

The Agenda:

An Historic Chance for the Baltic Sea Region

- Opening New Opportunities for Europe and Russia



As the Baltic Sea Region is emerging as one of the most promising growth centres of post Cold War Europe, it is becoming very clear that the region will not realise its full potential without Russia as an active and integrated participant. Moving towards that goal is no longer an illusion. It is one of the huge political challenges for Europe. For Russia, it is simply a necessity.

No one should underestimate the domestic difficulties Russia is faced by and will have to overcome, as the country moves away from its Soviet legacy, but as *Mr. Pekka Sutela*, head of the Bank of Finland's Institute for Economies in Transition, points out, the Europeans must be aware of Russia's predicament as well as of Russia's huge potential. It is not a question of giving Russia preferential treatment, but of keeping the doors open for the Russians and being willing to give them a hand on their journey.

If the 1990's were the years of economic and political turmoil around the new Europe, the new century seems to offer more stability and direction and thereby opens a window of opportunity for strengthening the process of European integration. Russia is not only more able, but also more willing to move closer to Europe, feeling, in the words of *Mr. Dmitri Trenin*, Deputy Director of the Carnegie Endowment's

Moscow Center, "the pull of Europe, but also the push of Asia, and the turbulence of the Greater Middle East". With President Vladimir Putin at the helm making his latest overtures to Russia's European neighbours, this process is gaining more momentum, assisted by global events and new political realities.

To quote *Mr. Uffe Ellemann-Jensen*, chairman of Baltic Development Forum: "2002 should be the year when the EU in cooperation with Russia takes a decisive step towards closer political and economic cooperation. We ought to have a fixed roadmap for a Common European Economic Space. The potential is there and we urgently need to break down the various barriers for trade and movement of people in the Region. I strongly recommend a decision of substance to be taken at the EU-Russia Summit with president Putin in the late autumn 2002."

The countries of the Baltic Sea Region are well positioned to exploit this opportunity and create a Baltic Sea Economic Space within the wider European Economic Space as an important step or bridgehead in the integration of Europe. In setting this as an important item on their agenda, the countries of the Baltic Sea Region are seizing an historic chance in their search for a roadmap of how to turn a vision into reality.

by **Samuel Rachlin**

Managing Editor

2002 should be the year when the EU in cooperation with Russia takes a decisive step towards closer political and economic cooperation

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BalticSeaagenda

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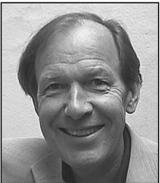
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New Agendas for a New Region

by **Erik Rasmussen**
Editor-In-Chief,
Mandag Morgen



During the coming year, the Baltic Sea region faces very substantial and far-reaching challenges - challenges which can be defining for the development in the region for generations. This creates a need for both a common understanding of the region's potential, and for a dialogue on how to fulfil these potentials. Baltic Sea Agenda has the ambition to become a catalyst for this dialogue.

Baltic Sea Agenda will be published three to four times a year, and in each volume focus will be put on a topic of current interest and of far-reaching consequence for the future of the region. We invite selected experts to analyse and debate the themes, thereby seeking to obtain as multi-faceted a description of the topics as possible. The goal is that each analysis will inspire new thinking, and will expand the understanding of the region's potential.

Baltic Sea Agenda is published by the Danish think tank Mandag Morgen in close collaboration with Baltic Development Forum. It will be distributed to all key figures in the Baltic Sea Region - top politicians, civil servants, leading business people, the finance sector, experts and advisers. In short, to everyone with a share in the responsibility for and influence on the development of the region.

For this the first issue of Baltic Sea Agenda we have chosen The Baltic Sea Economic Space as the topic. This has

been a natural choice. The perspective in developing and positioning the Baltic Sea region as a strong northern European region in close collaboration with the rest of Europe seems obvious. Even though the thought is right, it is also very ambitious and demanding, and implies both political and economic new thinking, as well as a great deal of courage from the involved parties.

We focus especially on Russia in connection with The Baltic Sea Economic Space. This focus acknowledges the fact, that Russia, its role and its involvement is absolutely crucial for the vision of a new north European economic space.

The topic will be highlighted by three experts, each of whom - from different backgrounds and angles - has a profound insight into the region and its possibilities:

- Chairman of Baltic Development Forum, *Mr. Uffe Ellemann-Jensen*, former Minister of Foreign Affairs in Denmark and an experienced politician on the European scene.
- Head of Bank of Finland's Institute for Economies in Transition, *Mr. Pekka Sutela*, who has extensive knowledge in the field of Russia and the Baltic States.
- Deputy Director of the Carnegie Endowment's Moscow Center, *Mr. Dimitri Trenin*, who is an authority in the field of Russian and Soviet military and defense issues.

The coming issues of Baltic Sea Agenda will be published in June and September and will focus on specific aspects of the Baltic Sea Region as a new growth centre.

Cooperation with Russia in the Baltic Sea Region: **2002 - time to move!**

by **Uffe Ellemann-Jensen**
Chairman,
Baltic Development Forum



2002 is a decisive year for the development of the Baltic Sea Region and for longer term European relations with Russia: EU is to decide on the first wave of enlargement towards the East. Furthermore, NATO is to decide on whether to issue an invitation to the Baltic countries. Both decisions are crucial to our Region. But a third has to be made as well: EU has to decide on putting substance into its policy towards Russia. All three issues have to be dealt with as a whole. That can ensure coherence and prevent serious problems in the future.

I am worried that neither we in Europe, nor our friends and partners in Russia have fully realised the potential of creating genuine political and economic relations. The political mood in Russia seems favourable. All research clearly underpins the economic potential. The institutional framework in the EU is there. Business and consumers stand ready to seize the opportunity. And it is widely recognized that the international community would gain from a more stable region in this part of the world.

But - to cut it short: We need a new agenda.

The fact is that we all stand to win from a true partnership between Europe and Russia. If we want stability, prosperity and economically sustainable development in the Baltic Sea Region, we should not sit on our hands.

I recently visited Moscow as a participant in a debate on how to integrate Russia into future European development. At one point in the discussion, a young Russian politician exclaimed in obvious frustration and impatience:

” - **Why can't the Europeans take 'Yes' for an answer?**

And it struck me how important it is not to let this issue slip into the background while we are dealing with all the pressing questions regarding the most immediate requirements related to the enlargement of the EU.

2002 should be the year when the EU, together with Russia, takes a decisive step towards closer political and economic cooperation. We ought to have a fixed roadmap for a Common European Economic Space. The potential is there and we urgently need to break down the various barriers for trade and movement of people in the Region. I strongly recommend a de-

cision of substance be taken at the EU-Russia Summit with president Putin in the late autumn of 2002.

An initial element could be a more limited cooperation in a Baltic Sea Economic Space within the Region. This idea was endorsed by business executives, prime ministers, leading academics and regional organisations at the *3rd Baltic Development Forum Summit* in St. Petersburg in September last year.

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I hope and believe that before the end of 2002, the final decision will be taken to bring in Poland and the three Baltic states as members of the EU from 2005 - and that NATO invites the three Baltic countries to become full members of the organisation. Anything but that would be a serious detriment to the last 10 years positive development in the construction of Europe. It will be burdensome and complicated, but there are no valid excuses to delay this process further.

Developments after September 11th have opened new possibilities for international cooperation. Both the US and Russia have constructively seized this opportunity and we have seen the beginning of new partnerships. So many difficulties and disagreements were all of a sudden put aside. Many problems suddenly acquired a new dimension against the background of the horrors that hit us all.

I am particularly pleased with Russia's emphasis on the need to establish a stronger international cooperation. This demands clear and unequivocal answers from the European side. We need political statements and support from the European side towards swift accession of Russia to the WTO when Russia has fulfilled the conditions. It is also important that the EU becomes more specific about how to fulfil the objectives of the Partnership and Cooperation Agreement and secure the

long term goal of a free trade area. A Common Economic European Space is the obvious vehicle for this.

Kaliningrad is a hugely important element in this new "rapprochement". After EU-enlargement, the oblast will be de facto isolated from the EU. This is a serious challenge for the EU as well as for Russia. Russian ministers have very appropriately called Kaliningrad "a test-case for EU-Russia cooperation". I agree with this analysis and urge both sides to be constructive. There are huge gains to be obtained in terms of stability, trade and prosperity. Kaliningrad therefore ought to be in the forefront of EU-Russia cooperation in 2002.

Statements of good intention are not enough. We need to move from words to action. The EU should continue the important work of developing its Northern Dimension and assure appropriate funding from all sides.

A window of opportunity has been opened - maybe only for a short moment - and its potential should be fully explored. It is crucial for the Baltic Sea Region that no time is wasted. A new agenda is needed. And 2002 is the year where action must follow words.

It is time to move!

Baltic Sea Economic Space - vision or illusion?

by **Pekka Sutela**

Head of Bank of Finland's Institute for
Economies in Transition (BOFIT)



Executive Summary

One of the success stories of the transformation of Europe in the 1990's is the chain of positive events in the Baltic Sea Region, where so much could have gone wrong, but did not. The newcomers to the Baltic community of states, Poland and the three Baltic states, defied the odds and made a smooth transition.

They are on track to becoming valued European players much faster than many had expected - or feared. Even Russia, despite its ups and downs and its vacillating identity, seems to be on the move toward a closer relationship with Europe. That road is not without bumps or hurdles, but no one can deny that the current situation in the region offers new opportunities of immense historic significance.

As far as regional economic integration is concerned, Russia remains a huge challenge, with its institutional and productive structure and the internal skirmishes about property rights and a free-market economy. These problems should not be overlooked or underestimated, but at the same time they should be seen as a challenge and not an immovable barrier.

Possibilities of influencing Russia

It has become clear that the international community can only have a limited impact on the internal developments in Russia, but the fact is that possibilities of influencing the course of events in Russia do exist. The decision about entering the European club of nations is, of course, Russia's alone to make, but the Europeans must remain aware of the Russian pitfalls and keep their doors open.

It is not a question of making Russia's entrance easier or of offering her special privileges. Russia should be getting the same conditions and incentives as everybody else. It is, however, important that the importance of Russia be taken into consideration, and thus it is crucial to keep the open door policy in mind. With President Vladimir Putin at the helm, Russia has taken a more decisive step toward a realistic European policy.

Balts Secured Their Success Because They Knew Where to Go

For a number of reasons, Russia is not ready for EU membership, but nevertheless, Russians, in Putin's words "will gradually be building up Russia, Russian economic life according to the rules which are in operation on the continent, of which Russia is an inalienable part." Although Russia remains far from fulfilling European rules, her stated intentions should be noted and acted upon. An approximation to European rules of conduct by Russia, would be a step towards creating a Baltic Sea Economic Space inside a wider European Economic Space.

Despite the burden of their Soviet legacy, the Balts secured their success because they knew where to go and what they wanted to achieve. All three countries chose a privatisation strategy that allowed foreigners to come in as strategic investors, realising that there are few more efficient methods of integration than the internationalisation of property rights.

The EU Has a Crucial Role to Play in the Baltic Sea Economic Space

With the European Union following the unfolding events in the region with a watchful eye, the Union itself has an important role to play in the next stage of integration. The Baltic Sea Economic Space will be part of the wider European Economic Space. The European Union must become the main actor in creating it. But there are other players, too. The WTO and other multi-lateral organisations have important parts to play. Bilateral relations between Union countries and Russia are another significant factor in the equation. ■

Defining the Baltic Sea Rim Area

What is the area relevant for the Baltic Sea Economic Space? Let us call it the Baltic Sea Rim Area. The natural way of definition is the geographical one. A rim is defined as following the paths along which waters flow. The Baltic Sea catchment area, home to some 80 million people, reaches in the West right to the Norwegian fjells. In the North, waters flow into the Baltic from Swedish and Finnish Lapland and in the South all the way from the borderlands of the Czech and Slovak republics. In the East waters come from afar in Ukraine and Belarus. See figure 1.

This would seem the natural way to define the Baltic Sea Rim Area. But actually the Rim should not be seen as a geographical concept. Most of Norway is outside the catchment area, but still almost everybody wants to include Norway in the Rim. Half of Belarus is inside the catchment area, but few want to include Belarus among the Baltic Sea countries. Clearly, definitions of areas are deeply embedded in history, culture and politics. They have always been defined in a context somehow wider than geography.

Baltic Sea Rim Area Population 1999

in millions

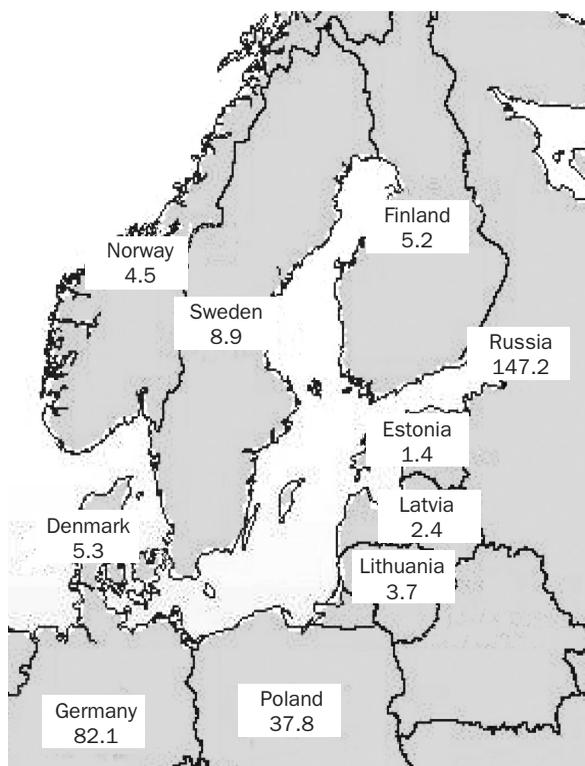


Figure 1

Source: BOFIT

This context has been forever changing. There is no Baltic identity in the former Habsburg lands of the Czech and Slovak republics or in the former Soviet republics of Belarus and Ukraine. Defining the Baltic Sea Rim only in terms of the catchment area thus makes very limited sense. More is needed for defining the Baltic Sea Rim Area.

One might proceed from the fact that Germany is economically pre-eminent among the countries bordering the Sea. The Russian, or Swedish, or Polish gross domestic product is about a tenth of the German one. Actually, when compared at market exchange rates, the German national product is almost exactly twice the size of all the other Baltic countries counted together. When purchasing power parities, which allow for systematic differences in price levels between the countries, are used, the picture changes somewhat. See figure 2 on page 10.

Russia, in particular, now reaches about one third of the German size. But it is unclear whether the bases for using purchasing power parities are any stronger than the ones for using market exchange rates. And using some other indicators instead of national product would lead in conclusions even more extreme than the ones reached above. See figure 3 on page 12.

But the Baltic Sea is no German lake. Only a small corner of Germany is actually in the catchment area. Most Rheinländer and Bavarians don't feel themselves in any sense Baltic. German economic and political power has been shifting towards Stuttgart and Munich, away from Hamburg and Lübeck. The northern Germans first resurrected the historical analogy with the Hanseatic League at least partly as a counterweight to this shift. The origins of the New Hanseatic League discourse were thus to be found in something that could be seen as compensatory rhetoric.

Getting Clues from the Lessons of History

The Baltic Sea Rim first became a true historical concept at the time of the Hanseatic League in the fourteenth century, even if many regions in the Baltic Sea Rim were part of the Hanseatic trading system only indirectly, if at all. Among Finnish towns, for instance, only Vyborg was really involved in the Hanseatic system. The League was a unifying trade network with legal arrangements of its own, but it was based on monopoly and privilege. The Baltic Sea Rim of today must be different from the historical Hanseatic League.

The trading system itself could be interpreted in quite different ways, depending on the shades of grey

	GDP (market exchange rates)	GDP (purchasing power parities), 1999	Imports	Equity market capitalisation
Germany	100	100	100	100
Denmark	8.66	7.07	9.09	8.80
Estonia	0.27	0.62	1.01	0.14
Finland	6.50	6.12	6.86	23.12
Latvia	0.40	0.78	0.58	0.04
Lithuania	0.60	1.26	1.08	0.13
Norway	8.65	6.51	6.36	5.21
Poland	8.44	16.76	10.48	2.50
Russia	13.42	56.05	6.77	3.55
Sweden	12.15	10.29	13.86	25.84

Figure 2

Source: BOFIT

one finds between mutually beneficial trade and colonial exploitation. Seen from Bremen, Vyborg or Veliky Novgorod, the Hanseatic League could and did look quite different. This is – though we sometimes prefer not to remember it - true of any trading system. The asymmetries of interdependence may still come back to haunt us.

The availability of mutually beneficial exchange possibilities is not sufficient in the real world: the distribution of gain also matters. This is also true of globalisation and of the enlargement of the European Union. We must remember that the distribution of gains also matters, and be prepared to see all kinds of unholy alliances criticising the development of a Baltic Sea Economic Space.

Another Baltic trading system, this one with Britain as the hub, emerged in the nineteenth century. This trading system did not have the formal structures or exclusivity of the League. Instead, it was maintained by the dominant role of Britain in world production and trade. After the Russian revolution, the trading system only remained in a truncated form. Soviet Russia cut itself out of most interdependencies. Four newly independent countries emerged from the collapse of the Tsarist empire. Only one of them was able to maintain independence for the rest of the twentieth century. Poland also re-established her independence.

After 1945, the Baltic Sea no longer existed as an economic, cultural and political entity. The Soviet Union had extended its self-imposed exclusion from the international system to all the Eastern and most of the Southern rim of the Baltic Sea. The Soviet leaders tried to define the Baltic Sea as a Sea of Peace. Others

were less enthusiastic, perhaps remembering Comrade Stalin's references to the deadly peace of the cemetery.

The Balts are Coming Back as Normal European Countries

This exclusion and fear of interdependence had changed by the time change became possible in the late 1980's. For the Balts and other Central Europeans it was a matter of "returning to Europe", of "again becoming normal European countries". This meant escaping from the remnants of the USSR, and joining the Euro-Atlantic alphabet soup of international organisations as soon as possible. The urge to join the EU, NATO, OECD and others has created a high degree of conditionality upon policies, legislation and institution building.

As long as the overarching goal of re-joining Europe is shared by the elites and population of a country, it will provide policies with a consistency and credibility that is otherwise difficult to reach and maintain. Governments, ministers and central bank governors will come and go, but the basic mainstream of policies will remain. This has paid off handsomely, as a look at growth statistics will show.

In not too distant a time, the Baltic countries and Poland will become members of the Union, if their electorates so decide. Accession by the Central European countries will go a long way towards defining them as "ordinary European states". The end of the transition is already at hand in these countries. Even if one country or another in the end decided not to join, the barriers to full economic and social integration would be minimal, as the cases of Norway and

Switzerland in their very different ways show. The Baltic Sea Rim will inevitably be defined by the European Union. The remaining question is the position of Russia.

Counting Russia in or out as a Member of the European Club

The conditionality imposed by “rejoining Europe” was not available to Russia. Most Russians argue that Russia was never an ordinary European nation. Most would probably argue that Russia never will or should become an ordinary European state. Joining the Euro-Atlantic clubs was never adopted as the overarching goal of political and social development. The conditionality enjoyed by the Central Europeans thus went missing.

Russian policies have tended to be short-term, inconsistent and easily captured by vested interests. Russians do generally support a market economy, open society and democracy of some sort. Over time, policies have converged towards generally reasonable forms. There was never a major willingness to return to the old system, most talk of specific Eurasian development path has died away, and in a process of learning, an important consensus has emerged on avoiding major macroeconomic policy mistakes. Still, a well-defined goal has been absent.

EU members routinely point out that Russia will never become a member of the Union. Surely Union enlargement to the borders of Transcaucasus, Central Asia and China would open up huge issues. The possibility of a Russian membership is so distant that even mentioning it may raise unjustifiable hopes – and perhaps claims for pre-membership privileges and resource flows. No such claims should be accepted. But still Russia should be told firmly and loudly that she will become a member of the Union – when and if she fulfils the same membership criteria as everybody else. One should, as far-fetched and weak as the idea may seem, provide a goal, not soft finance.

In the end, Russia might well choose not to join the Union. In that case, a Norwegian solution would be available: fulfilling the *acquis*, but choosing to remain outside. Such an approach has been advocated by some Russian analysts, and it was adopted by Russia’s president Vladimir Putin in a March 2001 interview. He argued that for a number of reasons Russia is not ready for EU membership.

Still, “I think it would be right if we build up our legislative base in tune with how different areas, in-

cluding, and first of all, the economy, are regulated with the European community,” Putin said. “As a matter of fact, this is how we are acting, in a majority of cases. Thus, we will gradually be building up Russia, Russian economic life, according to the rules which are in operation on the continent, of which Russia is an inalienable part.”

Obviously, Russia remains very far from fulfilling European rules, but the stated intention should be noted and acted upon. Any approximation to European rules of conduct by Russia would be a step towards creating a Baltic Sea Economic Space, embedded inside a much wider European Economic Space.

The Strange Case of Baltic Success

The basic explanation for the economic success of the Balts and other Central Europeans is thus simple. They knew where to go to, while the Russians (and Ukrainians, Belarussians and other) did not. Obviously, this explanation does not go all the way. There are other reasons as well. These countries re-emerged independent through a deep and widely shared patriotic movement. Still, they never tried to build independent national economies. From the beginning they acted as if they wanted to become just regions within the north-western European economic system.

In the case of privatisation, all three countries finally adopted the strategy of privatisation by selling to strategic investors. In the case of small and relatively poor countries like the Baltics, the strategic investors could only be foreigners. There are few more efficient methods of integration than through the internationalisation of property rights.

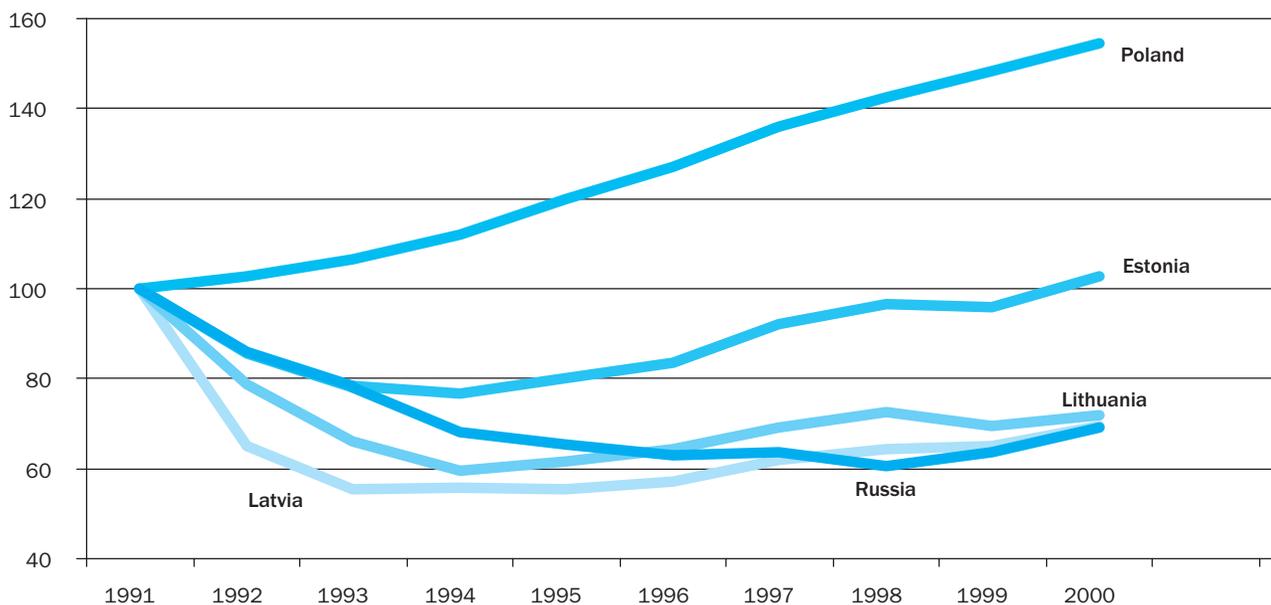
To stabilise their economies after the collapse of the rouble, all three countries chose a monetary regime based on fixed exchange rates. This provides investors and other economic actors with much needed predictability – if the fixed exchange rate is credible enough. After all, since the three Baltic countries adopted one of the hardest imaginable exchange rate arrangements (either a currency board or a currency board -like system), credibility has generally not been endangered. This has been another vehicle for full integration. See figure 4 on page 15.

Economic liberalisation has been exceptionally fast and far-reaching in these countries. That is true of commodity and labour markets, trade, finance, investment and entrepreneurship alike. The barriers to entry and exit have been lowered to the extreme.

This policy line obviously comes with a price. Libe-

GDP in Russia, the Baltic countries and Poland

1991=100

**Figure 3**

Source: BOFIT

realisation without proper supervision has invited repeated banking crises. The uneven capacity (or willingness) of citizens to benefit from these very simple rules of the game has created the spectre of two nations: the contrasts between those who have and those who do not have are quite stark.

But the very simplicity of these economies has also protected them from crises that other transition economies have met with. The Balts have been able to combine full financial liberalisation without proper supervision, exchange rate stability, and large current account deficits (needed to balance large foreign direct investment). See figure 5 on page 16. Usually this combination would invite financial crises. But not in the Baltics, and for two main reasons.

First, there has been the credibility due to responsible economic policies. There were no debts to start with, and their accumulation has been prevented by conservative fiscal policies. Prudent monetary policies have led to low inflation. Economic policy fundamentals have therefore been good. Second, and this is much less understood, the policies adopted have abolished the bases of some potentially instability-creating markets that independent national economies usually have.

As there is almost no debt, markets for public and

private debt instruments hardly exist. As companies have been sold to strategic investors, equity markets are small and stagnant. Due to banking crises and the now prevalent foreign ownership of the financial industries, there are hardly any inter-bank markets, and deposits have not been an attractive investment to make. In short, these economies, which have become regions in the north-western European economy with a full set of markets, do not need to have all those markets themselves. This protects them from destabilising and potentially destructive speculation. Joining the EU and the Euro system will simply cap this achievement.

The Failure of Russian Policies in the Baltics

The Balts wanted to escape from the USSR, which they never joined. They were occupied in 1940, and the independence regained in 1991 was seen as the restoration of the statehood born in 1918. The non-participation of the Baltic countries in post-Soviet cooperation was also accepted in Moscow. There were few if any attempts to entice them to participate. Independence of the Baltic States is recognised virtually by all political forces inside Russia. Some, of course, wish to influence, intimidate, or even control the Balts, but not to annex them back to Russia.

Russia's Baltic policies have been defined more in negatives than in positives. None of the political catastrophes predicted ten years ago has taken place. Both the Balts and the Russians have conducted themselves generally well in the new and often unexpected circumstances. Still, it is worthwhile looking at the past history of Balt-Russian relations in more detail. This is, after all, the divide where the Baltic Sea Economic Space might fail.

With regained Baltic independence, the Soviet inheritance continued to exist. It is very visible in issues like the Russian speaking population of the Baltic states, energy supplies, transport infrastructure, various security issues and such. This inheritance and the problems created, had to be regulated in one way or another, and it has been.

In retrospect, the Soviet legacy in the Baltic countries has been handled surprisingly well. Though both sides may every now and then have used what has been interpreted as confrontational language, Russian-Baltic relations never amounted to actual confrontation, or to major crises. The relative ease of the divorce is even more surprising given that Russia never really had a consistent long-term policy vis-a-vis the Balts. Neither had, in the very beginning at least, the Balts.

Independence was gained at a speed that came as a surprise. There were few plans to implement, and Russia's future was often seen in very dark colours. But there has been no ethnic violence, no serious attempts to challenge Baltic independence, nor any attempts by the Balts to sever all their ties with the CIS countries. This has been the Linen Divorce. Linen, contrary to velvet, is rough when first used, but over time grows softer, and is one of the most resilient of fabrics. It is much cultivated in the Baltics as well as in the neighbouring provinces of Russia, in Belarus and Ukraine.

In the 1990's, Russia took a number of unilateral steps to press the Balts into what they took as better behaviour. By doing that, Russia harmed its own goals. Discrimination in Russian markets speeded up the re-orientation of Baltic foreign trade from the CIS-area to Western markets. Without such discrimination, the 1998 Russian crisis would have hit the Balts much worse than it did. It is also clear that the ones to suffer most from discrimination were usually the Russian speaking workers of those Soviet-era factories that were oriented to the Union market. Russia thus harmed the ones it was claiming to protect.

Russia's policy of "punishing" the Balts has been

counterproductive. Russia has lacked a consistent long-term policy vis-à-vis the Baltic States. That has been increasingly understood since 1997. There has been a shift in Baltic attitudes as well. The Russian-speaking population in these countries has proved more loyal than expected; most of them did not want to move over to Russia; the Russian state was not interested in regaining them; and the international community was suspicious of anything that looked like ethnic cleansing. Consequently, Baltic elite opinion has been moving towards integration and even multiculturalism.

Russia became conscious of the need for a consistent Baltics policy only in 1997. Moscow offered security guarantees to the Balts, but the offer found no takers. Russia increased its diplomatic activity along its western borders. A border treaty with Lithuania was signed, though not ratified and Russian leaders made a number of proposals on regional cooperation. Meanwhile, the Balts kept moving towards the West, and the Western organisations and states kept drawing the Baltic countries inch by inch closer to full integration. EU membership negotiations were started by all the three states. Relations with NATO were developed. In early September 2001 President Putin finally admitted in Helsinki that though Russia still regarded the NATO membership of the Baltic States as a mistake, it would not be a cause for "hysterical campaigns".

These countries remain dependent on Russia in various ways. Energy is the most important example. The USSR had a unified electricity grid. This means that the Baltic countries can only exchange electricity among themselves, with Russia and with Belarus. The Baltic republics were also supplied with natural gas and other energy carriers from Russia. In end-1990's, Estonia's energy self-sufficiency was estimated at about 70, Latvia's at 50 and Lithuania's at less than ten per cent. In electricity, self-sufficiency was respectively 100, 30 and 90 per cent.

Estonia has major natural energy resources. Though the oil shale of north-western Estonia is quite poor in energy contents and ecologically highly problematic, the Soviet Union invested much in its exploitation to supply Estonia and to a degree Leningrad with electricity. In the process, the region was turned Russian speaking. Latvia has some hydropower resources in the Daugava River. A large Chernobyl-type nuclear power plant was built in Ignalina in Lithuania. It is a major export revenue earner, and the attempts of the European Union to have it closed have so far failed.

Benefits and Challenges from Mutual Dependence

In 1999, an agreement was signed on parallel work of the Russian, Belarussian and Baltic energy networks. The Lithuanian government hesitated, but finally decided to join the agreement. There have been plans to join the Baltic countries into a north-western European network embracing the whole Baltic Sea rim. Due to technical reasons, that would demand major investment and also disconnecting the Baltics from the inherited Soviet network.

The Russian Gasprom and oil majors have a strong position in the Baltics. Gasprom has, following its standard strategy in export markets, acquired major stake in Latvian gas distribution company and is interested in buying one also in Lithuania. Russian Yukos and Lukoil are the most important crude oil suppliers to Mazeikiiai oil refinery, Lithuania's biggest company. Russia is increasingly becoming an energy and raw materials producing appendix of the European economy. The share of exports in GDP has grown, partly due to high world market commodity prices, to some forty per cent. Most exports consist of energy sources, minerals and metals, a few basic chemicals and roundwood. The relative role of machinery has dropped further, partly because military exports have declined since the 1980's. Russian producers seem to have been unable to introduce any new major export commodities in spite of the steep under-valuation of the ruble since August 1998. See figure 6 on page 19.

Oil and gas remain the basic Russian export commodities. Both are mainly exported in pipelines. The Soviet Union left a large pipeline system, which remains with a few additions. In 1999, the most important transit corridor between Russia and foreign markets was through Poland and Belarus. The value of the transit transport there was some 16 billion dollars. According to BOFIT calculations, Latvia came second with 10.6 billion USD, followed by Slovakia-Ukraine (5.9 billion USD), Lithuania (3.8 billion USD), Estonia (3.7 billion USD) and Finland (2.4 billion USD).

Transit transport accounted in 1995-1999 for most Baltic transport by volume. According to BOFIT calculations, the GDP shares for transit transport were in 1999 7-9 per cent for Estonia, 8-10 per cent for Latvia and 4-6 per cent for Lithuania. These are high figures, though much lower than the ones sometimes cited to show that the Baltic economies are totally dependent on transit between Russia and the Baltic Sea.

Seen from the Russian side, Russian entities reportedly pay 1-2 billion dollars annually in Baltic transit

fees. In the 1990's, about one third of Russian sea-based exports went through the harbours of the three Baltic countries. Such dependence is seen as excessive in Moscow. In the near future, a new oil export terminal should be operational in Primorsk, just northwest of St. Petersburg. The St. Petersburg harbour has also increased its volumes greatly, and there are additional Russian harbour projects in the Gulf of Finland. Russian authorities have decreased tariffs for cargo going through Russian harbours, and amounts of vehicles going to Baltic harbours have been decreased.

The EU Attraction – No Americans and No Military

Contrary to the NATO case, Russia's attitude towards EU enlargement into the Baltics has been consistently neutral or positive. Russia likes the European Union, it has been said, for the two things it lacks – American presence and an integrated military force. In the Baltics, Russia wished that the implicit security guarantees given by EU membership would be an alternative to NATO membership. It was also assumed that the *acquis communautaire* would prevent any discrimination of the non-titular residents by the Balt majority. Overall, therefore, Baltic membership in the Union would, in the Russian view, improve the position of the Russian speakers and enhance stability in the Baltic Sea rim area.

Economically, Russian analysts in the late 1990's also saw many benefits from Baltic membership. The perspective of EU membership will make the Baltics increasingly attractive as a Russian investment target. Russian business communities in the Baltic countries will facilitate a better Russian business foothold inside the EU. The economic and political position of the emerging Baltic "EuroRussians" will improve and there will be more finance available from EU sources for regional purposes in the Baltics.

By the early 2000's the position of some Russian analysts has shifted. It is now claimed that the dividing lines in Europe, which the Russian elite dread, are more likely to appear in the form of the EU's eastern limit of enlargement than in the wake of NATO enlargement. In particular, it is argued that the introduction of new standards and regulations as well as EU trade preferences to developing countries will impede Russian exports.

This basic effect will not be cancelled by faster growth in the new members, by some benefits from lower EU tariffs, or by trans-border cooperation. The

Current Account balance

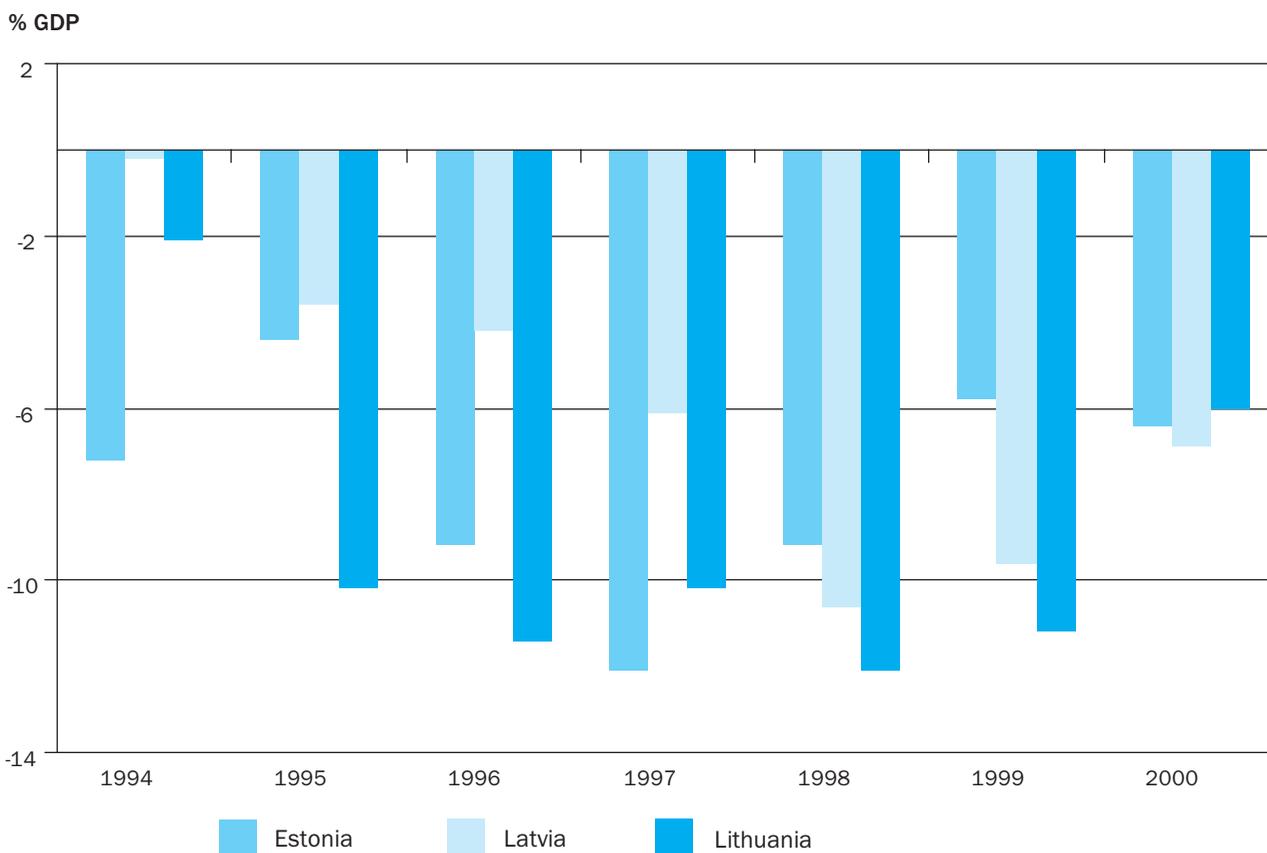


Figure 4

Source: BOFIT

introduction of the Schengen regime will impede freedom of movement of people. Russia's political isolation will worsen. Poles and Balts who have a negative attitude to Russia will have an impact on EU policies. Brussels will no longer be a neutral middleman in Baltic-Russian relations, but will take always take the Balts' side. The Northern Dimension policy will lose whatever momentum it has had.

These problems will, it is argued, be particularly severe in the case of Kaliningrad, which is to become an EU enclave. The Schengen regime will hinder movement of people, also from Kaliningrad to the rest of Russia. Shuttle trade and other grass-root contacts will suffer from the introduction of visas. The region, which is totally dependent on food imports from the neighbouring countries, might even collapse, projecting crime and social problems across borders.

Overall, the Baltic – Russian relations in the 1990's were cool but stable. Both sides had their own goals. Russia was grappling with its triple transition to a post-imperial identity, a democracy of sorts and a Rus-

sian market economy. The Baltic countries had the agenda of re-joining Europe. This was generally interpreted as implying creating as much distance from Russia as possible. There was a historically based fear of Russian imperialism re-emerging. But any distance was not possible. There was the Soviet legacy that had to be settled. Neither side had a clear, well thought-out and long-term strategy about how to handle their relations.

Remembering that, the 1990's were a major success story in Baltic-Russian relations. There were a number of potentially explosive issues: borders, the withdrawal of Russian troops, the status of the Russian speaking residents in the Baltics, Kaliningrad and so on. But almost no blood was spilled, no serious crises arose, Baltic independence was never seriously threatened. Perhaps this is because both sides had more urgent matters to attend to. Perhaps Baltic – Russian relations were too important for the relations of both sides with third countries to be left to the mercy of changing political passions. Or perhaps the

elites of both countries were simply too rational to let serious problems intervene.

Mixed Signals in the Views of Russia's Transition

The international community's Russia policies in the 1990's were thus orchestrated by the United States and based on two postulates. First, it was argued that Russia is in a transition from central management to a free market economy, from one party rule and official ideology to a pluralist democracy, from a closed society to an open one. Second, it was argued that this transition happens more surely, faster and with less costs if assisted by major resource flows from outside. Channeling these resources was delegated to the international financial institutions. There was also much bilateral assistance, particularly from Germany, but also from other countries.

This Clintonian consensus on Russia went into disrepute in the late 1990's. The 1998 crisis showed the weakness of the Russian economy. The peculiarities of Russian democracy in Chechnya and elsewhere became too evident to be ignored. Doubts about the uses of some of the assistance also surfaced. The new consensus emerging before 11 September 2001 seemed to be based on two postulates that were very different from the earlier ones. First, Russia is not in a transition, it has already arrived. A distinct system with a de-

gree of keeping power has emerged. What we see now is probably not far from what there will be in ten or fifteen years. Second, possibilities for the international community to have an impact in Russia are quite limited.

These postulates – never unknown in Europe and certainly very familiar in Finland – are widely shared among the opinion makers of the Bush administration. Some, before 11 September, drew the conclusion that Russia is better forgotten. It is neither the challenge nor the possibility many observers earlier thought they had found.

For an American decision-maker, Russia was still seen as possessing some importance because of her remaining military strategic capability and unique geopolitical location between Europe, Transcaucasus, Central Asia, China and the Pacific Rim. A serious social failure in Russia might destabilise many regions. In Europe, a "forget about Russia" school of thought could never have a major impact. The interfaces here are simply too numerous and at least potentially important to allow that.

The US no longer seemed eager to lead the Russia policies of the international community. Perhaps the European Union should take over the lead from the United States? The thought may have been tempting, but surely one should never pick up the torch simply

Trend of industrial production

1995=100

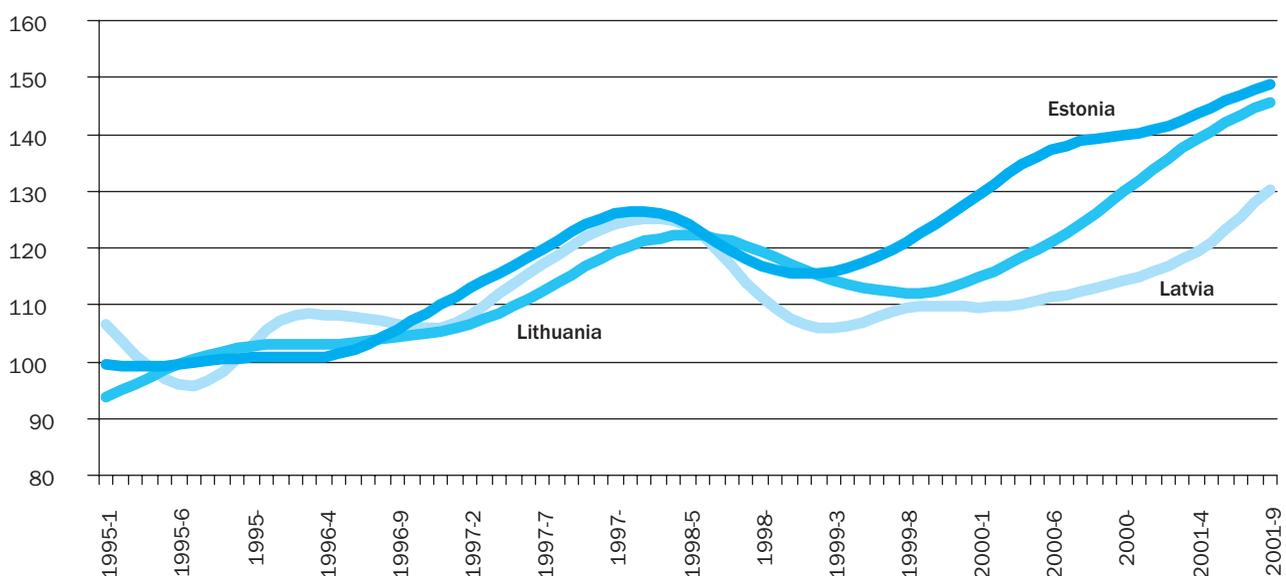


Figure 5

Source: BOFIT

because it is there. It is not clear whether the Union could ever share a common view on Russia and act as a unified decision-maker on that basis. But the question is of crucial importance.

If the Union is unable to have a common foreign and security policy on Russia, on what issue of any importance can the Union have unified foreign and security policies? The first issue to be addressed is whether we should believe in the first or the second of the paradigms just outlined? If a sufficient degree of consensus on that is impossible, we would be justified in forgetting about any meaningful Russia policies of the Union. That would to a large degree amount to forgetting about common foreign and security policies.

If Europe were to believe in the first, transition-based paradigm, the problem would simply be to avoid the mistakes that were made in the 1990's. The approach as such would remain intact. Matters would obviously be more complex if the second view were the correct one. Assuming now that Russia has already arrived, what is Russia actually like? What are the defining characteristics of the newly emerged Russian economic system?

A Dual Economy in the Wake of Russia's Transformation

The first characteristic of the new Russian economy is the emergence of quite a classical dual economy. Russia is a dual economy in two senses, concerning property rights and concerning markets. The first duality is declining in importance, which unfortunately cannot be said of the latter.

In the 1990's and to some extent still today, Russia's distribution of property rights remains unique among contemporary economies. Most enterprises and jobs are owned by company insiders: employees and managers, who benefited handsomely from the privatisation strategy adopted – as a political concession and against the better knowledge of the leading Russian economic reformers – in the early 1990's.

Employees are often the majority owners, while managers are in these companies the sole active owners. Only slowly has this situation been changing, as outside owners have strengthened their position in many previously insider-dominated companies. This is important, as outside owners may be expected to be more often interested in increasing the value of their companies. Insiders often take a defensive attitude, trying to maintain existing jobs and the privileges connected with owning one's own job, however modest

they may have become by that point.

Most Russian companies also produce for home markets. Since the steep devaluation launched by the crisis of August 1998, many of them have increased production, protected by the undervalued rouble. In the beginning, aggregate demand was boosted by huge net exports, as devaluation cut into imports and made many exports highly profitable. Now that the rouble is strengthening towards an equilibrium level, Russian economic growth is no longer directly foreign trade based but is building upon increasing consumption and investment. It is however still unclear how much effective restructuring has taken place.

No major new Russian export commodities have appeared. The country thus so far fails what must be seen as the fundamental test of restructuring and competitiveness. Investment is growing rapidly, but is, at slightly less than twenty per cent of aggregate production, still low if compared with the Soviet past or contemporary experience in the other transition economies. Dependence on bank credits or security markets is seen as a weakness. Most investment is financed out of retained earnings.

The difficulty of securing bank credit – also because of the lack of bankable assets due to lacking land and other real estate markets – is also a major explanation for the small and stagnant size of the Russian small enterprise sector. Lacking a booming new private activity sector, Russia lacks what has been the most important source of growth in other transition economies.

Most exports, on the other hand, are generated by a small number of resource based and outsider owned companies. They also generate much fiscal revenue, but only a limited number of jobs. These are the flagships of Russian industry, often dominated by the small group of the so-called new oligarchs. These companies are closely linked with world markets and are also increasingly internationalising their activities. To be successful in doing that, their owners must be able to be seen as shedding some of the things they have been infamous for, doing things like violating minority shareholder rights.

Foreign investment still remains meagre. It seems particularly difficult to penetrate those traditional Russian and Soviet priority branches where the wealth of the new oligarchs is anchored: oil, minerals and metals. Together with the main infrastructure enterprises, these companies are the core of Russia's political economy. The future of the Russian economy is decided here. This sector may be willing and able to

reform itself in the direction international standards of productivity and management. Still, the dual structure of the economy would remain.

There is much evidence about the probable consequences of a dual economy: low average living standards, great disparities of welfare, instability with a tendency for the Dutch Disease of an excessively strong real exchange rate, and an inclination for political authoritarianism are among the most evident ones. Much of this is visible in Russia, and we have seen it all before in other dual economy based countries like Venezuela or Indonesia.

Russia as the Handicapped Outsider

To make things worse, the Russian authorities have so far been unable to decide upon a relevant and realistic development plan for the country. Though the necessity of maintaining and developing the existing technological capacities is routinely underlined, the decline of industry, exports, research and development had much weakened the possibilities for other than dual economy development paths. If this remains, the capability of Russia to truly integrate with the world economy – including in particular the fast developing Baltic Sea Rim countries – will be much handicapped. The Baltic Sea would be defined within the European Union, but Russia would largely still remain outside it. Energy interdependence between Europe and Russia would only underline this.

The early Russian economic oligarchs of the 1990's usually based their wealth on banking. It could be highly profitable because of high and variable inflation; unstable exchange rates; negative interest rates of credits and sometimes hugely positive returns to government securities. The new oligarchs – though sometimes the very same people – are based on energy and other basic commodities. Some 20-30 dominant groups seem to be emerging, bringing the structure of the economy close to what has been seen in Eastern Asia and several dual economies of Asia and Latin America. The problems in Russia would be quite similar to those there.

The second specific feature of the Russian market economy is its low degree of monetisation. Though the use of roubles has much increased after the 1998 crisis, barter is still quite frequent, at about one fourth of industrial output.

Third, Russia's regionalisation has failed to reach the positive economic and political results expected. This is partially due to the small size and economic

weakness of most Russian regions. More important, perhaps, is the lack of a true nation-wide political system. Unpredictability and arbitrariness of regional decision making remains a major problem. President Putin's centralising reforms may have limited the impact of regional elites on central Moscow decision making, but they have done little to actually rein in regionally based arbitrary decision making.

The final peculiarity of the Russian market economy is the still remaining fuzziness of the division of powers. The borders between legal and extra-legal are often badly defined, in particular in regional implementation. Though the availability of third party intermediation in economic disputes has much increased, the political use of the legal system is still frequent, also on the highest level.

This is a major barrier to foreign investment, and also contributes to the well-known problems in border crossing, taxation, licensing and various inspections. In particular, this creates a very unwelcoming environment to new private economic activities and is – according to any number of surveys – the most serious impediment to the growth of small and medium-sized enterprises.

Much more could and probably should be said, not least on the non-economic dimensions of Russian society. But the main contours of the system are already easy to outline. The crucial question is, whether these are temporary imperfections on the continuing path towards a free-market economy, or whether these characteristics have such consistency and interconnectedness that they have a high staying power. This is the first question that any true Russia policy should ask.

If, indeed, we have witnessed the emergence of a peculiar Russian economic (and possibly political) system, Russia has during the past fifteen years landed in what the institutional economists would call a low-level institutional trap. It would not necessarily prevent all economic growth

But surely maintaining the current system would prevent Russia's true well-being. It would also make impossible her full integration with the international community. If Russia has indeed locked herself outside the EU based European system (and there is no other game around), the future Baltic Sea Rim would have several similarities with the earlier analogies discussed above. At the eastern borders of Norway, Finland, Estonia, Latvia and Lithuania (because Belarus and Ukraine to a large degree are like Russia, only

The % share of Baltic countries' exports and imports to/from Russia

	Estonia		Latvia		Lithuania	
	exports	imports	exports	imports	exports	imports
1994	22.4	15.9	28.1	23.6	28.2	39.3
1996	14.1	10.9	22.8	20.2	24.0	25.9
1998	10.5	7.6	12.1	11.8	16.5	21.2
2000	2.0	8.0	4.2	11.6	7.1	27.4

Figure 6

Source: BOFIT

more so) several dividing lines would coincide. There would be a huge welfare gap, but also a large normative divide, and an increasing digital divide. The problems that would emerge are only too easy to imagine. We all deserve better.

Putin Delivers More Than Most Expected

What might shift Russia from the current equilibrium into a better one? Hopes – and fears, as the authoritarian tendencies have been very visible — for a Putin revolution from above were hesitant at first, much weakened then but on the rise very recently again. The economic reform agenda that the Putin regime has been able to legislate recently has been much wider, stronger and ambitious than almost anybody was able to foresee in early 2000.

Implementation, as always, remains the problem, but the least one can say is that without legislation there would be precious little to implement. In foreign policy, Putin has been willing and able to advance much faster and perhaps also in directions other than the important elites would have been able to contemplate. In economic reform that may be worth-coming as well. The dependence of policy making on the will and determination of a single man and his associates is very much a problem, but no better alternative seems available just now.

In Russian as in other history, change has sometimes come from an external shock. The Crimean War is the pre-eminent Russian example. A suitable shock did not seem available before 11 September 2001. Then, the shock did not directly face Russia, but the USA. The American administration did change its attitude on a number of aspects. Some of the changes, like the seeming abandoning of unilateralist thinking and action, were welcomed by most. Others, like the restrictions of civil liberties, are more problematic.

But Russia has been very skilful in re-positioning herself in the emerging new world order. Almost suc-

ceeding in not saying to the Americans: “we told you so”, Putin has taken initiatives that might have a major impact on the world to emerge. The integration of the Baltic states into Euro-Atlantic security structures is now much easier, though one should not forget that Putin gave the green light in principle to Baltic NATO-membership in Helsinki a week before the attack on America. Current lower oil prices should also destroy some of the previously excessive policy complacency.

The truly intriguing possibility is the adoption of a truly European goal by Russia as the fundamental policy anchor. Some of the prerequisites for that have been discussed above. The tasks ahead both for Russia and the Union are a tall order and the pay-off uncertain. Given the alternatives available, they must however be seized. The consequences of the choices to be made will be felt not only in the Baltic Sea Rim, but also beyond it. To assess the probable implications involved, it will be useful first to look at EU's Russia policies in the immediate past. And as the future context involves an enlargement of the Union into Poland and the Baltics, it may be useful to look at the past through the lenses of a previous new member of the Union, Finland.

Creating EU Policy from the Inside: the Case of Finland

Any member country of the Union has three levels of foreign policies. The first one is the multilateral one, including the United Nations and other international organisations. The role of the international financial institutions vis-à-vis Russia was important in the 1990's, but has now been overshadowed by WTO membership negotiations as described above. In becoming a member of the WTO, a candidate actually negotiates with each and every one of the incumbent nations. Some of them, like China, might prove active in the case of Russia.

The third level is that of bilateral relations. In most

cases this level probably remains a matter of practicalities. As such, they are important and any bilateral discussions are supported by the existence of the second level, that between the European Union and outside countries. The second level is where much of the action is, and the question of whether a single member country can make a difference, is an important one. It is also important in view of the forthcoming accession of the Baltic countries into the Union. They will participate in the formulation of Union policies, also vis-à-vis Russia.

Looking at the role one new member country has had after her accession helps to understand whether a small new member can make a difference. It is then up to the Balts to show in due time whether and what kind of a difference they might wish to make. The Russians, as is known, have their doubts here. They sometimes argue that while Finland has made a positive contribution, a similar attitude is not obviously present in the Baltic countries.

As a new member of the Union, Finland was anxious to leave its mark on the EU. Vital national interests were involved, and membership had also been sold to the Finnish electorate – as against the option of remaining within the European Economic Area – as giving Finns the possibility of having an impact on EU policies. In the case of Russia policies, Finland did not only want to make an impact; she wanted to make a difference. And there were grounds for that. Finnish membership gave the Union for the first time a common border with Russia, and some 1300 kilometres of it. The relation between Russia and the Union gained new urgency and practical implications. The Finnish answer to this was the Northern Dimension, first as a Finnish initiative and then as a jointly decided EU policy.

Over time, and in particular in the wake of the 1998 Russian economic debacle, the Russian policies of the US administration were widely judged to have miscarried. EU was offered additional responsibility. EU and Russia had substituted their 1989 agreement on trade and cooperation with a Partnership and Co-operation Agreement (PCA) on Corfu, in summer 1994. In the works since 1992, this agreement remains the basic document on economic relations between EU and Russia.

The underlying thinking is that Russia could not become a member of the Union in the foreseeable future. Instead, it should be made into a “partner”, later upgraded into a “strategic partner”. Neither of the terms has been defined very clearly. The main goal of the PCA agreement is free trade between the partners.

The first Chechen war caused the agreement to take force only in December 1997. So, when the agreement came into power, it already had the history of five turbulent years.

The PCA foresaw that the two partners would consider the possibility for that in 1998. In practice, the preconditions were missing and still are, as in October 2001 Russia is still a long way from joining the World Trade Organisation, the natural precondition for considering free trade between Russia and the EU. In fact, though President Putin has repeatedly called for speedy accession, even setting the end of 2001 as the time limit, ongoing vertical integration into large Russian conglomerates sets a question mark over the existence of such major Russian interest groups in whose interest a speedy accession might be. Russian business associations have agreed to support WTO membership. It is unclear how strong the support actually is.

The inherited scheme for the development of EU-Russian relations reminds one in a peculiar manner of the quasi-Marxist order in which the EU itself has developed over the years. It started with a political recognition of mutual interdependence (in energy on one hand and steel and coal on the other), passed through a basic agreement (PCA and the Treaty and Rome), is then supposed to sail through expected free trade perhaps to the four freedoms and in the very long run possibly even into membership. It is unclear, however, why the sequence should be the same in these two very dissimilar cases. It may well be that concerns of urgency might well front-load the weight to be given to cooperation in education, environmental matters, political and even security issues. Free trade is clearly not a matter of even medium-term reality. Such considerations may have played a role when the EU started to draft a Russia strategy in Autumn 1998. There simply had to be a new initiative.

The common EU strategy on Russia is based on a very similar thinking as the PCA. (For further information see: http://europa.eu.int/comm/external_relations/ceeca/com_strat/russia_99.pdf). It clearly upgrades the importance of cooperation in sectors like energy and nuclear safety, the environment and health, internal and juridical matters, regional and cross-border cooperation and infrastructure projects. There is thus liberation from the model of EU's own evolution. In truth the strategy is a kind of a shopping list. The EU enumerates all the positive processes that it wants to support and strengthen in Russia. On the other hand, the strategy is very quiet on possible

risks and threats. Clearly, this document lacks analytical clarity and clear goals. But it did force the Union to study its own structure and activities for the purpose of checking for possible fields of cooperation with Russia.

Strategic Partnership, But with Different Approaches

The very existence of the EU strategy on Russia forced the Russians to reconsider their relation with the EU. Much, after all, had happened since the PCA. Russia answered in autumn 1999 with her own medium-term EU strategy. (For further information: www.eur.ru/eng/). There had been much less understanding of what the Union actually is. In that respect, Russia's EU-strategy marks clear progress. Moscow had been forced by developments to reconsider. Still, room is left for improvement.

Thus, both sides are talking about strategic partnership, but still the approaches are quite different. The EU sees the partnership as serving the goal of reforming Russia's economy and society. Russia see its as a vehicle for creating a multipolar world to counterbalance US pre-eminence. The EU (as long as it denies the prospect of Russia's membership) has few positive incentives to offer. Neither has it many negative sanctions to use. The most important practical tool, the Tacis-programme, has had both its successes and problems.

The Russians initially overestimated the possibilities of using the EU to counterbalance US influence. They seemed to shift their approach in early 2001, when President Putin unambiguously stated that consistency with the EU *acquis* should be made the criterion for legislation and institutional development in Russia. But his remarks failed to have a major impact, either in Russia or outside it. Perhaps the idea was seen as totally lacking in credibility. But something remained. The October 2001 EU-Russia summit decided to establish another high-level working group, this time to study establishing something called Common European Economic Space. One aspect of that would seemingly be the convergence of legislation.

In the 1990's, the Finnish foreign policy establishment shared the view that Russia would never become a member of the EU. Speeches by President Ahtisaari (1994-2000) argued that the forthcoming expansion of the Union to the Baltic States would mark its geographical finality in this part of the world. Still, closer cooperation was needed for fundamental secu-

rity policy arguments, as well as for plain economic benefit. And Finland wanted to leave its mark on common policies.

In a speech in September 1997 held in Finnish Lapland (available through www.vn.fi), Prime Minister Paavo Lipponen proposed that the EU should adopt a Northern Dimension Policy. Lipponen described Northern Europe and especially northwestern Russia as a region of great hopes and expectations but potential dangers as well. To exploit the possibilities and to solve the problems a co-ordinated policy was needed.

The success of the idea was fast. It was accepted as a part of the external relations of the Union a year later at Vienna. There the Northern Dimension also saw its first official document, the European Commission's communication on the Northern Dimension. The communication, like Lipponen's speech a year earlier, characterised the policy mainly through a list of negotiations. The Northern Dimension was not to mean new institutions, new monies or new forms of regionally-based cooperation. The communication was very long in enumerating the threats, possibilities and risks in the regions, but very short in concrete proposals.

The June 2000 Feira European Council adopted the action plan for the Northern Dimension. Meanwhile, the geographical focus had tended to shift somewhat south. Lipponen had introduced the concept in a conference dedicated to Barents Sea cooperation. The improving prospects for accession of the three Baltic States lead into an enlargement-related Northern Dimension.

What to conclude? There is no doubt that the Finnish proposal was conceptually contradictory from the very beginning. A great number of possibilities, threats and risks were enumerated, but new monies rule ruled out. The need for better cooperation of existing programmes both within the Union and outside was emphasised, but no institutional body or new wisdom for cooperation was proposed. The relation between the Northern Dimension and the EU Russia Strategy has always remained less than clear. But politics is not about philosophical purity. The Northern Dimension has been an extremely useful tool to keep the northern and northeastern relations of the Union in focus. Without the use of this catchword, the interest of the Union might have concentrated even more in other - and better financed - dimensions than has been the case so far. The improved cooperation of the international financial institutions in the region - as evidenced by the Northern Dimension Environmental Partner-

ship – might not have taken place without the political clout offered by the Northern Dimension, and the Feira Action Plan. The discussion on a separate EU budget line for the Northern Dimension will resume. Even new and small members can make a difference, at least of a kind.

Conclusion: Baltic Sea Economic Space is Ours to Make

It is difficult not to conclude that the Baltic Sea Rim has been a success story in the 1990's. So many things could have gone so badly wrong, but did not. The announced European orientation of the Putin administration, together with ongoing structural change in Russian society, also provides new opportunities. In spite of that, the caveats outlined above must be remembered. The institutional and productive structure of Russia is such that it will prevent a full integration of the country into the European Economic Space – and to the Baltic Sea Economic Space as part of it.

But that is a challenge, not an immovable barrier. Though the possibilities for the international community to have an impact on internal Russian developments are much less than some believed in the early 1990's, they do exist. Doors that can be left open should not be closed. It is up to the Russians to decide whether they want to enter or not. Making entrance as easy as possible cannot be the correct response. Russia should get the same conditions and incentives as others do, only more so, remembering the importance of the country. Russia, for instance, should not be allowed to slip into the World Trade Organisation. It should use WTO accession as a lever for internal reform, the way China has been doing.

EU – Russian relations are in ever-present danger of splitting into the profane technicalities of borders, customs and tariffs on one hand and into the grand rhetoric of summit conferences on the other. Such bifurcation may be inevitable, but it is not the best basis for development. In spite of all its problems, the Northern Dimension may still prove to be a useful middle-level vehicle.

The Baltic Sea Economic Space will become part of the wider European Economic Space. The European Union, therefore, has to be the main actor creating it. But it is not the only one. There is the multilateral level of the WTO and other organisations. There is also the level of bilateral relations between a Union country and Russia. Even here, multilateralisation may often be useful. The triangular cooperation between Fin-

land, Estonia and Russia in developing functional borders and security of sea traffic may be one such example.

But finally, the formal international cooperation of agreements and summit conferences is rarely enough without the strong support and initiative of civil society. This is increasingly true in modern societies, where amazing amounts of information can be gathered and processed extremely fast. Civil society integration is the best existing guarantee that politicians and diplomats truly do what they have promised. It is also the best available source of new ideas and initiatives. Therefore, the coming Baltic Sea Economic Space must also rest on the integration of universities, research institutes, interest groups, and lobby organisations. That will also work towards preventing the forces of economic integration – interdependencies – from taking too much the character of independent processes for their own ends.

Pekka Sutela

Pekka Sutela was born in 1951. He completed his master's degree, majoring in economics, at the University of Helsinki in 1973, and took his doctorate in 1984. Sutela was appointed Professor of Transition Economic Research at the University of Helsinki in 1995. In 1998 he was appointed head at Bank of Finland's Institute for Economies in Transition.

From 1973 to 1990, Sutela held positions as lecturer in economics, researcher at the Academy of Finland, and was a visiting scholar in England and the Federal Republic of Germany. He was appointed docent in economics at the University of Helsinki in 1988. In 1990, he became a special adviser to the Unit for Eastern European Economies at the Bank of Finland. He was acting head of the unit in 1995. Since the beginning of 1996 he has been adviser to the Board.

Sutela's earlier research concentrated on Russian and Soviet economic history and planned economies. His recent research emphasis concerns economies in transition, particularly Russia and the Baltic states. Sutela has published extensively.

The Toils of Closing the Rim

by **Dmitri Trenin**

Carnegie Moscow Center



The question which Pekka Sutela asks in his excellent piece, *Baltic Sea Economic Space – Vision or Illusion?* is relevant only as far as one attempts to bring Russia into the equation. A Baltic Sea Economic Space that includes the Nordic countries, Germany, Poland and the three Baltic States is neither a vision nor an illusion. It is an emerging reality.

The coming enlargement of the European Union, by erasing the economic and political dividing lines among the member states, will create a solid basis for most intense exchanges and closest interaction around the Baltic Rim. Geographically, the rim will not be wholly closed of course, but if one were to find a way to police the perimeter of the Kaliningrad enclave and happily treat St. Petersburg and the far eastern corner of the Gulf of Finland as a conduit for raw material imports to Europe, while safely ignoring the backward Russian hinterland, the system would be sustainable.

Indeed, this is what the medium-term future holds. The outlook is an increasingly intertwined and interdependent German/Nordic core, with the Poles and the Balts trying hard to catch up, using their comparative advantages such as lower labour costs. There will continue to be a major gap in the standard of living between the core and the periphery, but this gap is more likely to

stimulate exchanges than to stifle them. Russia, of course, will be an odd man out.

For the foreseeable future, its mode of economic interaction with its north-western neighbours will probably stay the same. Russia will be an energy and raw materials supplier to the richer and more advanced economies, and will depend on them for investment and technology. As Dr. Sutela correctly implies, Russia's principal contribution to the well being of others is that it has not been much of a problem to them in its imperial decline. And this is not a small contribution from a historical point of view.

No More Grand Designs for Russia

Pekka Sutela, however, sets himself the difficult task of squaring the Baltic circle. As someone coming from a country sharing a long common border with Russia, this is not only a courageous, but also the correct thing to do. He looks beyond the horizon, weighing the risks and identifying opportunities. His central plea is for the European Union to move from pompous declarations and ground-level incrementalism, toward a workable mid-level strategy of relations with Russia.

There is no question that such a strategy is badly needed. To make his case more compelling, Sutela could have come up with a list of good reasons of why the EU in general, and the Baltic Rim nations in particular, should care about Russia – beyond ensuring that “Russia is no problem”. This is *the* central question – what makes Europe

think about integrating Russia into some common space? Actually, this is not a question about Russia. This is a question about what Europe wants to be.

Naturally, I will not attempt to answer this question. As for Russia, things are somewhat clearer. Having irrevocably lost its unique position as a world unto itself, and having stopped integrating others *into* itself as a means of enhancing its security and maximising its power, it is searching for a new role, new position, and new quality. *Russia as Eurasia is over, for good.*¹

Transition may have become a dirty word to some, but Russia continues to be in transit. Dr. Sutela gives an insightful and incisive analysis of Russian economy and its body politic. He concludes, however, that societies do change, and sometimes for the positive. It would be intriguing, he writes, if Russia were to adopt a “truly European goal... as the fundamental policy anchor”.

Well, the time for presenting grand designs to the Russian nation has passed. In the 1990s, words were devalued as much as the rouble (if not more). Or, alternatively, the time has not come for publicly airing a “European vision” for Russia. The public would refuse to be enthused, and a fine goal would be discredited.

Russia Will Keep Moving toward Europe

Today and in the foreseeable future, the Russians will need to solve a myriad of practical problems, from land reform to legal reform to pension reform to federation reform, etc. The list is as long as the Trans-Siberian railroad. The Russians will not need to say to themselves: “we are doing it the European way”. They will only need to ask, “which is the best way for us *if we want to stay in the real world?*” The answer in

most cases will be what *others* will call “European”.

Putin’s new foreign policy strategy is credible because it organically flows from his “Russia project”. The goal is modernisation through Europeanisation. This means a market economy with a substantial role for the state, a democracy, which harmonises individualism and social solidarity, and a civil society that will have finally ended the coincidence of the country with the state.

This is a long-term goal, and Putin will not preside over its attainment – which itself will be a contribution toward reaching the goal. There will be ups and downs, regressions and diversions, but there is a good chance that Russia will steadily move toward Europe, rather than away from it. On balance, its first ten years have not been a total disappointment, considering the departure point.

As opposed to the countries of Central Europe and the Baltics, Russia cannot even pretend that it is *returning* to Europe. As distinct from them, again, it cannot and should not emphasise the goal of formal integration through membership in the European and Euro-Atlantic institutions.

Russia Cannot Afford to Ignore the European Union

For Russia, “entering Europe” is 95% *not* about diplomacy. As Pekka Sutela points out when he refers to the WTO membership, the name of the game is using the prospect of joining as a vehicle and incentive for domestic reform. To repeat a much-used phrase, the goal is nothing; moving toward it is everything. But why should Russia strive to move toward it?

The answer is straightforward. Russia is doing it out of necessity. The pull of the European Union is too strong to afford the luxury of staying aloof. Forty

¹ See my book, *The End of Eurasia: Russia on the Border Between Geopolitics and Globalization*. Moscow: Carnegie Moscow Center, 2001. (U.S. edition: Washington, Carnegie Endowment for International Peace, 2002)

percent of Russia's foreign trade is with the Union; by the end of the decade it is likely to exceed one half. The EU and NATO are the only two games in the neighbourhood, and one can afford to ignore them only at one's own risk.

There is also a powerful demonstration effect. The Russians of course have always wanted to "live like they do in Europe", knowing that they can hardly catch up with the Finns and the Danes. This failure is relatively easy to explain away. What will be increasingly more difficult to explain away, is the growing gap between the Russians, on the one hand, and the Poles, the Estonians, and *the Russians in the Baltic States*, on the other.

The Russians will not only feel the pull of Europe, but also the push of Asia and the turbulence of the Greater Middle East, reaching up to their southern borders. They may not consider themselves fully European if they live in Narva or Vyborg, but they cannot consider themselves *anything but* European if their home is in Vladivostok or Khabarovsk. It would be folly to think otherwise. Integration into Europe is different from integration into China.

Kaliningrad Could Show the Way

In the future, Russia will only regain confidence in dealing with China if it manages to identify itself with Europe. As a wanderer between the EU and China, Russia will be essentially insecure. And of course, as Dr. Sutela mentions, there is bound to be a generation change (I would add: several consecutive changes are required), resulting in the Soviet Union and the Russian empire receding farther and farther into history. This process will be admittedly slow, but so much more effective for it.

The urgent and unavoidable item on the Russian-European agenda is called Kaliningrad. Both sides need to deal

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Dr. Trenin won his Ph.D. from the Institute of the U.S.A. and Canada, Russian Academy of Sciences (1984), was a Senior Fellow of the Academy's Institute of Europe (1993-1997) and a visiting professor at the Brussels Free University (1993-1994).

Dmitri Trenin is the author of several books and numerous publications. His most recent work, *The End of Eurasia: Russia on the Border Between Geopolitics and Globalization*, appeared in 2001 in English.

with it because they cannot safely afford not to. They are under time pressure (the enlargement schedule). The issue is of the right size for the moment (neither too ambitious nor too minuscule), and it is of the right quality and structure (economy, environment, humanitarian issues, and crime-fighting first).

Kaliningrad is almost created to serve as a laboratory for Russian-EU cooperation. A Russian exclave, it is an ideal economic testing ground. The first tests, however, will have to be taken by the politicians and the bureaucrats in Moscow and Brussels. They may flunk them, but the problem will not go away, and someone will have to revisit it. To paraphrase an ancient saying, *hic Kaliningrad, hic salta!*²

² The original phrase "Hic Rhodus, hic salta" is ascribed to Aesop. A fellow was boasting of some incredible jumps he had made in Rhodes. A bystander broke in with "Make believe this is Rhodes; let's see you jump." (ed.)

News from the Director of Baltic Development Forum

Introducing a Unique Platform for Networking in the Baltic Sea Region

by **Ole Frijs-Madsen**
Director of
Baltic Development Forum



Dear reader,

In this first edition of *The Baltic Sea Agenda* it is a pleasure to present you with an update on *Baltic Development Forum* and our activities in 2002.

Our mission is to advance the growth potential in the Region through new partnerships between leaders from business, government and academia.

Since its launch in 1998, *Baltic Development Forum* has gradually established a strong platform for networking in the whole of the Baltic Sea Region, including Russia. As an independent, non-profit organisation, *Baltic Development Forum* stands above political and economical interests.

Our vision is that the Baltic Sea Region can position itself as one of the most dynamic and prosperous economic centres in the new Europe. Everyone in the region stands to win, and there will be huge gains for the rest of the world in terms of increased stability, sustained economic growth and a huge export potential. You can read

further in our Summit Report about the very concise and positive predictions for the Baltic Sea Region, with its yearly growth potential of 4 to 6 %, made by Michael E. Porter, Professor at Harvard Business School.

” **The fundament for growth in every economy is productivity - on this crucial point the Baltic Sea Region has a huge potential**

Prof. Michael E. Porter

The Organisation

Baltic Development Forum is a foundation funded through membership from an exclusive number of companies, institutions, cities and foundations. Membership is granted on a strict case-by-case basis and a maximum of 100 members can join. The Chairman of the Board is former Danish Minister for Foreign Affairs, **Uffe Ellemann-Jensen**. The daily work, preparation of Summits and various other activities is undertaken by a small Secretariat headed by the Director of *Baltic Development Forum*.

The Summits

I invite you to read about the 3rd *Baltic Development Forum Summit* in St. Petersburg on the following pages of

this publication. The annual Summits represent the highlight of *Baltic Development Forum's* activities and attract interest from roughly 500 leading representatives from business, government and academia. Previous Summits have been held in Copenhagen and Malmø.

Building on the success from the 3rd *Baltic Development Forum Summit* in St. Petersburg in September 2001, we shall be following up on the main conclusions from the political, economic and business segments of the Summit and in a pragmatic way implement our slogan by "moving from words to action". We shall do so through our privileged contacts with trade and industry, governments, the European Commission as well as other regional players like the Council of Baltic Sea States,

Baltic Development Forum's **Advisory Board** consists of some of the most visionary players in our Region today. They are:

- **Hans Dalborg**, Vice Chairman Nordea, Sweden
- **Yuri Deryabin**, Director of the Institute of Europe Russia
- **Grete Faremo**, Executive Vice-President of Storebrand, Norway
- **Jaakko Iloniemi**, Millennium Prize Ambassador, Finland
- **Wolf-Rüdiger Janzen**, President of Baltic Sea Chambers of Commerce Association, Germany
- **Andrius Kubilius**, MP and former Prime Minister, Lithuania
- **Viktors Kulbergs**, President of the Latvian Chamber of Commerce and Industry, Latvia
- **Toomas Luman**, President of the Estonian Chamber of Commerce and Industry, Estonia
- **Andrzej Olechowski**, Chairman of the Central Europe Trust Fund, Poland
- **Eero Rantala**, Managing Director of Pro Baltica Forum, Germany.
- **Thorvald Stoltenberg**, President of Norwegian Red Cross, Norway.

EastWest Institute, BCCA, and Pro Baltica Forum. We have close cooperation with the World Economic Forum, and its founder, Mr. Klaus Schwab is a member of *Baltic Development Forum's* Honorary Board.

The 4th Baltic Development Forum Summit will be held in Copenhagen, 13-15 October. The venue has been chosen in view of the Danish Presidency of the European Union during the second half of 2002.

You can read more about the Copenhagen Summit in the next edition of *The Baltic Sea Agenda* and on our website (www.bdforum.org) in due course. You can also contact our secretariat by e-mail (bdforum@mm.dk) to get more information about the Summit.

The Conferences and Round Tables

At our **first Members' Conference in 2002**, we shall be focusing on how to bridge the political and commercial gap between an enlarged EU on the one hand and Russia on the other. At *Baltic Development Forum's* Summit in St. Petersburg, the notion of a **Baltic Sea Economic Space** was widely endorsed by Prime Ministers and leading businessmen from Scandinavia and Ger-

The 4th Baltic Development Forum Summit

The preparations for the 4th annual Baltic Development Forum Summit are in progress, and the Summit is taking shape.

The **venue** for the 4th BDF Summit will be the new buildings of Copenhagen Business School, 13-15 October 2002.

The **political theme** will be the upcoming EU enlargement, and this will be connected to closer cooperation with Russia.

The more specific **business themes** are still under consideration and will be presented in the next edition of *Baltic Sea Agenda*.

Baltic Development Forum stands above political and economic interests

Conclusions from the 3rd Annual Baltic Development Forum Summit in St. Petersburg 2001

A coherent approach by Europe and the Baltic Sea Region demands:

- A speedy accession of Russia to the WTO
- A closer cooperation between Russia and the EU
 - The European Economic Space must include Russia and must start with a unified educational space
 - Russia should de facto adopt the EU acquis
 - The EU and Russia must make full use of existing cooperation, not least the Action plan on the Northern Dimension
 - Kaliningrad can be perceived as the pilot project for future EU-Russia relations
- Accession to the EU of Estonia, Latvia, Lithuania and Poland during the Danish EU Presidency in 2002

Recommendations from the Summit's business theme: visions and strategies for economic development

A strengthened microeconomic environment in the Region and its parts is needed to foster productivity and competitiveness as well as creating a structure for cooperation that fully mobilizes the Region's economic potential.

The speakers and participants of the Summit pointed to the following appropriate steps in the Baltic Sea Region to achieve this:

- Upgrading of the physical networks connecting the Region
- Enlarging the research and development capacity in the Region, creating an educational environment within the Region's business sector competitive with the US
- Creating conditions for brain circulation as well as cooperation between companies and research institutions in the Region
- Focussing the bilateral and multilateral assistance given to Russia and the candidate countries on developing the Region's business sector
- Initiating regional cluster fora to enhance specialization, cooperation, and competition in areas like biotech, energy, ITC, transport and tourism etc. Baltic Development Forum was entrusted to develop a brand for the Region based on the Region's most powerful characteristics.

Recommendations from the Summit's specialist theme: The Northern Dimension Action Plan – Monitoring progress and the over-all implementation

The main general recommendations are as follows:

- The support of the Northern Dimension Action Plan must be abundant. The Northern Dimension Action Plan is now an important part of the cooperation between EU and Russia. It gives the necessary framework to deal with the two great challenges facing the European Union:
 - The integration of Russia into Europe
 - The Enlargement
- The Northern Dimension Action Plan must be used to strengthen security for both the EU and Russia against crime, violence and terrorists attacks equal to the recent attacks in the US
- The implementation of the Northern Dimension Action Plan must be given the necessary speed. This can be done by:
 - Securing the necessary investments by using the Northern Dimension Environmental partnership as a model, for, amongst others, the energy sector.
 - Combining the Action Plan with the methodology of Jacques Delors' White Paper on the Single Market, creating - in parallel with Enlargement - a Baltic Sea Common Market with Russia

many in the Western part of the Region through to Poland and the Baltic States, to Russia on the Eastern shores of the Baltic rim. It is essential for growth and prosperity that goods, services and people can flow as freely as possible in the whole region.

At our Members' Conference in Copenhagen on 23 January, high level representatives from the EU, presidents of Employers Unions in Russia and

Scandinavia, the Danish Minister for Foreign Affairs and incoming president of the European Union, as well as leading business representatives discussed **how to overcome trade barriers and bureaucracy in a practical way**. This first edition of the *Baltic Sea Agenda* focuses on the vision of a Baltic Sea Economic Space and thus created the analytical basis for the debate.

The summits represent the highlight of Baltic Development Forum's activities



Branding expert Wally Olins, Estonian Minister for Foreign Affairs Toomas Hendrik Ilves, Former Norwegian Minister for Oil and Energy Olav Akselsen and Chairman of RWE Power AG Gert Maichel in a panel discussion at the Baltic Development Forum Summit in St. Petersburg



Russian Deputy Minister for Foreign Affairs Yevgeni Gusarov (far right) listening to a friendly conversation between Uffe Ellemann-Jensen, Former Danish Prime Minister Poul Nyrup Rasmussen and the Governor of St. Petersburg Vladimir Yakovlev at the Baltic Development Forum Summit in St. Petersburg

Baltic Development Forum has cooperation and partnerships with several regional key-organizations including:

- World Economic Forum
- Council of Baltic Sea States
- ProBaltica Forum
- EastWest Institute
- Baltic Sea Chambers of Commerce Association

Further events will take place during the year. Among the topics under consideration are:

- Kaliningrad and its situation after EU enlargement
- Branding of the Baltic Sea Region
- Transport structures and barriers.

The Network

Meetings, conferences and Summits within the framework of Baltic Development Forum represent a **unique opportunity to meet decision makers from Scandinavia, Russia, the Baltic States, Poland and Germany**. Through Membership of the Foundation or participation (by invitation only) access can be obtained to this extended network of executive business representatives, ministers and high level politicians from the Region, leading aca-

demics, mayors from the main cities of the Baltic Sea Rim, regional organisations etc.

We are furthermore in the process of establishing a **specialized network** of leading think-tanks and research institutions which may supplement and elaborate further the work of Baltic Development Forum. Only by such concrete action shall we be able to push forward the vast and challenging agenda to the benefit of the whole of the Baltic Sea Region.

I wish you a prosperous and happy 2002, and look forward to welcoming you as a member, speaker or participant at some of the various activities undertaken by Baltic Development Forum.

Baltic Development Forum

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Everyone stands to win from closer cooperation in the Baltic Sea Region