic crisis, been prioritized by the participants. Considerable interest has been shown in participation in these programs and the concrete projects have contributed to establishment of networks that will pursue close co-operation in, e.g. joint EU projects.

The three offices of the Nordic Council of Ministers in Tallinn, Riga and Vilnius play a key roles in realizing the NCM's objectives for cooperation with the three Baltic countries. They help forge closer Nordic–Baltic political dialogue through, e.g. high-profile seminars on energy issues and the EU's Baltic Sea Strategy, organized together with relevant partners and very often involving also the Nordic embassies. The offices help to facilitate Nordic–Baltic cooperation in sectors such as the creative industries, the environment and the challenges faced by the welfare state – areas in which there is great Baltic interest in Nordic experiences. The offices also run Nordic–Baltic the mobility programs for public administration respectively business and industry, as well as a small program for Nordic–Baltic NGO partnerships.

Other cooperation in the Baltic Sea Region

The Nordic Council of Ministers finds it important to engage all relevant partners in the development of a strong Baltic Sea Region. Through its' offices in St. Petersburg and Kaliningrad, the Nordic Council of Ministers work with Northwest Russian partners in a number of fields where especially the involvement in the Northern Dimension partnerships is prioritized. Cooperation within the Northern Dimension Partnerships is especially intensive in the fields of social and health, where a number of Nordic-Baltic-Russian projects on combating trafficking in human beings are carried out. The Nordic Council of Ministers is, in 2010, supporting the development of the new Partnership for Culture under the Northern Dimension, which is seen as an important framework, also for initiatives in the field of culture and creativity under the Baltic Sea Strategy.

Cooperation on issues related to Belarus is also an important element of Nordic-Baltic cooperation. The Nordic Council of Ministers has since 2005 supported the Belarusian university-in-exile European Humanities University in Vilnius in close cooperation with the European Commission, the Government of Lithuania, as well as other major international donors including the United States. On the initiative of the European Commission, the Nordic Council of Ministers established, in 2008, an international Trust Fund, which coordinates the international support to the university.

Another priority is strengthening of the cooperation of the civil society of the Nordic countries, the Baltic countries and Poland, and the neighbors in Northwest Russia and Belarus. The Nordic Council of Ministers has since 2006 supported tri-partite NGO-cooperation through its' NGO-program for the Baltic Sea Region. The program is first and foremost focused on capacity building of NGO's in the neighboring countries in order to strengthen the civil society in Northwest Russia and Belarus.

4. Assessment and implications

The Baltics 2000 – 2010: A lost decade?

The last decade has seen a dramatic economic transformation of the three Baltic countries and in Poland. All chapters in this part of the 2010 State of the Region Report bear evidence to these changes that have moved this part of the Baltic Sea Region from a phase of systemic transition into an era of normal economic development.

The current crisis in the Baltic countries has to be seen in the historical context of the last two decades. The only relatively recent experience of significant prosperity improvements might explain why societies and political systems in the region have proven to be remarkably resilient in the face of the stark social and economic challenges that have emerged. Despite relatively poor rankings on institutional quality, governments across the Baltics have been able to act decisively. And while there has been unrest, there has been no wave of populism or other signs that the democratic systems are becoming ineffective in dealing with the crisis. This compares quite favorably, not only with the experience in other parts of Europe but also globally.

Also, in purely economic terms, the net achievements over the last decade remain impressive, even after the deep and painful downturn since 2008. The social costs for the many unemployed, for pensioners, for people in rural regions, and for many others are very real. The downturn has amplified the social tensions that had been around for some time but were less visible as high growth was lifting standards of living more generally. Nevertheless, the average prosperity level in the Baltics in 2009 remains 60% higher than at the beginning of the decade. And across the Baltic countries there are now clear signs that the situation is stabilizing.

Despite this maybe surprisingly positive assessment, it is crucial not to be fooled into seeing the crisis just as a deep but ultimately temporary bump in the road. Marek Tiits, Dorel Tamm, and Rene Tõnnisson identified this as *"a very tempting, yet dangerous way of thinking"*. I can only agree. The last ten years have not been a lost decade for the Baltic countries, even though the sequence of boom and bust has put a high and, to a large degree, unnecessary burden on their economies and societies. The three countries have also done quite well in dealing with the crisis, certainly better than the worst case scenarios that seemed a real possibility at times. Alf Vanags and Morten Hansen give a striking account of the Latvian experience from their perspective as critical observers of government policy. But for all three Baltic countries it is clear that they now need a strategy to move beyond crisis management towards a new sustainable growth path. And here, most of the work remains to be done.

Lessons for the future

Any discussion about a new growth strategy for the Baltic countries needs to start with a critical assessment of what went wrong in the last decade.

The three chapters on the Baltic countries in this Report provide a number of interesting observations to draw on. The fourth chapter on Poland, a country that has long been seen as a laggard but during the crisis became the best performing economy in the entire EU, provides one case that needs to be studied for hints about a more robust growth strategy. The final two chapters on the EIB's and the NCM's activities in this part of the Baltic Sea Region adds perspective on how international partners can help but also on how they might need to adjust the way they operate in light of the experience over the last decade.

What do the six chapters tell us about the two possible scenarios to describe the current state of the Baltic countries? Maybe not surprisingly, the reality seems to be somewhere between the two: some upgrading of underlying competitiveness has happened but it has not been enough to allow economic policy to just return to its pre-crisis path. In fact, the analysis of which dimensions of competitiveness improved and which did not contains important information for what to do now.

In terms of *macroeconomic competitiveness*, the EU accession process defined standards for both institutional quality and for macroeconomic policy. Social infrastructure and political institutions are, at the aggregate level, relative strengths for Estonia and Latvia and are neutral for Lithuania (and Poland). The more detailed profile is more heterogeneous, with, for example, Latvia getting much lower scores on its political institutions. Macroeconomic policy presents a more mixed picture, with Estonia and Lithuania registering it as a relative strength while Latvia's (and Poland's) performance in this area is much weaker.

Overall, this leads to two observations, one on the role of the EU and the other more specifically on the macroeconomic policy framework. The EU standards were clearly helpful in defining clear external benchmarks on what had to be achieved. But by their very nature, they only defined generic minimum requirements - they do not outline what would have been optimal in the case of any individual country. This leads to significant heterogeneity in terms of the absolute level of macroeconomic competitiveness achieved. And it gives a first indication that the role of the EU as a standard-setter has to be matched by the country as the strategy-driver.

The macroeconomic policy framework in the Baltic countries was narrowly focused on the Maastricht criteria for Euro-zone accession. This created complex trade-offs in monetary policy: how to keep inflation low while having monetary policy being determined by an exchange rate target? And it gave policy makers a false sense of short-term security in fiscal policy, where it was easy to meet the annual debt and deficit targets during the high growth period. With both monetary and fiscal policy on (close to) autopilot due to the objective of Euro-accession, insufficient attention was paid to managing the emerging macroeconomic imbalances. An additional problem that emerged during the crisis was that other countries in the Region did not follow the same policy approach: while the Baltic countries defended their stable exchange rate to the Euro at significant economic costs, Sweden, Poland, and Russia let their currencies drop, which made the adjustment for the Baltic countries even harder. For a number of economic and political reasons, devaluation was not an attractive option for any of the Baltic countries. But it would have been easier if this option would have also been off the table for their neighbors. Again, the external orientation provided by the EU (or in this case the Euro-zone) turned out to be not wrong but incomplete and, in some sense, setting problematic priorities.

In terms of *microeconomic competitiveness,* there was progress as well but on the aggregate level, not as significant as in macroeconomic dimensions. The Baltic economies opened up to foreign trade and investment, and rules and regulations were brought in line with internationally established EU standards. Factor input conditions such as skills and infrastructure continued to be seen as relatively strong. But there was limited progress in developing these assets further, despite the inflow of EU funds. Most importantly, there was very little upgrading within local companies and the sophistication of the export-oriented foreign investment was quite limited.

Two observations stick out, one again on the role of the EU and the other on the process of upgrading company sophistication. The

EU context has provided the foundation for the improvements in microeconomic competitiveness across the Baltic countries. But there has been a serious mismatch in the understanding of the relative roles of member countries and Commission: the Baltic countries have, by and large, used all tools and applied all rules that the EU provided. But there was no integrated strategy – the countries seemed to assume that following the EU guidelines was what was needed for competitiveness upgrading. The EU did not see the guidelines it provided as a strategy blueprint, and also did not have the mandate to provide a strategy. Documents such as the National Reform Programs (NRPs) of the Lisbon Strategy or the National Strategic Reference Frameworks of the Structural Funds could have played a role in setting strategy. But, in practice, they did not, not only in the Baltics. The EU is about removing weaknesses by getting all member countries to meet the same minimum standards. Economic strategy is about creating strengths that are by their nature different across countries. The Baltic countries were focused on the activities that the EU structure motivated but put too little attention on their own role in positioning their economy in global competition.

On a more narrow technical level, the experience of the Baltic countries and of the international organization that work with them on programs related to economic development highlights the importance of implementation. International partners usually provide support in project design and planning, but not in implementation. During the accession period, there was "partnering" with public administrations in other EU countries but this has largely been phased out over the last few years. The reality now is that the implementation of projects is often not as good as it could be. With the funds flowing in through these programs, now often the only public money available for investments, it becomes increasingly crucial to improve the effectiveness of their use. Programs like JASPERS, the Commission-EIB initiative outlined in the contribution by the EIB, are important efforts in this context.

Company upgrading is crucial for changes in the business environment to translate into ultimately sustainable growth in prosperity. So far, this has been the biggest failure in the development of the Baltic economies. There are a number of possible reasons: the small local market might have made it harder for home-grown companies to reach efficient size and sophistication. The economic boom probably made it easier to make money by exploiting short-term market opportunities rather than building long-term competitive advantages. The openness to foreign trade and investment might have exposed local companies to a level of rivalry in which it was hard to make the necessary changes for upgrading competitiveness. FDI attraction efforts were maybe too focused on capital inflows and job creation rather than on building export capacity and on leveraging the presence of foreign-owned activities to develop local companies. This is a complex challenge facing many emerging economies, and the Baltic countries are not alone in this situation. Algirdas Miškinis points to an interesting example in Lithuania where an emerging cluster in biotech seems to provide a conducive environment for the development and upgrading of local companies. There are no quick solutions but there is an emerging sense that improvements in company sophistication in countries like the Baltics are not happening sufficiently quickly if government fails to have a strategic approach towards the competitive advantages it wants to develop in the country's business environment.

Macro- and microeconomic competitiveness interact in important ways. The Baltic countries provide yet another example of this process. Solid macroeconomic competitiveness and market opening but an absence of upgrading company sophistication easily leads to overheating and crisis: capital inflows and largely market access-oriented FDI occur. Some export-oriented FDI might be visible as well but its position erodes once cost advantages or the access to other specific assets, like a well-trained workforce or research capabilities, disappears. The ensuing consumption boom becomes ultimately unsustainable as the lack of export success leads to structural current account imbalances that ultimately erode the confidence of foreign investors. Macroeconomic competitiveness and market opening is necessary but without broader strengths in microeconomic competitiveness, especially in company sophistication, it is not sufficient to generate sustainable prosperity growth.

Macroeconomic competitiveness, in particular the quality of the political process, tends to condition the policy choices available in other areas of competitiveness. The stronger the political institutions, the easier it is to pursue solid macroeconomic policies. The more effective the government administration, the easier it is to design and implement effective policies for microeconomic upgrading. This might explain the relative success of Estonia. It chose an economic strategy of small government and open markets. With the highest rated institutions in the Baltics, it was able to implement more robust macroeconomic policies. With a lean administration, it naturally opted for strong use of IT and was able to turn this into a highly visible part of the country's positioning in global competition. Neither of these was sufficient to avoid the macroeconomic imbalances or the insufficient degree of microeconomic upgrading. But they put Estonia in relatively better position to weather the storm.

How does the Polish experience fit into this analysis? Marzenna Anna Weresa ends her discussion of the country's recent economic development on a cautionary note: what worked in Poland might not work in other countries. The lack of progress in upgrading Polish competitiveness prior to the crisis was real and costly in terms of prosperity. But it also reduced the amount of capital inflows and overheating that occurred in the Baltic countries at the same time. Two other factors are important:

- The proximity to Germany enabled Poland to attract a much larger share of export-oriented foreign direct investment than the Baltic countries. What started out as a relatively small difference (the complaints in the Baltics about the lack of interest from German investors are actually quite old), became increasingly larger as the boom in the Baltics led to a rapidly deteriorating cost position in these countries.
- The large size of the Polish market limited the overall impact of foreign capital inflows and provided room for local companies to grow and upgrade their sophistication. Poland is the only country in this part of the Baltic Sea Region where company sophistication is not a disadvantage. Given the size of the market, there was sufficient domestic rivalry, despite some cases where government policy seemed to disadvantage foreign companies.

Poland continues to have a full agenda of action items to upgrade its competitiveness. The good performance during the crisis gives it an important opportunity to make progress on these issues, catching up to or overtaking some of its Central European peers that have tripped up in the crisis. Poland cannot afford to waste this opportunity.

Overall, the evidence presented in this section strongly suggests that the Baltic countries and Poland would benefit from an in-depth assessment of their current approach towards economic development. This review should include their partners in the Region and at the European level which clearly play an important role in economic development.

The current approach has two key components: first, it focused on the general framework conditions in the economy, with few active programs in specific clusters or sectors of the economy; second, the targets for developing these framework conditions have drawn on the international view about general best practices, not on an analysis of the specific needs in the four countries. Both components should be critically reviewed. Framework conditions are important but alone often insufficient to achieve timely upgrading of company sophistication, an issue that has been particularly critical in the Baltic countries. International best practices are useful benchmarks but they do not easily translate into the most action priorities for specific countries, especially if their institutional capacity for action is limited.

In short, the Baltic countries and Poland need an economic development approach that is more strategic. Strategic in the sense of identifying the value proposition they are making to companies as a place to do business: what benefits do you gain from operating here; for which type of activities do these benefits matter most; and how does this leverage our geographic location in the Baltic Sea Region and any other existing assets? And strategic in the sense of defining country-specific action priorities to deliver on this value proposition: what are the policy areas in which we need to be truly leading; what are the areas in which we need to avoid falling too much behind; and what are the areas that are currently less critical for progress?

The answers to these questions require in-depth data on the specific situation each country is in. And they require a dialogue that involves many stakeholders in the respective countries. If the current crisis helps to motivate efforts along these lines, it can turn into a real opportunity for this part of the Baltic Sea Region, despite the significant short-term pain it has created.

Final observations

Roughly twenty month after the collapse of Lehman Brothers, the world economy continues to be shaped by the global economic and financial crisis. While at the launch of last year's State of the Region Report emergency interventions remained high on the agenda, the focus is now gradually shifting towards exit strategies and the outlines of new growth policies. In the Baltic Sea Region, the economic situation is tough but improving, maybe even too quickly. Countries that had entered the crisis with solid competitiveness have returned to pre-crisis levels of consumer sentiment. Countries that had been pushed into turmoil by the crisis have in the meantime stabilized at a much lower level. Both would suffer if the recovery in the large European economies is getting derailed by the debt crisis that can easily spread beyond Greece.

Competitiveness across the Baltic Sea Region remains solid, with many parts of the Region among the global leaders in areas such as institutional quality, company sophistication, skills and innovative capacity, infrastructure, demand sophistication, and the openness of markets. The crisis might even create the potential for some gains due to the Region's strong fiscal position relative to many of its peers. While fiscal strength alone is not sufficient to upgrade competitiveness, it creates opportunities. Other countries will be more preoccupied with consolidating their budgets than designing new growth strategies. This is, unfortunately, also a real concern for some countries in the Region. Despite this generally favorable assessment, the Baltic Sea Region is facing some clear longer-term competitiveness challenges - key trends in the global economy, i.e. economic activity shifting to Asia and innovation becoming more reliant on the type of high-growth SMEs that are traditionally few in numbers in the Region, might gradually erode the position of the Region.

Collaboration across the Baltic Sea Region remains much higher than in many other parts of the world, including those European regions next in line for an EU Macro-regional strategy. The cohesiveness among the many regional organizations, networks, and projects is rising, with the EU Baltic Sea Region strategy playing an important "self-organizing" role. But there is no coherent new institutional architecture to govern collaboration activity. So far, existing bottom-up activities have been canalized into an overarching structure. However, the overarching vision and leadership that would give them clear direction and integrate them with activities at other levels, national as well as European, is still missing. Even more problematic is the shift in the economic and political context that has created an environment that is not very conducive to regional collaboration. Few in the general public ask for it and many important current policy challenges cannot be addressed at this level.

What is to be done? Last year's State of the Region report ended with a call for reflection. A few months on, it is time to suggest action along three main dimensions:

Renew *the argument for regional collaboration.* While the people involved in regional collaboration continue to work in joint efforts, the broader public no longer is so sure. But without their support it is illusionary to expect political leaders to make decisive steps forward on regional collaboration. The case for regional collaboration again needs to be made publicly, taking on the concerns that exist about contagion from economies in crises and lack of support from neighbors that could do more to help. At the heart needs to be an economic argument: more collaboration can help countries in the Region to overcome some of the costs of their small absolute size; and collaboration across the Region can help to turn heterogeneity into an advantage, bringing benefits to both sides. These arguments have been pushed to the back as countries across the Region had to deal with the impact of the global crisis. But they are again of crucial importance as the quest for new growth moves in to the center. Without regional collaboration, upgrading competitiveness will be significantly harder for all countries in the Region, whether they are strong or weak.

***Rethink** the appropriate approach towards competitiveness upgrading.* The crisis has been more than a deep bump on the road. For the Nordics (and Germany), it might have very well accelerated structural changes in the global economy that work to their disadvantage. For the Baltics, Poland, and Russia, it has been – despite the very different experience during the crisis – a common signal for the need to adopt a new and more balanced approach towards upgrading competitiveness across all dimensions. Part B of this Report provided clear evidence that such a change in course is necessary to move beyond what has been achieved over the last decade. There is no simple action plan for either group of countries. But both have sufficient assets to successfully address the challenges that the future holds, if they chose to do so. The biggest danger is not the competition from other parts of the global economy but complacency and unwillingness to change at home.

***Rebuild** the institutional framework for collaboration*. The Region needs not only a vision and a mission, it also needs the tools to implement them. The individual pieces are there: a wealth of linkages through organizations, networks, and projects; the EU Baltic Sea Region strategy process as an integrating factor. But it is now critical to put them together in a coherent and effective architecture that is able to deliver. This will not be possible in a bottom-up structure alone. It will require another decisive step by government leaders across the Region. Whether or not this will lead to a new institution is almost secondary In fact, the almost obsessive commitment to achieve a new level of regional collaboration without new institutions and without new money might have been counterproductive. The Region needs an architecture that works and, if that is best achieved through a new institutional arrangement that integrates or replaces existing structures, so be it.

The coming twelve months will be a difficult time for collaboration and competitiveness across the Baltic Sea Region. Another economic shock could seriously hurt the economic recovery and again force countries to focus on the emergencies they face domestically. Conversely, a quick recovery could tempt politicians to avoid the complex task of reviewing their economic growth strategies. Between these two scenarios the room for meaningful progress on regional collaboration will be small. This is unlikely to lead to a significant reduction of regional collaboration: there are too many established connections and a constituency across the Region and in Brussels that will continue to work together. But it could lead to stagnation. And the Baltic Sea Region cannot afford to stand still.

Observers from outside the Region might find this assessment overly pessimistic. Hardly any other region in the world can claim the same level of deep and active collaboration or a similar level of competitiveness. And, as this Report again has indicated, there remain many opportunities to improve competitiveness through collaboration that are well within the reach of the Region. It is up to us in this Region to turn this tension between what seems possible in principle seen from the outside and what seems possible in the political reality of the day seen from within into a force for change.

About the author

Prof. Christian Ketels

Christian Ketels is a member of the Harvard Business School faculty at Professor Michael E. Porter's Institute for Strategy and Competitiveness and a Senior Research Fellow at the Center for Strategy and Competitiveness, Stockholm School of Economics. He holds a PhD (Econ) from the London School of Economics, degrees from the Kiel Institute for World Economics and Cologne University, and an Honorary Professorship at the European Business School in Oestrich-Winckel. 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

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Nygade 3, 5th floor
P.O. Box 56
DK-1002 Copenhagen K
Denmark
Telephone +45 70 20 93 94
Fax +45 70 20 93 95
bdf@bdforum.org
www.bdforum.org

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