THE BALTIC SEA REGION ECONOMIES:

PROGRESS AND PRIORITIES

- A 20-year perspective

David Skilling

NIB NORDIC INVESTMENT BANK

Baltic Development Forum

FOREWORD

On the occasion of the 20th anniversary of the Baltic Development Forum, it is indeed appropriate and timely to take a longer-term perspective on the economic development of the Baltic Sea Region over the past two decades.

As such, we have asked Dr David Skilling of Landfall Strategy Group, based on his vast experience on the economic advancement of small developed countries, to provide a short but comprehensive overview of the region´s performance, integration and outlook. With an eye to the future, the idea is to identify challenges and opportunities facing the region. The report takes inspiration from BDFs annually published State of the Region reports, that analyse the BSR's growth, innovation and competitiveness.

The region has developed from a geographical area mostly characterized by the division of the Baltic Sea, to a highly integrated, dynamic and growing collection of nations, considered by many as a frontrunner in several respects. The BSR has undoubtedly benefitted from European integration and the attributable effects of the Baltic states and Poland chasing its more developed Nordic neighbours. Today, after two decades of steady progress, the outlook for the region is still positive, but a variety of challenges lies ahead in an ever more complex global environment. This suggests that the road forward may not be as smooth as it was before, unless the region is able to face stronger global competition and the ever-faster pace of technological change. These challenges, it can be argued, may be best taken head on, as a concerted region working for common interests based on shared values. However, as the geopolitical and economic environment changes, so may the current institutional and co-operational framework that supports the BSR require a change too. It may be time for BSR 2.0!

For two decades, BDF has dedicated itself to promote growth, innovation and competitiveness in the Baltic Sea Region through cross-border public-private partnerships. As a platform for many projects and activities, particularly within ICT, energy and environment, it is our hope that these activities have and will continue to inspire others to build lasting relations across the borders of Baltic Sea Region states.

Our sincere appreciation to David Skilling for his insightful analysis. Also, our sincere thanks to the Nordic Investment Bank for their support which has made possible the preparation of this anniversary report in connection to the 20th BDF Summit in Tallinn. As always, the views expressed in this report are those of the author and not necessarily those of the sponsor.

We hope that the report will be a valuable input to the discussions on which path the Baltic Sea Region should take in the years to come.

Lene Espersen
chairman

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director

CONTENTS

AUTHOR

David Skilling is the founding Director of Landfall Strategy Group, a Singapore-based economic advisory firm that provides advice on global economic, political, and policy developments to governments and financial institutions. David serves clients in Australasia, Asia and Europe, bringing distinctive perspectives on the changing global economic and political environment – with a particular focus on how these developments impact on small advanced economies.

David also writes regularly on global economic and political issues, including in a regular column in Singapore's Straits Times as well as in the Wall Street Journal, Project Syndicate, Foreign Affairs, Neue Zürcher Zeitung, and the Nikkei Asian Review.

David has recently served as Senior Advisor to the Permanent Secretary of the Ministry of Foreign Affairs and Trade in New Zealand. Prior to founding Landfall Strategy Group in 2011, David was an Associate Principal with McKinsey & Company in Singapore, as well as being a Senior Fellow with the McKinsey Global Institute. Before joining McKinsey, David was the founding Chief Executive of the New Zealand Institute, a privately-funded, non-partisan think-tank. Until 2003, David was a Principal Advisor at the New Zealand Treasury.

David has a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as a Master of Commerce degree in Economics from the University of Auckland. David was named as a Young Global Leader by the World Economic Forum in 2008.

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Dr David Skilling

EXECUTIVE SUMMARY

The BSR economies have performed strongly over the past couple of decades, out-pacing many of their European peers. There has been strong income convergence from the Baltic states and Poland, together with ongoing strong performance by the Nordic economies that are closer to the income frontier. And even in a challenging post-crisis environment, the BSR economies have performed well – growing faster than other crisis-hit European economies, as well as the broader EU group.

This performance has been underpinned by strong engagement with the global economy, as well as investments in innovation and human capital, and strong policy foundations.

Deepening integration within the BSR – and with the broader European region – has been integral to the economic success of the region. Over the past two decades, there has been substantial growth in cross-border flows of goods and services, capital, firms and people. Regional connectivity has also been strengthened in multiple ways, from infrastructure to regional institutions.

Although substantial progress has been made in terms of BSR integration, the extent of economic integration is roughly in line with what would be expected given the characteristics of these economies. The BSR remains a collection of connected economies rather than a single regional unit. An important contribution of regional integration in the BSR has been to support the integration of BSR economies into the broader European economy. This has allowed the lower income members of the BSR to more effectively take advantage of the opportunities of the Single Market.

The BSR economies continue to perform well, and the near-term outlook is positive. But there are several emerging challenges and opportunities that these economies will need to respond to in order to sustain this performance. For one thing, many BSR economies are facing aging populations. A greater contribution will be required from labour productivity growth – and at a time when productivity catch-up gains are less available because the BSR economies are closer to the income frontier.

In addition, the open economies of the BSR region will need to respond to emerging challenges and opportunities in the global economy. First, there is rapidly increasing global competition – which means that the BSR economies will need to work to sustain a competitive edge. Second, the global economic and political environment that has supported BSR growth is facing a series of risks – from protectionism, to the weaponisation of international commerce, to geopolitical risk. And third, disruptive technologies such as automation and AI are bringing a series of new growth opportunities as well as the potential to disrupt labour markets and economies.

In response, there are three classes of action that are important for the BSR economies, collectively and individually. First, policies to improve national competitiveness and to position individual BSR economies to respond to increasingly intense global competition and disruptive technologies. Second, actions to further strengthen integration in the region and to respond to new opportunities, such as the potential to lead deeper connections between Europe and Asia (including responding to developments such as the Arctic Route). And third, acting to develop a coherent voice on regional and global issues of common concern. Indeed, there is some evidence that this is happening, such as the eight country-strong statement on Eurozone reform – signed by six of the BSR states as well as Ireland and the Netherlands.

INTRODUCTION

This essay describes the progress and achievements of the Baltic Sea Region over the past two decades in order to provide a perspective on how the region can remain competitive and dynamic in the future.

The past two decades have been an eventful period, punctuated by the global financial crisis and more recently challenges in the Eurozone area. But the BSR economies have continued to grow and to integrate, and continue as one of the stronger performing regions in Europe. However, for this strong performance to continue in the face of emerging challenges and opportunities, additional actions will need to be taken by individual Baltic Sea Region (BSR) economies as well as the BSR as a group.

The essay is structured into four parts. Part I considers the performance of the BSR region since 2000, with some benchmarking against its peers. Part II discusses the progress that has been made in terms of BSR integration on a range of economic and other dimensions. The next two Parts are more forward looking in nature. Part III describes a series of emerging challenges and opportunities that will shape the outlook for the BSR economies. Part IV then outlines some priorities for action to further strengthen economic performance and integration across the BSR.

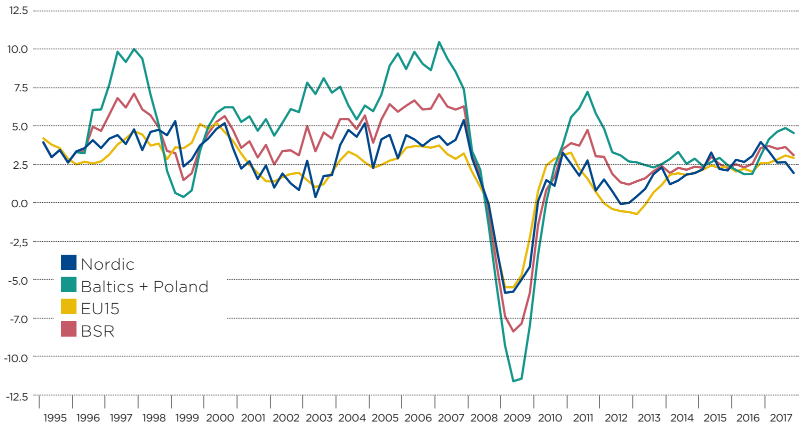
I. BSR PERFORMANCE

The BSR economies have generated strong GDP growth rates relative to the rest of Europe over the past 20 years. On average since 2000, the BSR economies have grown at 2.7% v 1.6% for the EU28. This out-performance has continued through the more challenging post-crisis period, with BSR economies navigating a deep crisis followed by the fall-out from the Eurozone crisis. There is a good reason that the BSR has been called the 'Top of Europe'.[1] This superior BSR performance – and the contributing policy actions – has been consistently documented in numerous BDF State of the Region Reports over the past several years.[2]

FIGURE **1**

The BSR economies have consistently out-grown the EU 28, led by the Baltic states and Poland

Real GDP growth, %, average, Q1 1995 - Q4 2017



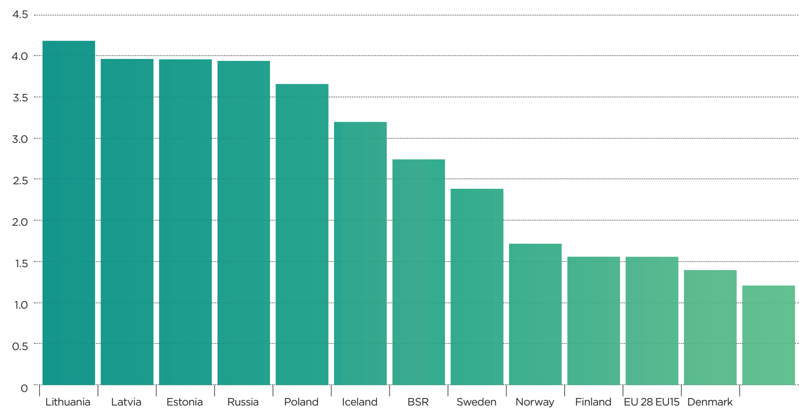
Source: Macrobond; OECD; Landfall Strategy Group calculations

This performance was partly due to a strong process of income convergence by the lower income BSR economies, and partly due to ongoing strong performance by the BSR economies that were closer to the income frontier.

FIGURE **2**

The Baltic states and Poland have grown strongly since 2000, with the Nordics registering lower GDP growth rates

Real GDP growth, %, average, Q1 2000 - Q4 2017



Source: Macrobond; OECD; Landfall Strategy Group calculations

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1 *Christian Ketels, Helge Pedersen, and Mikael Olsson, '2017 State of the Region Report: The Top of Europe – A Competitive Baltic Sea Region Ready for the Future?', Baltic Development Forum, 2017*

2 *Previous editions of the State of the Region Reports are available at* http://www.bdforum.org/publications/publication-category/state-of-the-region-reports/

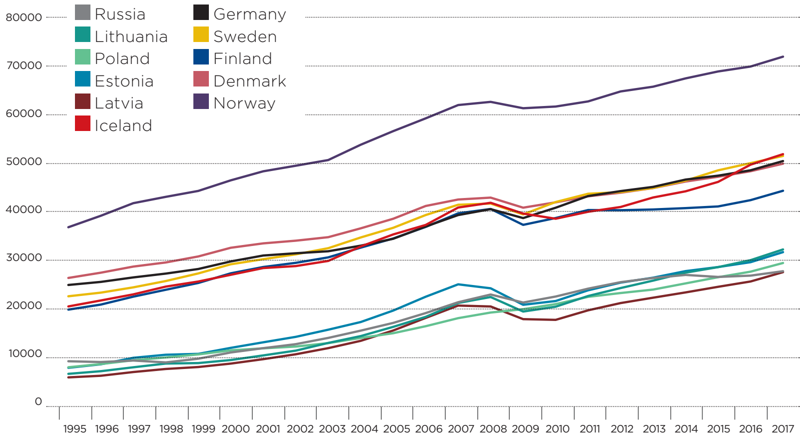
The BSR economies cover a relatively small geographic area, but a wide range of per capita income levels. There is a big spread from the Nordic economies at the income frontier to the Baltic states and Poland. However, this gap has closed rapidly over the past couple of decades and is substantially smaller than it was. Within the BSR group, the per capita income range shrank from a multiple of about 4.5x in 2000 to a multiple of less than 2.5x in 2017.

In terms of the process of convergence, the three Baltic states plus Poland grew very rapidly from the mid-1990s. Widespread economic reforms were implemented in these countries, coupled with – and reinforced by – deepening integration into the European Union. As a consequence, the three Baltic states moved from an average of 30% of the EU 15 average income in 1995 to 60% today (on a PPP basis). The Baltic economies out-performed the speed of convergence of other central and eastern European economies.

FIGURE **3**

There is a wide range of per capita income levels across the BSR group

Real per capita income, PPP, 1995 - 2017

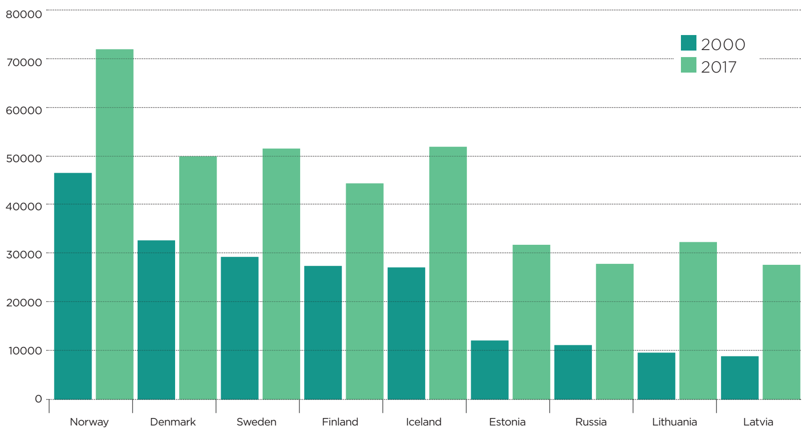


Source: Macrobond; IMF; Landfall Strategy Group calculations

FIGURE **4**

The Baltic states and Poland have converged towards the higher income BSR economies

Real per capita income, PPP, 2000 v 2017

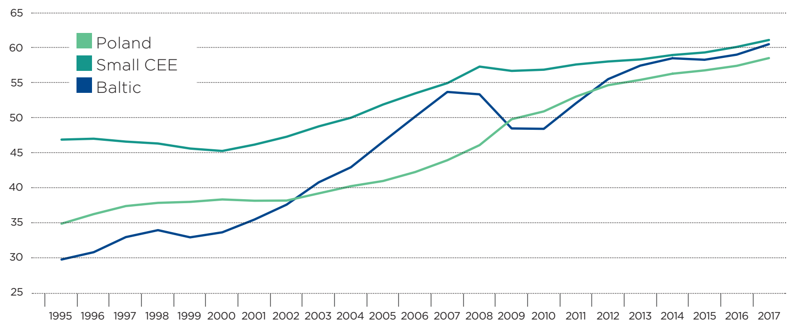


Source: Macrobond; IMF; Landfall Strategy Group

FIGURE **5**

The Baltic states and Poland have converged towards the EU15 average more rapidly than the other CEE economies

Real per capita income, PPP, % of EU 15, 1995 - 2017



Source: Macrobond; IMF; Landfall Strategy Group

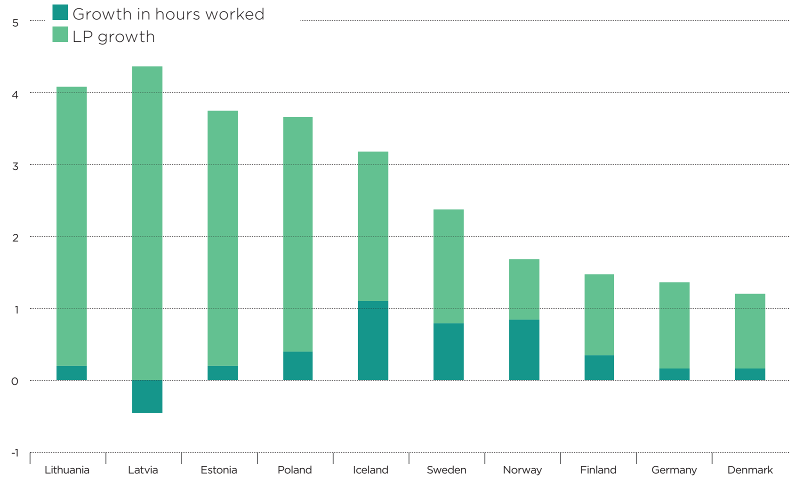
And for the countries close to the income frontier, such as Denmark and Sweden, ongoing investment in innovation led to ongoing productivity growth. These economies benefited from substantial progress in ICT as well as the process of intense globalisation. And countries like Finland also grew rapidly, developing a reputation as a technological powerhouse on the back of Nokia and other successful firms. These BSR economies at the income frontier have performed strongly relative to peers in Europe and beyond.

One of the notable features of this growth was that it was driven by sustained labour productivity growth. For the less advanced economies, there were substantial productivity catch-up gains to be had as they absorbed new technologies and business practices. And ongoing investment in the more advanced economies also supported productivity-rich GDP growth.

FIGURE **6**

Labour productivity growth has been the dominant source of GDP growth across the BSR economies since 2000

GDP growth decomposition; 2000-2017



Source: Macrobond; The Conference Board Total Economy Database, May 2017; Landfall Strategy Group calculations

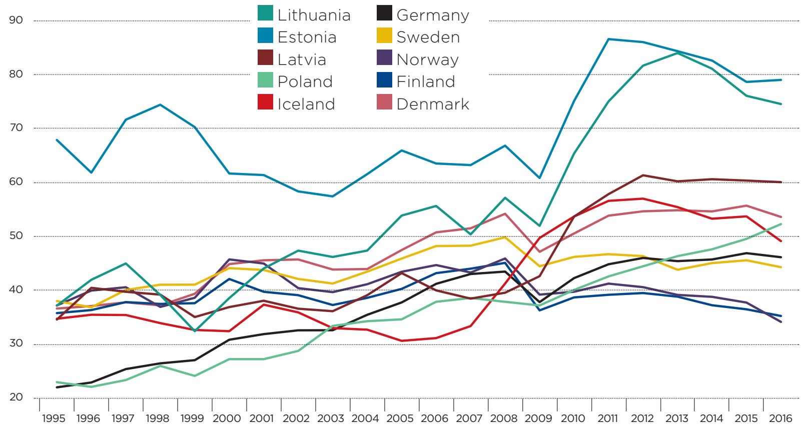
An important reason for the strong economic performance of the BSR economies was that they took advantage of the opportunities of strong global growth and globalisation. Across the BSR region, these economies were actively engaged in the process of intense globalisation that took hold around the world from the 1990s. And they benefited from deeper European integration as well. This was reflected in their growing export shares, particularly in the Baltic states.

The ability of the relatively small economies of the BSR to expand into larger markets was central to their economic success. In addition, the more advanced economies undertook substantial amounts of outward direct investment – including into other BSR economies, which supported the convergence process.

FIGURE **7**

The export share has grown strongly in many BSR economies

Exports of goods & services, % of GDP, 1995 - 2016



Source: Macrobond; World Bank

This development has not been a linear process, of course, and several of the BSR economies were severely impacted by the global financial crisis. The Baltic states and Iceland in part were deeply hit by the global financial crisis, with GDP contracting by 15-20% in the Baltics. Finland also experienced a contraction in GDP through the post-crisis period, due to a coincident series of shocks (including the Nokia shock).

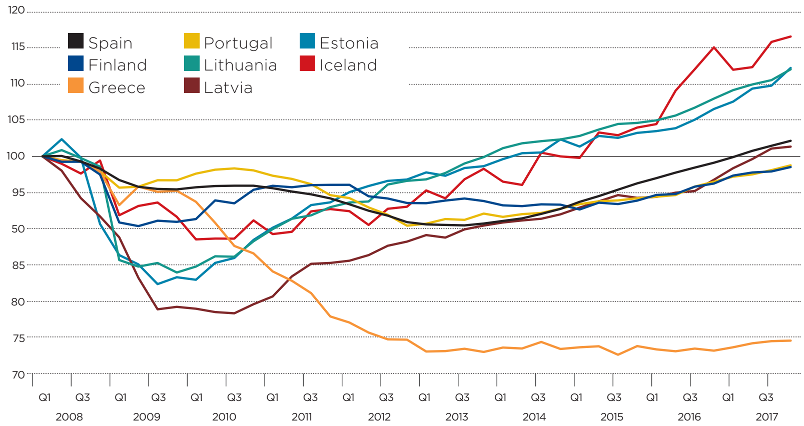
But relative to other European economies that were hit by the global financial crisis, such as Spain and Greece, the BSR countries recovered relatively strongly. The policy response included a very strong internal devaluation (wage cuts, reductions in government spending). But, although painful, the economies in the region out-performed many other parts of Europe during the post-crisis period. The overall message is one of resilience.

Overall, the BSR has been one of the better-performing groups of advanced economies around the world. And relative to Europe, the BSR has developed a deserved reputation for strong economic and social performance.

FIGURE **8**

The global financial crisis had a deep impact on several BSR economies, but they have recovered relatively well

Real GDP, Q1 2008 = 100, Q1 2008 – Q4 2017



Source: Macrobond; OECD; Landfall Strategy Group calculations

II. BSR INTEGRATION

Part of the strong BSR growth story was due to domestic policy choices and good economic management. But part of the success was due to the process of BSR integration – which provided a strong basis for GDP growth and for income convergence.

The BSR was transformed by the end of the Soviet Union, with the independence of the Baltic states and the reunification of Germany. The Nordics had also begun to integrate into various European bodies, and had stepped up efforts to create pan-Nordic institutions. Denmark had joined the EC in 1973, followed by Sweden and Finland in 1995 – and then the Baltics and Poland in 2002. A range of regional institutions were created to further support this integration process, including the BDF.

Christian Ketels and Emily Wise note that 'The Baltic Sea Region has over the last 25 years become a strongly integrated economic space, with multiple linkages in terms of trade, investment, labor mobility, and research collaboration. A rich structure of cross-border organisations and collaborative efforts supports and further develops these linkages.'[3] These regional institutions, as well as the tendency for relatively intense levels of trade and investment with adjacent countries, have supported healthy levels of regional integration.

On average, intra-BSR exports (exports between BSR members) account for just under 20% of total exports from the BSR economies. This is led by Latvia and Estonia (with intra-BSR export shares of 40-55%), well ahead of the Nordic countries that export more to other European countries. And about one third of the inward FDI stock into BSR economies comes from other BSR countries: again this is dominated by the Baltic countries, who have received substantial investment from the Nordic countries. Integration has allowed for comparative advantage to be exploited, as capital has flowed from the richer countries to the poorer countries in the region.

There has also been evidence of increased people flows and other interaction between the BSR economies in the region; for example, due to freedom of movement, exchange programmes, expansion by Nordic MNCs, and so on. The joint programmes and institutions associated with EU regional programmes have also built connectivity. And in addition to institutions, the connective tissue of infrastructure (transport, energy) has helped to support integration and outcomes.

This process of economic integration has been an ongoing trend over the past two decades. And it is hard to disentangle the process of BSR integration from the broader process of EU integration. As Ketels & Wise note, 'Collaboration within the Baltic Sea Region, since 2009 supported by the EU Strategy for the Baltic Sea Region, has amplified these national choices. It provided the soft linkages to better exploit the potential for trade and investment that the Single European Market offered.'

In significant measure, BSR integration is best understood as the way that European integration has been translated into this region, further deepening and leveraging access to the rest of Europe and the markets that the EU provides. Note that integration of the BSR economies with North West Russia is lower than with other parts of the region; partly because of the absence of institutional alignment that exists within EU members (and with EFTA in the case of Norway and Iceland). And more recently, economic integration has been hindered by the escalating sanctions on Russia, and the counter-sanctions by Russia, which has significantly constrained export growth from the rest of the BSR to Russia.

3 *For a comprehensive discussion of regional integration in the BSR, see Christian Ketels & Emily Wise, 'Regional Integration in the Baltic Sea Region – lessons for Asia', paper prepared for the Asian Development Bank.*

Indeed, the level of economic integration in the Baltic Sea Region is approximately what would be expected given the predictions of academic models. Despite the improvements in cross-border flows, and the connective hard and soft infrastructure, 'companies do not look at the Baltic Sea Region as one integrated market in terms of their strategies. For most of them, the region remains a group of individually small markets within the EU, each with its different dynamics, rivals, and often even regulatory rules'.[4]

> *Companies do not look at the Baltic Sea Region as one integrated market in terms of their strategies.*

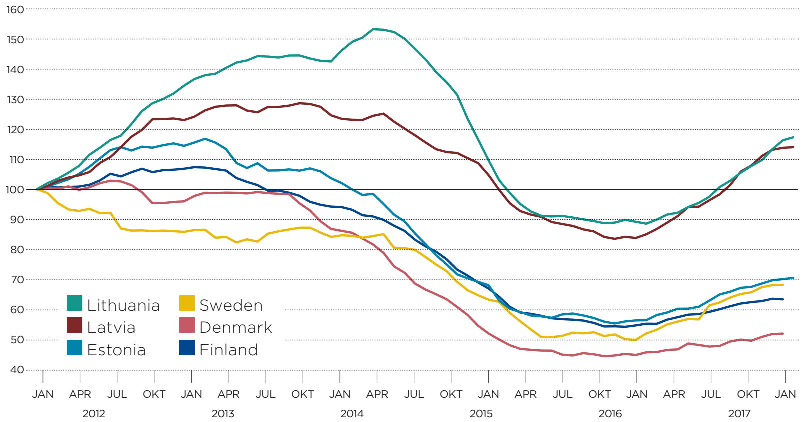
This is complicated of course by the overlapping political and economic arrangements: NATO, EU, and Eurozone membership varies across the region; as do the varying outlooks from the countries.

However, it is also important to note that the integration associated with the BSR likely contributed to the rapid income convergence process described above. Within the region, it allowed capital to flow to economies with more development opportunities – speeding up the convergence process. And BSR integration provided the platform for some of the smaller economies to participate more actively in EU integration.

FIGURE **9**

Russian sanctions have had a substantial effect on BSR exports to Russia

Exports (goods) to Russia, January 2012 = 100, January 2012 – January 2018



Source: Macrobond; National sources; Landfall Strategy Group

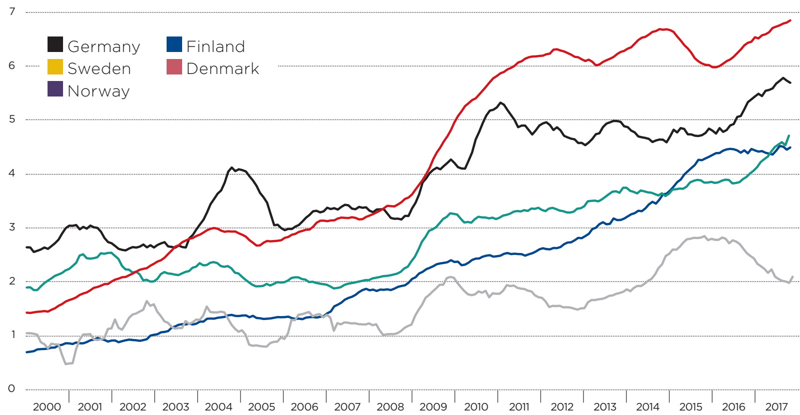
4 *Ketels & Wise, ibid.,*

III. BSR OUTLOOK

FIGURE **10**

Several BSR economies have been strongly growing their export shares to China over the past decade

Exports shares (goods) to China, %, January 2000 – January 2018



Source: Macrobond; National sources; Landfall Strategy Group

Growth in several of the BSR economies has picked up on the back of the broad-based global economic recovery since the middle of 2016, after several years of relatively sluggish global growth. This is a common picture across other open economies, including elsewhere in Europe. This external impulse has accelerated the final stages of the post-crisis recovery process.

However, there is a degree of variation in performance: Denmark and Iceland are not currently growing as strongly as many of their peers. And Norway was impacted by weaker oil and gas prices. But the Baltics as well as Finland and Sweden are growing strongly. And the near-term forecasts are healthy. In general, the BSR group of economies are tracking in a positive direction.

Looking forward, one structural challenge to sustained performance relates to the labour force. Particularly in the Baltic countries and Poland, there are issues relating to the retention of talent within their economies, as well as attracting skilled people to help staff new opportunities. And across the BSR economies, populations are aging, which will reduce the contribution of growth in hours worked to GDP growth. The dependency ratios in countries across the region (the ratio of retired people to working age people) are expected to rise steadily over the next few decades. Over the next few decades, many BSR economies will converge to a ratio of two people of working age for every person aged over 65.

In this context, a stronger contribution from labour productivity growth will be required to sustain strong GDP growth rates. Unless this is addressed, it will be difficult for the BSR economies to sustain their performance edge. And for some of the lower income BSR economies, this will become more challenging as the convergence process has become more advanced: the productivity catch-up gains will not be as readily available.

And there are also several emerging challenges and opportunities in the global economic and political environment that will further shape the economic outlook for the BSR economies over the next several years and beyond. There are three dynamics that are of particular relevance to the BSR economies.

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INTENSE GLOBAL COMPETITION

As noted above, the BSR economies have high external shares, and are highly exposed to the state of the global economy – both in terms of the strength of total external demand, as well as by the intensity of competition from firms in other economies.

Over the past few decades, global growth has been strong – with global trade and investment flows growing strongly as well – which has supported the economic performance of open economies. This period of strong global growth and globalisation has also coincided with more intense global competition. In particular, the integration of large emerging markets in Asia has changed the competitive landscape fundamentally. China's share of global exports has moved from about 3% in 2000 to over 10% today. Combined with improvements from other emerging markets, including in central and eastern Europe, there is an elevated level of competitive intensity in global markets.

This is one reason why manufacturing shares have reduced across advanced economies over the past few decades (particularly expressed in terms of employment, but also in terms of GDP). The wage and cost structures in many advanced economies challenge the competitive position of manufacturing, except when there is something highly distinctive about the manufacturing activity. However, the decline in manufacturing shares was a little less marked in small advanced economies – where much of the manufacturing activity was externally-oriented, and where there was frequently a strong competitive advantage (such as a strong research and innovation base). These dynamics have been seen in the BSR economies as well.

And now many emerging markets are moving rapidly into relatively knowledge and technology intensive activity, providing additional sources of competition. As one example, consider China's recent 'Made in China 2025' plan in which it aims to develop strength in several advanced sectors. This greater competitive intensity in knowledge intensive activities in which small advanced economies have typically had strong positions will have an impact on the competitive positions of small economies.

Given the frequent concentration of export strengths in a relatively small number of sectors, a loss of competitive strength can have a disproportionate effect. Finland is an example of what can happen in a small economy if there is a major shock to an important firm (Nokia) or sector.

There will be ongoing pressure on BSR economies to maintain and strengthen their competitive advantage. In response to these pressures, many are upgrading their investments in research and innovation, as well as in human capital; there is ongoing downward pressure on top personal and corporate tax rates; and efforts are underway to improve the business environment (infrastructure, cost structure, and so on). The relatively high cost structures in the more advanced BSR economies mean that there is a need to have commensurately high productivity levels.

BSR economies that are at the frontier will need to innovate; those further behind will need to be very careful of being caught by dynamics that are associated with the middle income trap.

CHANGES IN THE INTERNATIONAL ECONOMIC AND POLITICAL ENVIRONMENT

The BSR economies have been prime beneficiaries of globalisation over the past decades, benefiting from an open, rules-based international economic and political system. This has happened at a global level through successive rounds of trade liberalisation through the GATT and WTO, as well as through regional integration and FTAs.

Combined with substantial improvements in transport and communications technology, this has supported an intense process of globalisation over the past few decades. This has reduced the importance of economic scale, by allowing firms from relatively small economies to expand more readily into foreign markets without discrimination (tariffs and other barriers). This has also been supported by relative geopolitical stability over the past two decades.

But over the past few years, a series of risks have emerged to this system as a consequence of domestic political pressures arising from the economic and social disruption caused by flows of trade, capital and people flows. This is complicated by emerging strategic economic and political rivalry between China and the US (and increasingly Europe).

As part of its America First approach, the US has withdrawn from the Trans Pacific Partnership (TPP), has put the US/EU agreement (TTIP) on hold, and is renegotiating NAFTA. And in the first quarter of 2018, US tariffs on imports of steel and aluminium were imposed (followed by widespread exemptions) and a series of trade sanctions on China have been unveiled. China has responded with reciprocal tariffs, and more is likely. And China continues to act in a mercantilist way, making it challenging for foreign firms to operate in China and undertaking aggressive industry policy to create national champions. Both the US and Europe are acting to impose various restrictions on Chinese investment into their economies.

More broadly, there is an increasing intersection between economics and politics – to which small, open economies are exposed. From US and European sanctions on Russia, to the use of national security provisions as a rationale for the imposition of US tariffs, there is a growing relationship between the nature of bilateral economic and political ties. China provides examples of this also, imposing sanctions on countries with which it has political disagreements – from Norwegian salmon to South Korean tourism. Large countries are increasingly using their economic muscle to advance their strategic interests. These behaviours create exposures for small economies, which benefit heavily from access to large markets.

At the same time, there are some positive developments. The EU has progressed FTAs with Japan and Canada, and is now negotiating with Australia and New Zealand. And the TPP-11 (without the US) was formally signed in Chile in March. And global trade flows have held up well so far; world trade grew at 5% in the year to February, the strongest rate since 2011.

But overall, there are significant risks to the global economy from the outbreak of trade and economic tension, which could establish barriers to cross-border trade and investment flows. There are also geopolitical dimensions, with small economies increasingly focused on integrating into broader political and security alliances in order to improve national security (note the debates in Finland and Sweden with respect to NATO membership). Overall, the global environment for the BSR economies is becoming more complex and challenging. The global environment is unlikely to be as supportive as it has been over the past few decades.

Many of the BSR economies are caught in some of these fault lines. Note the sharp, sustained reduction in exports by BSR economies to Russia after the sanctions, as well as the impact of the sanctions imposed by China on Norway. Small open economies can be squeezed when bilateral economic and political relationships intersect to an increasing extent; and they are deeply exposed to these frictions because of their high external shares.

BSR economies are exposed because of their relatively high exposures to two points of particular tension: between the West and Russia; and the West and China. And there is also a general exposure to a systemic shock to global trade and investment to the extent that trade conflict between the large economies breaks out.

DISRUPTIVE TECHNOLOGIES

New technologies, from automation to artificial intelligence, will have a disruptive effect on advanced economies around the world. These emerging technologies are likely to have a profound impact on GDP and productivity growth, labour markets and income inequality, as well as leading to significant changes in the competitive positions of firms, sectors and economies.

There are clear opportunities from this technology, as there have been with previous waves of structural transformation. In recent analysis, the McKinsey Global Institute estimates that digitalisation could play an important role in lifting labour productivity growth to 2% within the decade, a marked lift from the productivity growth rates of around 0.5% that have been observed since 2010.[5] And parallels have been drawn between these emerging technologies and the introduction of previous general purpose technologies.

These technological advances offer a powerful way to strengthen productivity-led growth in the BSR economies, which is vital to respond to intense competitive pressures and aging populations. There are particular opportunities to strengthen the competitive position of externally-oriented sectors, which are disproportionately important to the economic success of the BSR economies. And over time, some of these technologies offer a way of significantly lifting the relatively low levels of labour productivity in domestically-oriented sectors such as retail and construction. These benefits are at least as substantial for relatively small economies as for larger economies: these technologies do not advantage scale.

In several BSR economies these emerging technologies are seen as a way of sustaining a competitive advantage, particularly in manufacturing, despite high wage and cost structures. Denmark has launched the Production Council, now the Disruption Council, to consider how best to capture value from these opportunities. Germany has launched a Digital Strategy 2025, with a particular focus on application to manufacturing. And across the BSR, from Sweden to Estonia, firms based on digital technologies are growing to global scale: Skype and Spotify are just two examples.

However, this will likely have highly disruptive effects on economies and on labour markets. The McKinsey Global Institute estimates that up to 30% of all tasks could be disrupted by automation alone by 2030, with a mid-point of 15%. These technologies are complementary to higher skills profiles, and will have a more disruptive effect on routine, lower-skill work. Combined with potentially higher rates of return on capital, this could lead to a sharp rise

5 *McKinsey Global Institute, 'Solving The Productivity Puzzle: The Role Of Demand And The Promise Of Digitization', February 2018; McKinsey Global Institute, 'Jobs Lost, Jobs Gained: Workforce transition in a time of automation', December 2017*

in income inequality (with a potentially material effect on reducing consumer spending).

Indeed, BSR economies have a series of distinctive characteristics that position them well to capture the benefits and to manage the risks and challenges from the deployment of these technologies. In particular, strong absorptive capacity (broad-based human capital, innovation capacity, firm capability); a supportive policy and regulatory environment (social insurance, active labour market policy, as well as specific Industry 4.0 and digital initiatives); and weakening growth in the labour force, which creates an incentive for investment and reduces some of the costs of the disruption.

The recent historical experience also provides a measure of confidence in the ability of the BSR economies to respond effectively to these new technologies. The adoption of new technologies from the mid-1990s, which generated significant productivity improvements in many of the BSR economies, is a useful parallel. However, a deliberate effort by policy-makers and the private sector will be required to capture the benefits and effectively manage the risks.

The State of the Digital Region 2017 noted that "Available data on the labour market consequences of automation indicate that the BSR countries fall below the EU and OECD average with respect to the risk of job automation. This does not, however, mean that the region does not need to adapt to the development. There is a significant risk of further polarization between high and low skill workers within individual BSR countries".[6]

6 *State of the Digital Region 2017, Top of Digital Europe,* www.topofdigital.eu

IV. BSR PRIORITIES

Overall, the economic outlook for the BSR is relatively positive. Many of the BSR economies are routinely identified as being top performers. And the growth trajectory has also strengthened on the basis of good fundamentals. The Baltics are held up by many as a role model in fiscal consolidation, and the Nordic model rated a recent cover story in the Economist.

However, as previous State of the Region reports (as well as third party commentary from the OECD and others) remind us, there are several structural challenges that need to be addressed by economies in the region. Sluggish productivity growth, an aging population and associated long-term fiscal pressures, and declining international market share in key sectors are just a few of the issues that have been identified. And, as the previous section has described, a series of disruptive dynamics are emerging.

The BSR economies will need to respond appropriately – both individually and as a group – in order to sustain this strong performance into the future. Indeed, an important reason for strong performance across the BSR economies is their ability to respond quickly and effectively to change in their operating environment. The change underway in the region and beyond will mean that they need to do so again.

This section considers some of the priorities for action in this regard, drawing on the relevant international experience. There are three classes of policy that are likely to be important[7]

- domestic policy measures undertaken by individual BSR economies to respond to challenges and opportunities and to upgrade their competitiveness.
- actions to further strengthen regional integration across the BSR economies.
- developing a common BSR voice on regional and global policy issues in order to shape the external environment.

DOMESTIC POLICY MEASURES TO UPGRADE COMPETITIVENESS

The various 'State of the Region Reports' published over the past several years have identified many of the economic policy and institutional strengths, as well as capabilities, that have supported strong performance across many of the BSR economies. However, a range of specific domestic policy responses will be required in order to sustain performance in this more complex environment.

In many ways, the priority is to continue to do many of the things that these economies have done in the past, and which characterise other successful small advanced economies. They also need to tailor these policies to directly meet emerging challenges and opportunities, such as disruptive technologies and a more turbulent economic environment.

There is much that the BSR economies can learn from small advanced economies around the world that are facing similar challenges and opportunities. Many small economies have further strengthened their domestic policies: fiscal consolidation; structural reform to make economies more resilient and flexible; invested heavily in skills and knowledge, to support workers and firms in capturing value from new technologies and business platforms; and are increasingly focused

7 *See also Christian Ketels & David Skilling, 'The Future of Europe and Globalization: Where is the Voice of the Baltic Sea Region?', prepared for 8th Strategy Forum for the EU Strategy for the Baltic Sea Region, Berlin, June 2017.*

on enterprise policy, particularly supporting high growth firms' entry into international markets.

In many respects, the BSR economies have been in the vanguard of these policy innovations. Looking forward, the specific policy challenges vary across countries – largely depending on their existing level of development. The Baltic states, for example, are classified as advanced economies but need to continue to work hard to graduate from upper middle-income status; and to generate higher levels of productivity to be able to sustain higher wage structured. The higher income Nordic economies need to invest more in innovation in order to maintain leading positions in key areas of strength.

There is a need to continue to invest in human capital. Indeed, this will become an even more important source of competitive advantage – for both the BSR economies at the frontier, and for those that are looking to converge rapidly. The challenges of population aging, migration flows, as well as disruptive technologies and intense global competition mean that developing a highly skilled labour force will be increasingly important.

And managing economic risks and building resilience will be increasing important: this can be achieved through measures such as fiscal consolidation, flexibility in labour markets, as well as a measure of diversification in export sectors and markets in order to avoid undue concentration risk.

One other policy priority, particularly given the changing nature of domestic politics, is to ensure that the gains from globalisation are shared and that the risks are appropriately allocated. Otherwise the risk is that political support for globalisation weakens. This has been an area of distinctiveness for the Nordic economies. But further changes will likely be required given the disruptive potential of new technologies and business models.

Many of these priorities are common across the BSR group. Although policy decisions are taken within the individual BSR economies, there is likely to be value in learning from each other in a more structured way.

STRENGTHENING REGIONAL INTEGRATION

There are several priorities with respect to regional integration. First, to continue to engage in broader EU integration that has been at the centre of BSR integration over the past two decades. Efforts to strengthen regional integration continue to matter for the relatively small, open economies of the BSR. The priority placed on further regional integration can be seen clearly in Asia, with initiatives such as the Trans-Pacific Partnership (TPP) and the ASEAN Economic Community. As protectionist risks emerge around the world, and as multilateral progress at the WTO become less likely, regional economic integration becomes increasingly important.

Second, to further develop infrastructure investment across the region. Indeed, there are major initiatives underway in transport infrastructure (e.g. the Fehmarnbelt project between Denmark and Germany and the Rail Baltica project connecting the Baltics into the European rail network). It is instructive that the regional integration focus in Asia is increasingly focused on infrastructure as much as institution building and regulatory alignment. This can be seen within ASEAN, as well as more broadly through China's Belt and Road Initiative (and new institutions such as the AIIB, the Asian Infrastructure Investment Bank). This has an explicit economic development focus.

In the BSR context, some of the new technologies offer the potential for relocation of supply chains to regions closer to end consumers (with labour costs of less consequence). For BSR economies to benefit from this, connecting transport and communications infrastructure is important. There is an opportunity to consider how global value chains could be implemented in the BSR.

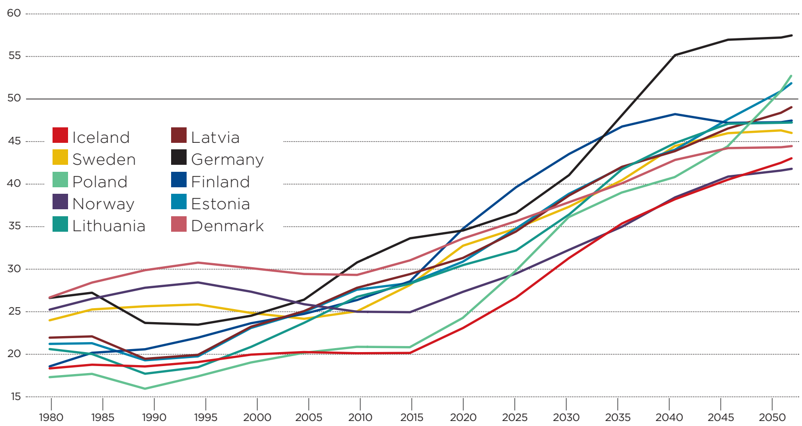
Third, a changing global economic geography also provides opportunities to broaden the way in which the BSR economies think about regional integration. In particular, there are opportunities for the BSR economies to leverage its location to provide a point of connection for Europe with Asia. It is instructive that the BSR economies have done particularly well in terms of engaging with the Chinese market; strong export shares compared to other European countries. Germany leads, but Finland, Sweden and Denmark are not far behind (although Norway has been hit because of the Chinese sanctions since 2010). And the BSR economies have been a frequent stop for Chinese leadership over the past few years.

Several BSR economies have already been investing in connecting to Asia; Finnair's use of Helsinki Airport to connect Europe to Asia (the 'Dubai of the North') is a good example. The opening of the Arctic Route may also provide additional opportunities for physical integration. This would imply new types of infrastructure connectivity running from North to South. In this regard, the proposals for an Arctic Railway south from Norway and Finland to the Baltics are particularly interesting. A key theme should be to position the BSR to benefit from these broader global developments.

FIGURE 11

Across the BSR, there is a pronounced aging tendency with ongoing rises in the dependency ratio

Old age dependency ratio (proportion of 65+ years per 100 people aged 20-64 years), 1980 - 2050



Source: Macrobond; United Nations; Landfall Strategy Group

JOINT EXTERNAL ENGAGEMENT

The BSR countries have long adopted a forceful stance on the liberal, rules-based order, in areas such as trade and in defence of EU rules. The BSR economies appear over-represented in many of the EU governance roles. And the countries in the BSR have a well-deserved international reputation as good global citizens; partly because they do what they say on climate change, trade, human rights, development aid, and so on.

But in the context of a more challenging and complex global economic and political environment, simply focusing on domestic policy responses is unlikely to be enough. There is an opportunity – and perhaps a need – for the BSR economies to be more active in projecting a common voice on issues of shared concern: from trade to EU governance. Small countries, like most of the BSR economies, are more effective in engaging on international issues jointly as opposed to as individual countries.

As we noted last year, 'The Region is too often a passive observer of the changes in Europe and the global economy, taking the structures that emerge as a given rather than as something that can be influenced'. Countries across the BSR could and should do significantly more, both individually and as a group. On trade, for example, this will likely be an increasing commitment to EU efforts on liberalisation – and doing so in a coherent, joined-up manner.

Although it won't be possible to achieve consensus across the BSR economies on all policy issues, but there will be coalitions of the willing on some issues. One area in which a BSR coalition is emerging is on issues of the approach to deeper EU integration. In March, the Finance Ministers of Denmark, Estonia, Finland, Latvia, Lithuania, as well as Ireland and the Netherlands, issued an issues paper on the future of the economic and monetary union – in response to recent French proposals for deepening eurozone integration.

The statement argued for reform of the EMU that focused on the completion of banking union, resilient national finances, and a focus for maintaining public support on new initiatives. The statement noted that 'Stronger performance on national structural and fiscal policies in line with common rules… should have priority over far-reaching proposals'. This was referred to by the Irish government as 'an articulation of a common outlook on the benefits of trade and open economies by a group of small and medium-sized member states'.

The development of this grouping has been motivated by the impending departure of the UK from the EU; and a sense that there is a need for like-minded countries to step up. This grouping has been referred to as a new Hanseatic League, which of course had its historic basis in the BSR. In the context of regional and global institutions that are facing significant challenges, this is the sort of action that is increasingly valuable.

A CHANGING ENVIRONMENT MAY REQUIRE CHANGING INSTITUTIONAL SUPPORT MECHANISMS.

To the extent that these more informal, issue by issue, groupings become more prominent, different institutional mechanisms may be required than the regional institutions that have been established over the past decade or two. This is partly because some of the countries involved will come from outside the BSR grouping – the Netherlands and Ireland in the example describe above – and because there may not be consensus on important issues across the full BSR group. A changing environment may require changing institutional support mechanisms.

CONCLUDING REMARKS

The BSR has made strong progress over the past 20 years in terms of regional integration as well as in terms of economic performance. It has shown a measure of resilience to substantial economic shocks, recovering after the deep impact of the global financial crisis.

However, the emerging environment will be more complex and challenging on a variety of fronts. Aspects of the response to this will benefit from collective action and a joint voice across the BSR economies. In other respects, there are a series of common policy priorities that will need to be undertaken at national level. The BSR economies are well-placed to respond to these emerging dynamics. But concerted action will be required.

ABOUT BALTIC DEVELOPMENT FORUM

Baltic Development Forum is a think-tank and network for business, politics and academia in the Baltic Sea Region.

Our vision is for the Baltic Sea Region to become one of the most dynamic, innovative and competitive regions in the world. Our mission is to advance sustainable growth and competitiveness in the Baltic Sea Region through private-public partnerships.

Baltic Development Forum publishes the latest thinking on developments and trends in the region and brings together actors from different sectors and countries across the region to inspire cross-border initiatives in key growth sectors.

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