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PROJECT

WORKING GROUP 1

Regional integration: Russia in the Baltic Sea region

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Preface

Since the fall of the Iron Curtain, the Baltic Sea Region has been in focus of many initiatives to cross the former East-West divide. In the field of spatial planning, a Committee on Spatial Planning was formed (CSD/BSR) and took initiative to produce one of the first transnational planning perspectives: 'Vision and Strategies around the Baltic Sea Region 2010' (VASAB 2010).

This document is now being revised into by a 'Long Term Perspective'. For the preparation of the new planning document, three working groups have been formed to prepare analysis and recommendations concerning three different relevant fields of spatial development:

Working Group 1: Urban networking and urban rural partnership

Working Group 2: Accessibility and developments zones

Working Group 3: Sea use planning.

This report is the product of Working Group 1. The report synthesises expert studies on regional integration with a special focus upon the interplay between Russia and the Baltic Sea Region. This study was financed by TACIS under the East-West Window program. The expert studies summarized in this report are:

Towards an Integrated Baltic Sea Region by Peter Schmitt, Johanna Roto and Jörg Neubauer, Nordregio, Stockholm.

The study is about the development of metropolitan regions, demographic trends and the role of small and medium-sized cities in territorial cohesion of the Baltic Sea Region.

Andreas P. Cornett and Nils Karl Sørensen conducted an analysis of integrative trade in the Baltic Sea Region: *Intra-regional and Intra-industry Trade in the Baltic Sea Region*, University of Southern Denmark, Sønderborg.

Two in-depth case-studies were carried out to elucidate regional integration processes from the perspective of St. Petersburg and the Kaliningrad region, respectively. The two case-studies, conducted within a joint framework elaborated in close contact with the lead consultant, include statistical studies as well interviews with business entrepreneurs and managers. The two studies are entitled:

Russian Integration in the Baltic Sea Region: Kaliningrad Region Case-study, prepared by G. Fedorov, T. Chekalina, Y. Zverev and D. Latnak, Immanuel Kant State University of Russia, Kaliningrad.

Russian Integration in the Baltic Sea Region: St. Petersburg Case-study, carried out by Nina Oding, Lev Savulkin, Denis Kadochnikov and Olga Varlamova, Leontief Centre, St. Petersburg.

Finally, Russian case-studies rural-urban relations conducted by national experts were synthesised by Wilfried Görmer, Federal Office for Building and Regional Planning, Germany, cf. section *Urban-rural relations and partnership* and recommendations *R22a-c*.

The present report is a synthesis of the above mentioned studies. Parts of the expert studies are extensively described, whereas other parts are summarised more briefly digested in order to produce a coherent document of its own. Where relevant, other studies as well as data from other sources are included, and conclusions and arguments are added for which the above-mentioned authors are not to blame.

The report was prepared by the lead consultant, assisted by Julien Grunfelder, University of Lille.

Niels Boje Groth
Lead consultant

Introduction: Regional integration and competitiveness of the Baltic Sea Region

Regional integration

Regional integration is the key concept of this study on the Baltic Sea Region (BSR). From a variety of perspectives, we examine the extent to which internal relations within the Baltic Sea Region are developing stronger than external relations, hence contributing to the forming of a strong European meso-region. Since the political transition in Eastern Europe, the former gulf between east and west BSR has been bridged by a myriad of political and institutional structures and by the development of new trade and investment relations. These integrative measures, however, are taking place on the backdrop of an intensive globalisation of the economy and politics, such that local connections with global networks may be stronger than the local relations themselves. It is, thus, needed to keep a double perspective, on the regional and the trans-regional relations.

What kind of relations do we examine? Economic relations are in focus. But we make efforts to balance the study of economic relations by also focusing on institutional or political relations. This double focus is important, since the institutional relations tend to be governed more by geographical proximity than are economic relations.

In brief, we approach the Baltic Sea Region from two sets of relations: the *economic* ↔ *institutional* and the *local* ↔ *trans-local*, as shown by table 1.

Table 1: Type and scope of integrative relations

Type	Scope	
	<i>Local</i>	<i>Trans-local</i>
<i>Economic</i>	Regional integration	Global integration
<i>Institutional</i>		

Studying relations with the purpose of identifying regional integrative relations makes it important to include observations on what is actually going on (i.e. trends) and what might be the potentials for integration. In focus are the trends. However, we supplement our evaluations of potentials and the significance of trends with interviews of business entrepreneurs and managers. Lack of time prevented us from interviewing key persons within politics, culture and institutional life.

Economic integration

The two indicators used in the study on economic integration are trade and direct foreign investments.

Trade

Trade between countries is an important measure of integration, not just the volume of trade but the kind of goods traded. The volume of trade indicates the extent to which two or more countries are integrated in trade-relations. The kind of goods traded indicates the extent to which two or more countries are integrated in the same markets, sectors or branches. Still being an emerging market, Russian trade is characterised by the volume of its traded goods rather than by special types of goods on competitive markets.

Dramatic increasing figures of trade show that Russia is taking part in a trade-integrative process. However, the kind of trade is characterised by buying and selling goods from different sectors (inter-industry trade). Also, the statistics as well as the interviews confirm that trade relations between Russia and the Western market are based largely on comparative rather than competitive advantages, i.e. the score for trade within the same branches or sectors (intra-industry trade) is relative modest. Exchanging goods of similar kinds between countries implies that the two countries are developing the same kind of expertise, competencies and products in competitive relations. We thus characterise intra-industry trade as more integrative than inter-industry trade.

When it comes to potentials, we focus on the potentials of developing competitive and innovative enterprises rather than just future trade potentials. This we do by interviewing entrepreneurs and managers of competent companies. As we shall see, the interviews indicate that Russian companies lag seriously behind companies of the USA and Western Europe. Furthermore, the huge Russian market is tempting Russian companies to follow a number of non-innovative business strategies.

Foreign investments

Intensification of international integration is reflected by the increased mobility of production factors as facilitated by foreign direct investment (FDI). From an integrative perspective, FDI can be seen as a strengthening of economic linkages originally based on trade. FDI is usually motivated by resource-based and/or market-seeking-based factors. The former seems to be relevant with regard to incoming FDI in Russia, but in future, the latter will become more important as well. FDI is a very important driver of economic integration, since besides capital, FDI brings 'new technology, managerial skills and culture, readiness for risk-taking and marketing channels to external markets.' (Kivikari U., 2006). Due to these prospects, the attraction of FDI is usually a key objective of business and development policies of local and national governments.

In St. Petersburg, for instance, the large investors, those investing more than USD 120 mill. are categorized as 'strategic' investors and are offered tax and custom incentives. As we will see, the most important investors are global multinational corporations from outside the BSR, an indication that global rather than BSR integration is a key driver for the city. As concerns Russian outward direct investments (ODI), Russian ODI - after a period with focus on the CIS - reveals a pattern of global rather than local integration. However, we also find ODI that are strategically located in the BSR in order, for example, to facilitate transit and access from Russia to gateways in the Baltic States.

Competition and innovation

The Russian investments and trade patterns reveal the importance of global economic integration. Crucial for economic international integration is the competitiveness of the Russian industry. Accordingly, competitiveness and innovations were considered as a specific topic of this study. Due to the lack of sufficient and comparable data, competitiveness and innovation were made a key issue in interviews with entrepreneurs and managers of innovative Russian companies. The general picture from the interviews was a characteristic of Russian industries as lagging seriously behind international standards, lacking sufficient innovative capacity, biased towards the resource sectors and trapped by the easy access to the huge domestic and protected Russian market as an alternative to expansion on international markets. Furthermore, the interviews showed that entrepreneurs and business managers are looking for other business strategies than those displayed by the St. Petersburg and the Federal authorities. They ask for institutional change of the framework conditions for business, whereas the authorities focus on strategic incentives, one of which is the formation of technological clusters. The case-studies showed only few examples of potentials for formation on BSR-related clusters. The most important cluster might develop within ICT, via cooperation between Finland, Russia and Estonia. Another interesting cluster currently being developed in St. Petersburg is automobile assembly. Only time will reveal whether the presence of several international car-makers will develop important subcontracting networks and competencies. However, since the car-makers are from outside the BSR, the new cluster is yet another example of local development driven by global rather than local/regional networking.

Institutional integration

Economic integration hinges on markets. Institutional integration is related to policies and institutions. While economic integration is heavily influenced by globalisation and the forming of global networks, institutional integration tends to be revealed in more local settings. Thus, one common driver of institutional integration is cooperation across borders. Cities and municipalities from neighbouring countries work together in their own interest or via cooperation arrangements such as the Interreg and TACIS programmes. Other examples are in the area of cultural cooperation on events that need a larger audience than situated in the hinterland of individual cities

or municipalities. Yet other examples are strategic cooperation between agencies and institutions of mutual interests, e.g. universities.

Political cooperation

An important backdrop for integration between Russia and the BSR is the Partnership and Cooperation Agreement between Russia and the EU. The agreement, which came into force in 1997, was followed by a decision on 2003 on developing a Common Economic Space (CES) between the EU and Russia. The CES program embraces four spaces of cooperation: (1) a common economic space; (2) a common space of freedom, security and justice; (3) a space of co-operation in the field of external security; and (4) a space of research, education, and cultural exchange. After more than 10 years of operation, negotiations have begun on upgrading and prolonging the EU-Russian treaty.

In this report, we focus on concrete examples of cooperation between local authorities in the BSR, the effects of which we believe are important for transnational integration in the region. Most of the co-operation activities - in the case-studies of St. Petersburg and Kaliningrad - take place within the framework of EU programmes, which in turn focus on public authorities and non-profit organisations.

Cultural cooperation

Culture is an international industry and supposed to be BSR-integrative. On the one hand, the cultural competencies in the BSR are of high international standards and suitable for developing new BSR-based events. One such example are the open-air festivals in Savonlinna and Mikkeli, Finland, founded almost 100 years ago, and currently organised with the participation of the renowned Russian conductor from the Marinsky Theater in St. Petersburg, Valery Gergievs. On the other hand, the common history of countries in the BSR is supposed to endow potentials for developing thematic cultural tourism, tracing the events of e.g. the Hanseatic League and the Vikings.

The Baltic Sea Region

The Committee for Spatial Development in the Baltic Sea Region (CSD/BSR), 'the VASAB committee', delimits the Baltic Sea Region as bounded by Northern Germany¹, the whole of Denmark, Norway, Sweden and Finland, the western part of the Northwestern Federal District of Russia² and the whole of Estonia, Latvia, Lithuania, Belarus and Poland.

¹ Berlin, Brandenburg, Bremen, Hamburg, Lüneburg, Mecklenburg-Vorpommern and Schleswig-Holstein.

² St. Petersburg, Leningrad, Pskov, Murmansk, Novgorod, Kaliningrad oblasts and republic of Karelia.

In this study on the integration of Russia in the Baltic Sea Region, the aforementioned BSR part of Russia is included in the statistical study, whereas the two key case-studies focus on St. Petersburg and Kaliningrad oblast.

The idea of the Baltic Sea Region as an economic, cultural and political reality constituted by more than just access to the common Baltic Sea has been challenged and modified by several observations on prevalent global relations, bilateral national relations, tense diplomatic relations and sub-regional developments. Thus, rather than just taking for granted that the BSR is becoming more and more real, one should look at the BSR as one of several overlapping political and economic territories, all of which are challenged global trans-regional networking.

Commenting on the overlapping with other territories, (Åkerholm J., 2005) notes that ‘much of the interest in Northern Germany and Poland is tuned to the South, the Baltic States³ are concentrating their interest on funds flowing in from the EU, Russia is focusing on the European continent and Norway looks towards the West’. Åkerholm concludes that the region ‘seems like a highly heterogeneous area and not one entity’. It is thus likely that BSR regional integration is being formed by a diversity of sub-regional integration processes, many of which are developing bilaterally, e.g. between Finland and Russia, between Russia and each of the three Baltic States, between Russia and Germany. The cooperation between the Nordic countries is well known. Further, the Nordic countries seem to develop special relations to the Baltic States. Thus, in economic terms, ‘it is estimated that a half of the aggregate FDI stock in the Baltic States originates from Nordic Countries’ (Sippola M., 2006).

If the countries around the Baltic Sea are going to form a coherent Baltic Sea Region, cooperation between the countries has to take place and potentials have to be realised in the future. As revealed by the USUN project⁴, this is likely to take place. Soon after the fall of the Iron Curtain, there developed regional integrative economic cooperation (industry, trade, sea transport and tourism) and institutional networking (city cooperation and university networking) across the former East-West gulf. In economic terms, the study showed that indicators of economic integration reveal trends of a low, however, continuously increasing economic integration (Cornett A.P. in (Groth, 2001 p. 19)). An update of the study presented in this report reveals that economic integration in the BSR has generally continued unabated. The findings of the study indicate that spatial and regional integration is facilitated by spatial proximity, as is the case among the BSR countries. The findings are confirmed by recent observations on trade relations using maritime trade forecasts. These data show that intra-BSR trade

³ Latvia, Estonia and Lithuania

⁴ An Interreg IIC study on urban systems and urban networking in the BSR carried out on behalf of the Committee for Spatial Development in the Baltic Sea Region by a network of research institutions in the BSR (Groth, 2001).

is supposed to be greater than maritime trade between BSR and the rest of the world (Saurama A., 2007). Also Gref (Gref G., 2007) observes that ‘one third of total trade in St. Petersburg is generated with the countries of the Baltic [Sea] region’.

In sum, there is no highway of regional integration in the BSR. A myriad of overlapping and even contradictory trends are operating. Political actions are part of this complex landscape, as are the recommendations aimed at further fostering regional integration. Based upon the findings, we end up with a set of recommendations, each of which may contribute in its separate field and only incrementally to foster the vision of the BSR.

Regional and economic integration

Economic integration is a crucial parameter of regional integration. As a backdrop for our studies, we examine the extent to which overall economic trends in the Baltic Sea Region reveal integrative trends. We shall concentrate on two economic measures, i.e. intra-regional and intra-industry trade. The findings of this chapter are based upon studies on economic integration by A. P. Cornett and N. K. Sørensen (Cornett A.P. and Sørensen N.K.).

Intra-regional trade is trade taking place between countries within the region. If the share of intra-regional trade of a country compared to its total trade, is high, the country in question is considered to be economically more integrated with other countries within the region than would otherwise be the case.

Intra-industry trade is based on trade within the same kind of commodities. Countries involved in intra-industry trade are involved in the same kind of production. In an economic sense, they are integrated in competitive relations and operate mainly on competitive rather than comparative advantages.

Intra-regional trade

Table 2 reveals the share of intra-regional trade as a percentage of the total trade of the BSR countries. The table illuminates the process of economic transition and integration based on intra-regional trade-flows within the BSR. The most important trends are that the Baltic Sea Region is the dominant foreign trade partner for the smaller economies only and that the last 5-6 years were a period of consolidation, as only minor changes in the trading pattern have taken place. Of particular interest is that Russia seems to have reverted to a normal pattern after the extraordinary situation in the years around the turn of the millennium. Due to internal economic developments in Russia, the foreign trade sector was affected and the importance of oil exports became very dominant. In 1996, the share of oil related products as a proportion of all exports to the BSR was 62%, increasing to 70% from 2000 and peaking at 74% in 2005 (Cornett A.P. & Sørensen N.K., 2008). Furthermore, the absolute size of exports increased considerably due to the soaring oil prices.

Considering the nature and the size of the German economy, the importance of the Baltic Rim as a geographical region diminished in the first years after the fall of the Iron Curtain, but has steadily increased since. With regard to trends of trade, 'the three Baltic States are on the way toward a trade pattern more similar to the Nordic countries.... For Estonia and Lithuania, the share of the BSR of total trade is above 50 %. For the four Nordic countries, the share of BSR trade is between 34.5% for Norway and 43.6 % for Denmark. Overall, the patterns have been very stable during the period, despite year 2000 for Norway, which was probably affected by energy exports.' (Cornett A.P. & Sørensen N.K., 2008).

Table 2: Share of intra-regional trade (exports) as percentage of the total trade of Baltic Rim countries since 1988

	1988	1992	1996	2000	2006
Denmark	39.8	48.7	42.5	40.9	43.6
Sweden	37.5	35.5	32.2	39.4	36.9
Norway	35.2	35.9	36.9	65.6	34.5
Finland	51.3	41.7	35.2	49.3	38.1
Germany (FRG)	13.5	8.6	9.3	9.6	11.2
German Democrat Republic (GDR)	24.6
Estonia	...	92.0	68.8	55.1	55.1
Latvia	...	61.8	48.8	45.9	33.4
Lithuania	...	57.8	46.1	33.3	55.5
Poland	46.7	47.4	48.2	29.7	39.8
Russia	34.1	18.9	21.5	75.2	22.9
Baltic Rim	26.5	17.9	18.9	19.9	21.0

Note: Figures based on exports to Baltic Rim countries as percentage of total exports. All figures are based on reported imports from receiving countries. Danish exports to Sweden in 1992 are based on Danish exports. For 1992, some figures are missing for former state trade countries. The 1988 figures are based on exports to GDR and Soviet Union. Figures for GDR trade with Germany and the Soviet Union for 1988 are based on German sources and converted to USD based on annual average exchange rate at Frankfurt (end 1987 and 1988).

Source: IMF 1995, 1998, 2001 and 2007. Statistisches Bundesamt 1991, cf. (Cornett A.P. & Sørensen N.K., 2008)

The issue is further explored in figure 1, which shows the internal BSR trade relations. Numbers in parenthesis reveal the percentage of the export of each country to other countries in the BSR, whereas the numbers underneath reveal the shares of import from each of the BSR countries.

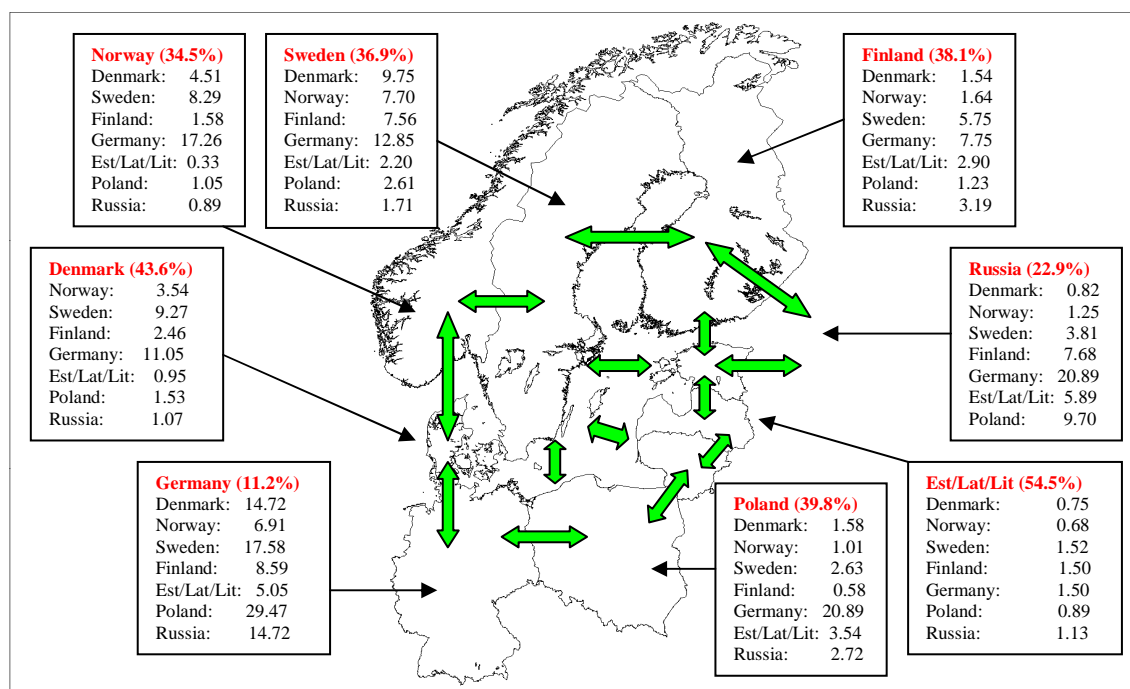


Figure 1: Trade in the Baltic Sea Region based on imports from receiving country, bill. EURO, 2006.

Note: The numbers in parenthesis are the shares of exports as a proportion of all exports to other countries in the Baltic Sea Region in 2006 (see table 2). The numbers underneath show the shares of imports from each of the BSR countries. Data has been converted from USD to € by use of the annual average exchange rate.

Source: Directions of Trade Statistics Yearbook (IMF, 2007).

The number in parenthesis corresponds to the share of imports from the Baltic Sea Region - out of all imports. Especially the three Baltic States and Denmark have substantially trade within the region. Notice also that the share for Germany is low. This is due to her size. However, considering the trade partners, Germany is indeed important for all the BSR countries. In general close relations are observed for countries sharing a land border line.

Intra-industry trade

A common indicator of intra-industry trade is the Grubel-Lloyd index, showing the share of intra-industry trade in the total. For further explanation on this method see Cornett and Sørensen (Cornett A.P. and Sørensen N.K.). Figure 2 shows the development of intra-industry trade in the BSR from 1988 to 2005.

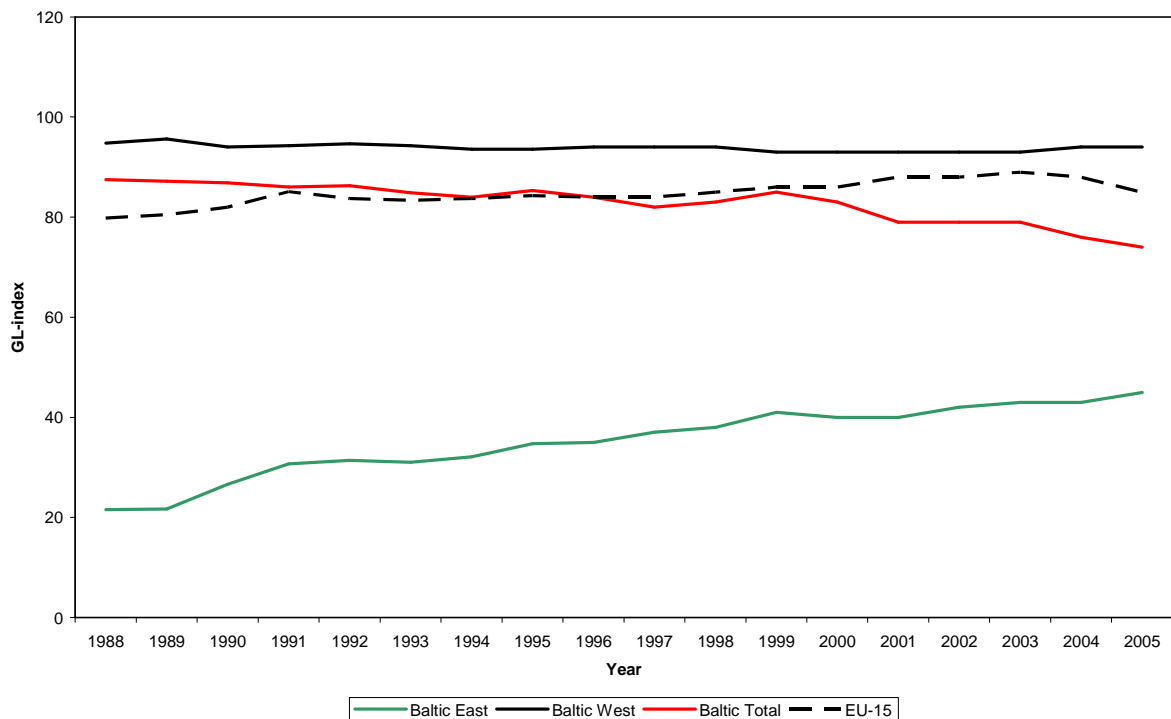


Figure 2: Intra-Industry Trade of Baltic Rim West 1988-2005

Note: Data according to Harmonized System Rev.1 1988-1996 and Rev. 2 1996-2006. Grubel Lloyd index estimated on 2-digit level 100 (100 commodities). Commodity classification not fully comparable; data are based on chain-index. Chain is based on 1996 data.

Source: (OECD-ITCS, 1998, 2000 and 2007)

Figure 2 provides an overview of the long-term trends of intra BSR intra-industry trade based on data reported from the five established market economies in the region.⁵ The level of intra-industry trade in the Baltic East area is lower than in the Baltic West area, where it exceeds the EU-15 average level.

⁵ Unfortunately, the data from ITCS are based only on OECD countries as reporting country; however, the figure still provides a useful measure for trade integration and specialization in the BSR.

A straightforward application of this definition is the well known unadjusted GL_j index proposed by Grubel and Lloyd (1975) and defined for product group j as

$$GL_j = \left[1 - \frac{|X_j - M_j|}{(X_j + M_j)} \right] \times 100$$

Where X denotes exports and M imports. The index measures the amount of *IIT* in product group j . The value of the index will range from zero to 100 percent. When X_j or M_j equals zero there will be no overlap, so no *Intra-Industry trade* will take place. On the other hand if $X_j = M_j$ matching will be complete and GL_j equals unity. Further, the index is non-linear. For example, the rate of increase of GL_j for constant increases in M_j (or X_j) for a given level of X_j (or M_j), decreases as M_j (or X_j) increases. By weighted additive aggregation across all $j= 1, \dots, N$ product groups we obtain the aggregate GL -index.

$$GL = \left[1 - \frac{\sum_{j=1}^N |X_j - M_j|}{\sum_{j=1}^N (X_j + M_j)} \right] \times 100$$

Source: (Cornett A.P. & Sørensen N.K., 2008)

During the period, the amount of intra-industry trade in the Baltic East sub-region has been constantly increasing. Overall, there is a moderate pattern toward convergence of foreign trade toward a higher share of intra-industry trade, indicating the integration into the Western, market-based system of production. It is worth mentioning that the analysis is conducted on a rather modest level of disaggregation of trade. Therefore, the results have to be interpreted carefully. Thus, a high level or increasing share of intra-industry trade indicates only sectoral convergence of the considered economies foreign trade sectors.

Table 3 provides a brief overview of the level of intra-industry trade of the 6 OECD member countries in the region. Apart from Germany, the level of intra-industry trade for the old market economies in the Baltic Rim area as a whole is higher compared to the total of foreign trade. The considerably low level of intra-industrial trade in the case of Norway is caused by the high share of crude oil and fuel in Norway's exports. 'With regard to East-West trade, intra-trade is significantly lower, but generally increasing during the period reported. The latter can be seen as an indicator of increasing integration of the transition economies into the regional system of production and specialization.' (Cornett A.P. & Sørensen N.K., 2008)

The figures of the BSR countries as a whole show a high degree of coherence of the production system defined as high shares of intra-industry trade.⁶

⁶ The figures reported here underestimate the intra-industry trade of the EU countries in the region because the lower level of intra-trade of the transition economies (and Norway) is included.

Table 3: Intra-Industry Trade in the Baltic Rim for the Six OECD Members in the Region

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Denmark:											
Baltic East	31	32	31	36	32	35	39	40	42	48	47
Baltic Rim	72	70	71	73	76	77	78	78	76	73	72
EU-total	68	68	69	70	70	71	71	72	71	69	68
World	73	73	74	76	77	77	77	77	77	77	77
Finland:											
Baltic East	35	35	33	33	34	36	31	29	27	30	29
Baltic Rim	72	71	72	70	68	73	70	69	70	69	68
EU-total	59	58	56	55	52	55	54	52	54	59	60
World	63	63	64	63	64	65	63	63	65	67	67
Germany:											
Baltic East	32	32	36	40	40	41	44	47	43	43	42
Baltic Rim	47	46	49	51	50	51	52	51	49	52	51
EU-total	76	76	77	76	75	75	75	74	73	74	76
World	72	73	75	76	77	75	75	74	74	74	75
Sweden:											
Baltic East	41	48	49	49	50	45	44	46	48	45	...
Baltic Rim	77	79	81	80	79	80	79	81	82	80	...
EU-total	73	73	78	77	79	75	76	77	79	79	...
World	73	74	76	75	76	77	75	74	75	77	...
Norway:											
Baltic East	50	43	50	53	41	43	45	37	36	38	...
Baltic Rim	49	49	47	49	45	45	42	42	41	34	...
EU-total	34	34	38	36	30	30	29	28	26	23	...
World	39	38	41	40	33	36	37	35	33	31	...
Poland:											
Baltic East	13	11	12	12	8	9	10	10	11	12	...
Baltic Rim	33	35	35	33	37	41	45	49	53	54	...
EU-total	48	50	52	54	61	62	65	66	69	68	...
World	52	53	55	56	61	65	69	70	75	73	...

Note: Data according to Harmonized System Rev. 2 1996-2006. Grubel Lloyd index estimated on 2-digit level 100 (100 commodities).

Source: (OECD-ITCS, 2007)

Based upon their findings, Cornett and Sørensen observe, that ‘in a BSR or regional perspective, we have strong evidence that political and economic integration is “powered” by spatial proximity and adjacency, but at the same time, political and economic integration reinforce the other aspect of spatial integration, accessibility, i.e. proposals for the development of traffic infrastructure.’, accordingly: ‘The result of the ‘spatial integration’ process should be seen in a dynamic perspective, leading to trade and production system integration, indicated here by regional trading figures offering a new perspective on interregional convergence in the BSR.’ (Cornett A.P. & Sørensen N.K., 2008).

These findings are promising for the VASAB vision of the BSR, because regional economic integration has been observed slowly but steadily through the whole period of 17 years, and because political initiatives improving accessibility within the region, physically as well as institutional and legally, are seen as a mediator of integration.

Cities, people - unused potentials?

Cities and regions

Much of this study is about the role of business, trade, investments, policies and institutions as means of regional integration. However, companies, economic agents, politicians and institutions are located in cities, which in turn we see as the drivers of development. This is why Nordregio was asked to provide an overview on current trends and innovative potentials of the territorial capital as regards cities and city-regions in the BSR. The questions dealt with are as follows:

- To what measure are the BSR cities and city-regions able to help enhance transnational institutional and functional integration in the BSR?
- How can they enhance the spatial integration and territorial cohesion of the BSR as well as integration with other areas of Europe?
- What kind of trends and policies are to be found in this respect?

In dealing with these questions, the urban landscape in the BSR was divided into metropolitan regions (MEGAs) and small and medium-sized towns (SMESTOs). The study on metropolitan regions was based mainly upon statistical indicators, whereas the study on SMESTOs was based upon a number of case-studies provided by national experts. The joint report is published by Nordregio (Schmitt P. et al., 2008).

Metropolitan regions

The concept MEGA (Metropolitan European Growth Areas) was first developed within the EU research programme ESPON by Nordregio. Since the present study goes beyond the borders of the EU territory, Nordregio has included data on the three relevant Russian and Belarusian MEGAs, St. Petersburg, Kaliningrad and Minsk. Figure 3 presents all the BSR MEGAs. The strengths of these MEGAs as nodes in the global economy are critical to the competitiveness of the BSR. In the study, the role and international importance of the MEGAs is supposed to correspond to the presence, strength and cross-fertilizing of the following metropolitan functions: (Schmitt P. et al., 2008 p. 5):

- decision and control
- innovation
- gateway functions.

Findings regarding these metropolitan functions are presented below.

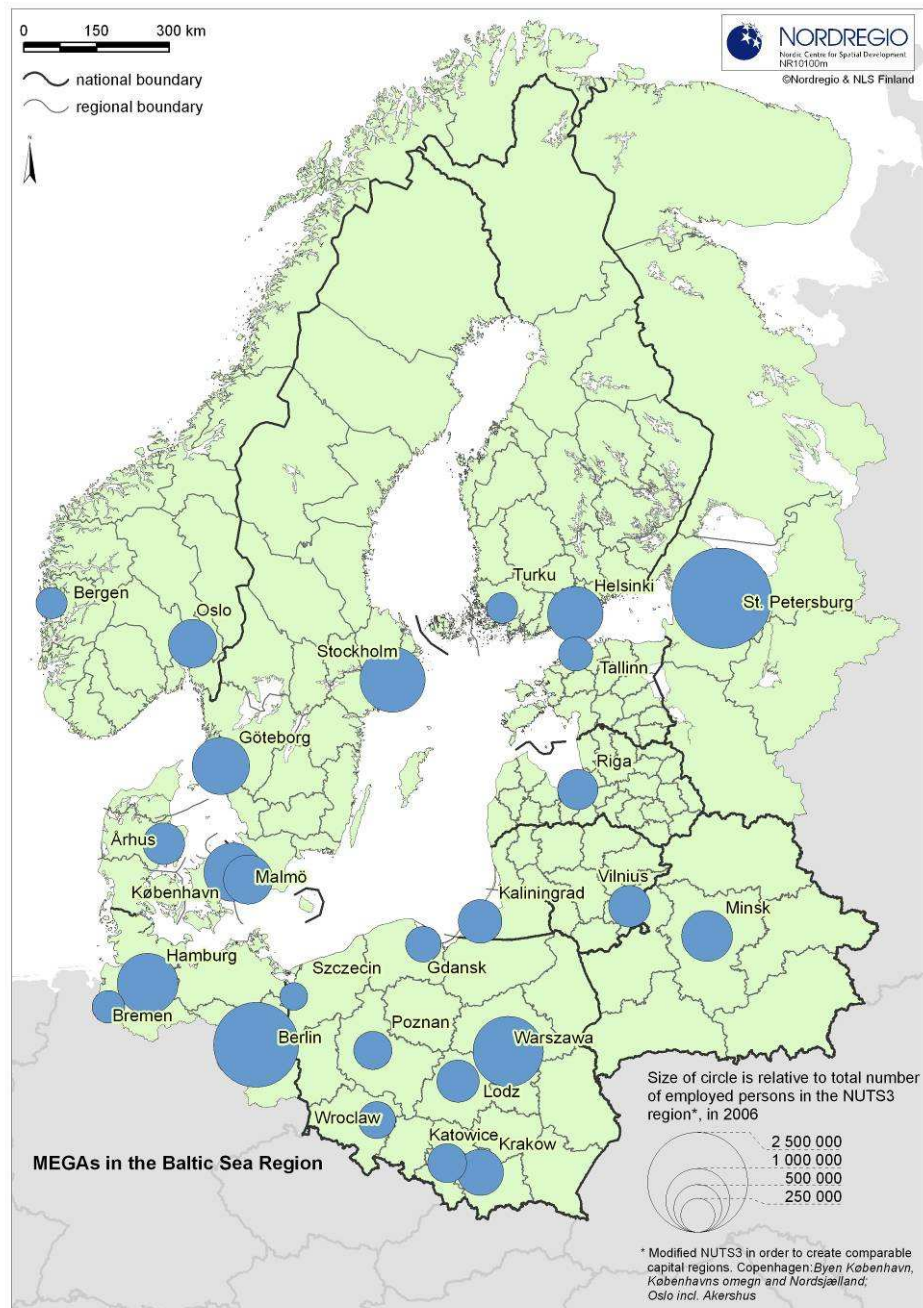


Figure 3: MEGAs selected for the study

Source: (Schmitt P. et al., 2008)

BSR metropolitan regions as international centres for decision and control

Several criteria related to economic and political power have been taken into consideration in order to evaluate the functions of decision and control of the analysed MEGAs. As could have been expected, some of them concentrated many decision and control centres, while others are lagging-behind. In fact, the four Nordic capitals, as well as Hamburg, St. Petersburg and to some extent Warsaw, take the lion's share of the decision and control function. For example, Copenhagen is by far the largest and the most polyvalent as concerns the location of key institutions such as the United Nations of-

fices, the Nordic Council of Ministers and the Baltic Sea Region. From a more global perspective, it is worth highlighting the position of Warsaw, that hosts many United Nation-related institutions. The main centres of BSR institutions correspond to capital cities (except Berlin, Tallinn and Vilnius) with Copenhagen, Riga and Stockholm occupying leading positions, and hence, are key sites of regional cooperation.

Concerning the largest companies, they are located mostly in the Nordic MEGAs with exception of St. Petersburg, which with OAO Gazprom-neft, represents a market value of about €160 bill. (in2007); this shows the importance of the energy sector in the economy of that part of the BSR. Far behind is Helsinki, with Nokia (€60 bill.) while Stockholm clusters many large companies but at a lower position.

The ranking of European cities' global network connectivities carried out by Taylor (see table 4) confirms the better position of Western MEGAs within the BSR compared to the Eastern MEGAs, apart from Warsaw, which has a quite high degree of connectivity.

Table 4: Top 35 European Cities for Global Network Connectivities

London	1.00
Paris	0.70
Milan	0.60
Madrid	0.59
Amsterdam	0.59
Frankfurt	0.57
Brussels	0.56
Zurich	0.48
Stockholm	0.44
Prague	0.43
Dublin	0.43
Barcelona	0.43
Moscow	0.42
Istanbul	0.42
Vienna	0.42
Warsaw	0.42
Lisbon	0.41
Copenhagen	0.41
Budapest	0.41
Hamburg	0.39
Munich	0.39
Dusseldorf	0.39
Berlin	0.36
Rome	0.36
Athens	0.36
Luxembourg	0.32
Oslo	0.32
Geneva	0.31
Helsinki	0.29
Stuttgart	0.27
Rotterdam	0.27
Bucharest	0.25
Cologne	0.24
Lyon	0.24
Antwerp	0.24

Source: Taylor (2003) / (Schmitt P. et al., 2008 p. 17)

Another criterion corresponds to the location of financial services with international importance: while MEGAs such as Warsaw, Hamburg, Berlin, Oslo and Stockholm concentrated many international banks, it is worth mentioning the setting of non-domestic BSR banks in numerous MEGAs, both in Western and Eastern BSR. The relatively dense network of BSR banks located in other BSR countries is supposed to facilitate internal, hence integrative BSR economic activities (see figure 4).

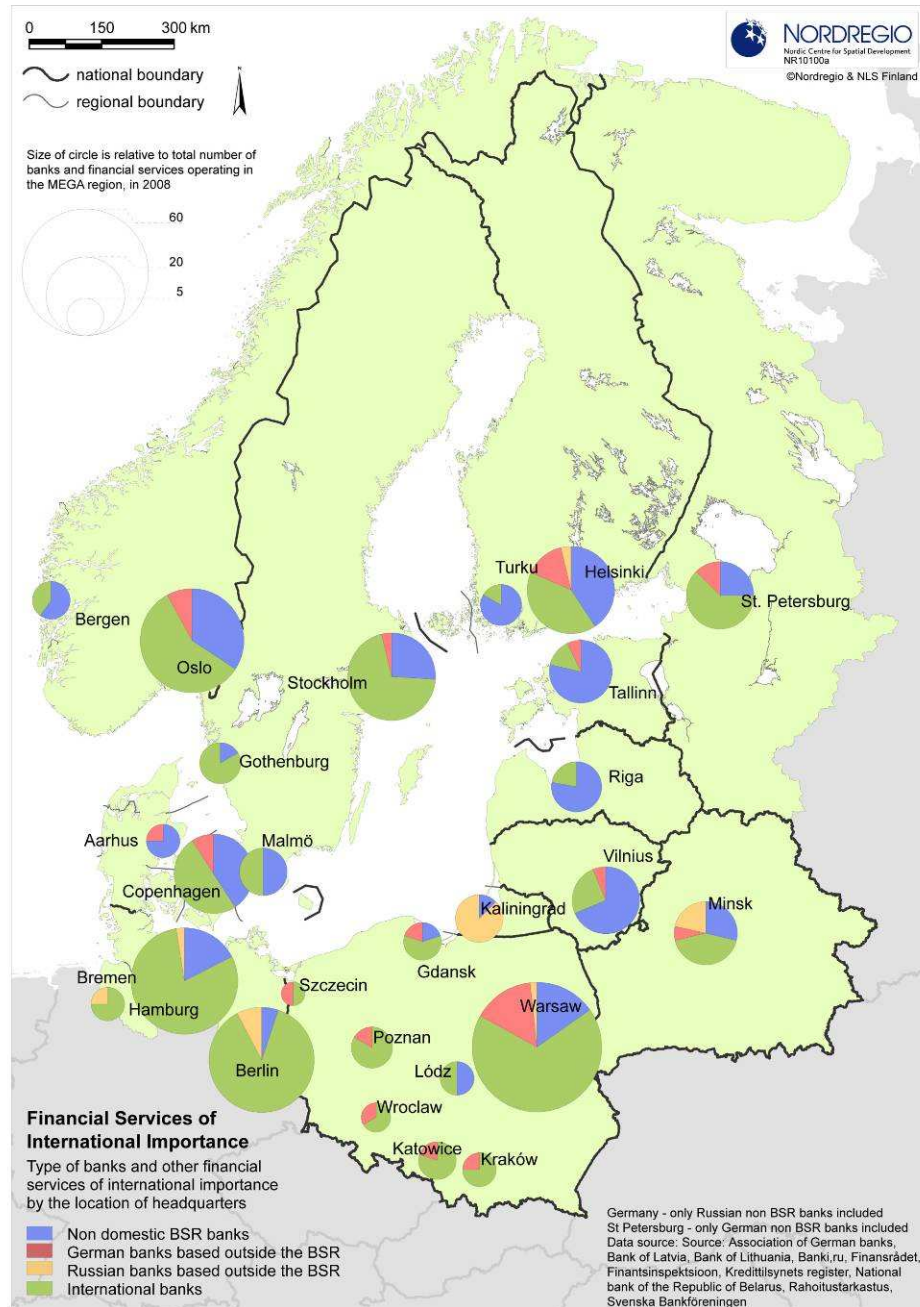


Figure 4: Financial services of international importance

Source: (Schmitt P. et al., 2008p. 13)

Other criteria, such as BSR headquarters of large international enterprises and regional networks of global accountancy firms are also taken into account in order to identify the metropolitan ‘decision and control’ function. The data indicate a clear east/west division with relative strong MEGAs on the western side and weaker ones on the eastern one. However, it seems that the eastern MEGAs have both the critical mass and the capacities to reduce that gap.

BSR metropolitan regions as centres for innovation, research and development

Even though innovations are not necessarily applied in the same place where it is produced, a certain image of the BSR concerning the second metropolitan function, ‘innovation and R&D’, can be mapped out using several criteria.

Data about postgraduate students is one of these criteria. By taking the total number, the most populated MEGAs constitute the Top3, these being Warsaw, St. Petersburg and Stockholm. However, by considering the share of postgraduate students among all tertiary level students, the ranking is quite different with a domination of Polish MEGAs followed by Finnish ones, where the former has more than 15% of postgraduate students and the latter between 10 and 15%. Apart from Stockholm and Finnish MEGAs, it is worth mentioning the low share of postgraduate students in the Western part of the BSR.

The number of employees in R&D oriented branches has also been analysed (see figure 5). As is the case for some criteria about the first metropolitan function (decision and control), a distinction can be made between the Western and the Eastern parts of the BSR. Thus, the Western MEGAs are characterized by an important share of the business enterprise sector, while the Eastern MEGAs have a very large share in the higher education sector. The situation both illustrates and confirms the strategy towards product and process innovation in the Western part by focusing on the business sector, while the Eastern part concentrates on the university sector. As we shall see later, this overall picture is confirmed by Russian business managers and entrepreneurs in their evaluation of the quality and innovativeness of Russian products. However, it remains to be seen whether the focus on the university sector in the eastern BSR countries hosts potentials for future innovation within product development, science or other sectors.

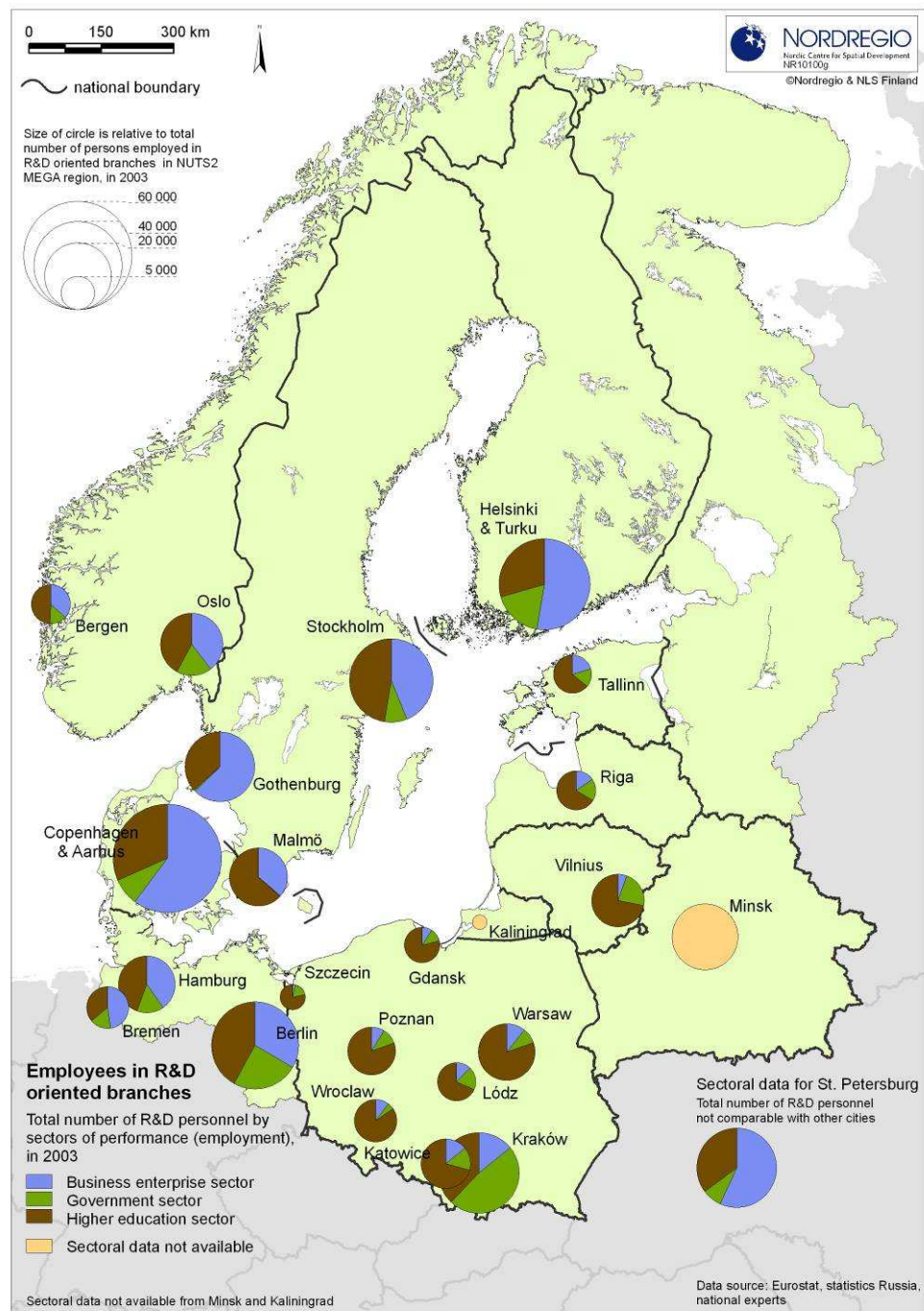


Figure 5: Employees in R&D branches

Source: (Schmitt P. et al., 2008 p. 22)

This analysis also identified potentialities for cooperation among MEGAs in the BSR by specification and diversification of their research centres. Four areas of competence can be found in almost all the territories surveyed: (1) health; (2) natural sciences; (3) food, agriculture and fisheries, and biotechnology; and (4) nanosciences and nano-technologies and new production technologies. However, mapping of employees in technologically oriented branches and employees in knowledge intensive services strengthen the distinction between the Western and the Eastern MEGAs of the BSR; more precisely, the Eastern MEGAs are more oriented toward low-tech manufacturing than the Western MEGAs.

In addition, patent applications to the European Patent Office reveal an east-west divide. Rather than expressing any innovative processes, the patent application data reflect the MEGAs' ambition to exploit knowledge for the European market. Hence, data from either 2002 or 2003 (none for Belarus and Russia) show that Western MEGAs are more willing to apply for patents, which can also be explained by a longer tradition of intellectual property in the Western Countries. For example, there were 600,000 patent applications for the MEGA containing Copenhagen and Aarhus, with an important share in human needs, electricity and physics, a share similar to other Western MEGAs. Examining Belarus and Russia, the number of total patent applications is very low: 2,237 for St. Petersburg, 1,662 for Minsk and 38 for Kaliningrad (figures in 2007) expressing the limitations on intellectual property rights in these parts of the BSR and consequently the need for institutional change in this area.

BSR metropolitan regions as gateways to markets, people and collective images

The main feature concerning the third and last metropolitan function corresponds to air traffic, both passengers and goods. The study takes into account several scales of analysis, namely the BSR, Europe as a whole the transcontinental routes. None of the BSR airports can be considered as international hubs due to a lack of global direct air connections; this contrasts with other European airports such as London, Paris, Frankfurt and Amsterdam. For the BSR region (see figure 6), the map shows the importance of connections among the Nordic capital cities that dominates the pattern of air travel connections in the BSR; domestic flights are also important, mainly in Poland and Sweden, as well as between the two Russian MEGAs that are part of the BSR; finally, Helsinki occupies a special position regarding its relative important air connections with Eastern capital cities compared to the other Western MEGAs. However, a common strategy should be developed in order to increase the BSR air connections beyond its territory, especially on the global scale; for example, by strengthening the position of Copenhagen as the current leading BSR airport.

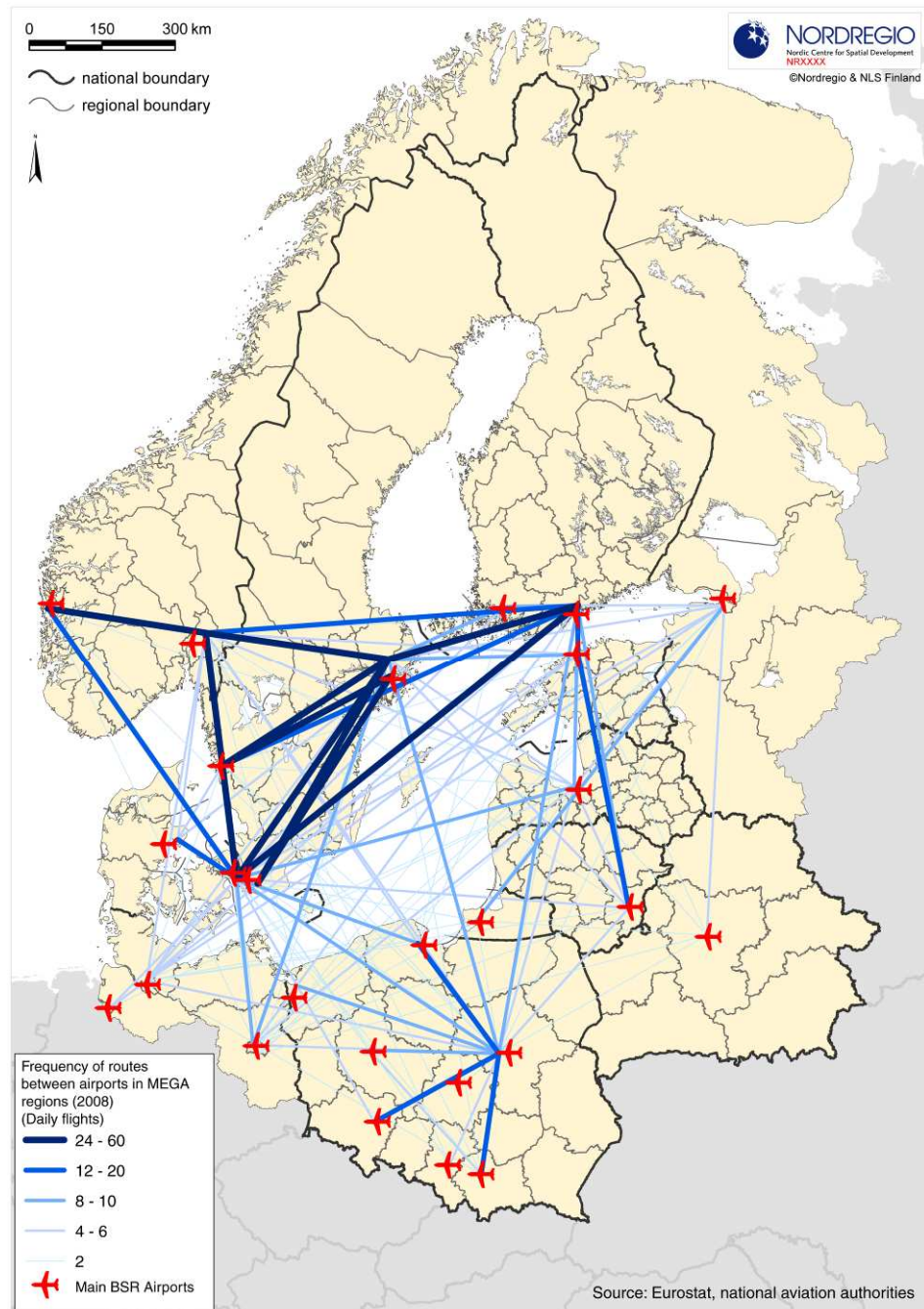


Figure 6: Air travel connections between MEGA airports within the BSR (2008)

Source: (Schmitt P. et al., 2008 p.36)

Seaports are also a strategic issue when it comes to gateways functioning around the Baltic Sea. On the one hand, the most dynamic ports for passenger flows correspond to nodes that are part of the main maritime links located within or close to MEGAs: Helsingborg-Helsingør between Sweden and Denmark; Helsinki-Stockholm between Finland and Sweden; and Rødby-Puttgarden connecting Denmark with Germany. It is worth mentioning that the Top 25 passenger seaports in the BSR comprise only one location in the Eastern part of the studied region, namely Tallinn at position 7. On the other hand, cargo flows shows a quite different picture of the region; in fact Hamburg, Bergen and St. Petersburg compose the Top 3, while East-

ern ports show themselves to be better in cargo traffic than in passenger traffic, with a significant increase between 2000 and 2006.

Gateways functions deal not only with transport. A criterion such as international fairs is also of importance. St. Petersburg takes the Lion's share in the overall BSR, followed by the MEGAs of Poznan and the other BSR capitals, whilst there is a rather well-balanced distribution of international fairs in the BSR's MEGAs. Also of interest are the international fairs held outside MEGAs, such as those in Jönköping in Sweden, Herning in Denmark and Rostock in Germany, all derived from local specificities.

Finally, this study takes into account the spatial distribution of UNESCO World Heritage Sites as a function feature for gateway in the BSR context. Indeed, these sites can be seen having potential for strengthening a MEGA's profile beyond its own territory.

Demographic trends

The development of the MEGAs has been given prime attention due to their importance as hubs for the development of the knowledge-based economy. But what about the small and medium-sized cities? Do they suffer from concentration of economic development in the MEGAs? The question is important because if the strong development of the MEGAs goes hand in hand with a weakened network of small and medium-sized cities, economic and demographic cohesion outside the metropolitan regions is at stake. We know that cities are not weaker just because they are smaller. Thus, some small and medium-sized cities achieve special functional importance due to their strategic geographical position, a specialised economy, position as a gateway or strong connections with international networks.

A detailed study of the development of medium-sized and small cities was beyond the range of this project. Therefore, Nordregio concentrated on two studies: national case-studies on the development medium-sized cities and a BSR-wide comprehensive study on the role and position of medium-sized cities in the demographic development. The case-studies are presented as they were provided by the national experts. The diversity of these studies made it difficult to form general conclusions. Nordregio, therefore, decided to present them as show-cases, valuable as they are in their own right (Schmitt P. et al., 2008, appendix 2) . The other study, on the role and position of medium-sized cities in the demographic development, was conducted as a statistical survey by Nordregio, assisted by national experts.

From the Nordregio study, we shall highlight the most interesting findings.

The demography of medium-sized cities

Starting with the overall morphological pattern of the urban system in the BSR, the uneven distribution of cities between the Northern and Southern parts of the BSR is confirmed by the mapping of all cities larger than 20,000

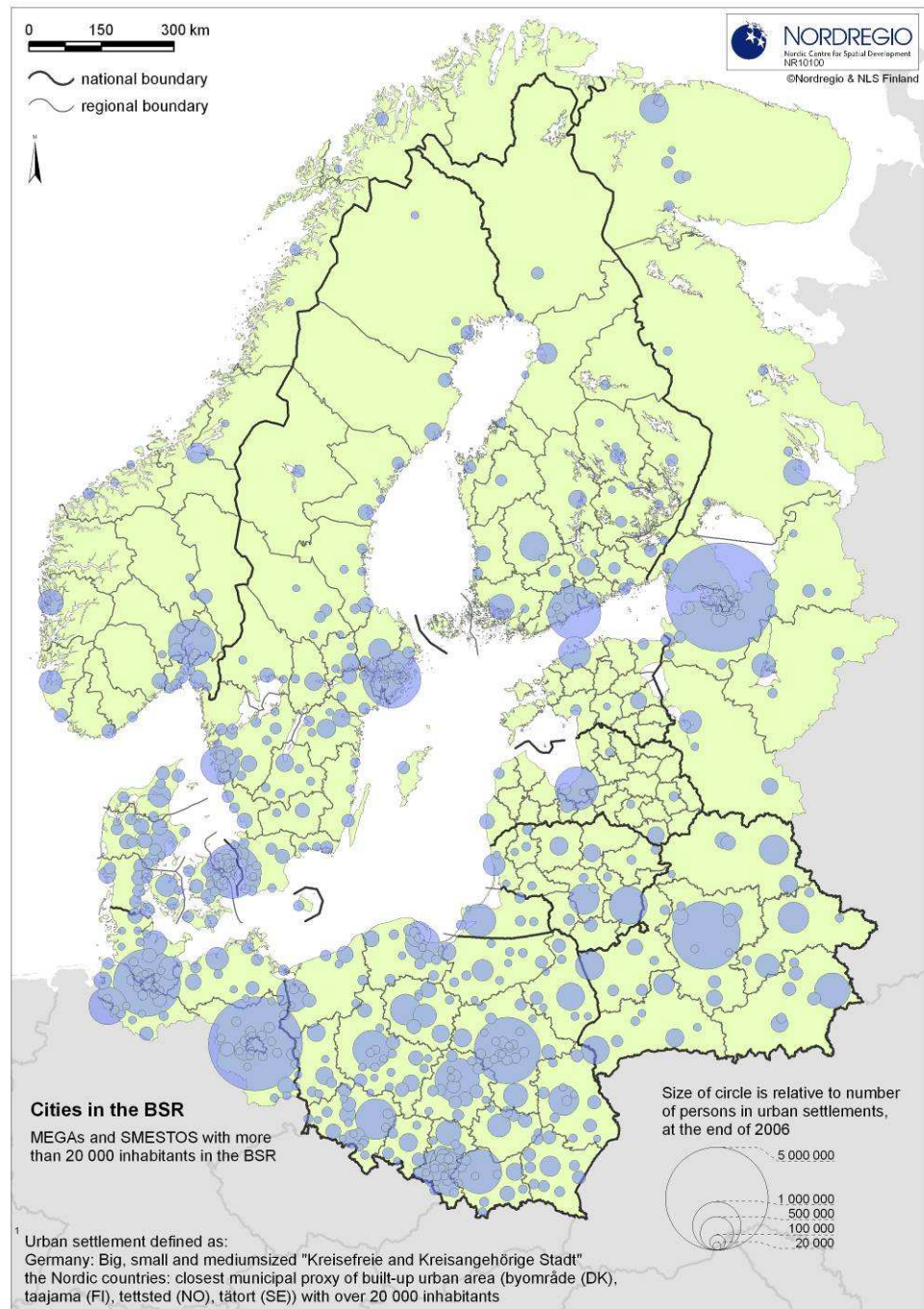


Figure 7: BSR cities with more than 20 000 inhabitants

Source: (Schmitt P. et al., 2008)

inhabitants (see figure 7). The map further reveals quite dense clustering of smaller cities in most of the metropolitan regions, notably the metropolitan regions of Berlin, Hamburg, Copenhagen, Oslo, Stockholm, Warsaw, Łódź and Katowice. As we shall see, these medium-sized cities in the metropolitan areas often are the “winners”. Closely located to the MEGAs, they usually are offered the opportunity to follow more than one track of development. They may offer attractive and cheap housing for people working in the metropolitan centre while at the same time offering private companies building sites, often with easy access to national and international infrastructure. Only seldom such double opportunities are at hand outside the metro-

politan areas. Medium-sized cities in regions outside the metropolitan regions are not offered the opportunities of integrating with the housing and labour markets of the metropolitan cities. They have to match the challenges and dynamic of the local regional economy, usually facing new trends of globalisation. Finally, the most peripheral cities are often due to negative development trends, especially if they are not endowed with attractive nature for tourism or gateway positions (Groth et al., 2005).

Recent demographic trends

The total BSR population is decreasing slightly, driven by substantial natural losses that are offset by in-migration. These overall trends vary from one country to another and between large cities and small cities and the rural areas. In figure 8, the total population changes in cities above 10,000 inhabitants is shown for the period 2002 – 2006, followed by the natural and migration components for the same period in figures 9 and 10. Figure 8 shows the increasing populations of most cities larger than about 100,000 inhabitants in the Nordic Countries and the Northwestern part of Germany (former Lüneburg region, Schleswig-Holstein, Bremen and Hamburg), whereas urban growth in other parts of the BSR reveals a blurred pattern, characterised, however, by negative population development. Most cities in the three Baltic States are declining, with Tallinn and Tartu and some small cities in the vicinity around Riga as exceptions. In Belarus, urban growth is restricted to the four largest cities. In the Eastern part of BSR, i.e., Germany (Mecklenburg-Vorpommern, Brandenburg and Berlin), the population of Berlin was stable from 2002 to 2006, and a corona of small cities around Berlin the only exceptions within a pattern of general urban decline. Poland reveals a most diverse pattern of urban development. Whether Polish cities grow or decline seems to depend on their regional endowments rather than their size.

Turning to the components of urban growth, figures 9 and 10 show that the positive net migration compensates for natural population decreases in the Northwestern part of BSR-Germany, Berlin and the corona of small cities around Berlin. This is also the case in small cities in the Northwestern parts of Poland, Warsaw and some parts of southern Poland, in the largest cities of Belarus and several smaller cities in Sweden. In the largest cities of the Nordic countries (except Copenhagen) including small and medium-sized cities in the metropolitan regions, natural population growth and migration reinforce each other. Generally, however, migration in most of the BSR countries – except the two Baltic States⁷ – has contributed positively to development, especially in the largest cities.

⁷ Data from Estonia not available.

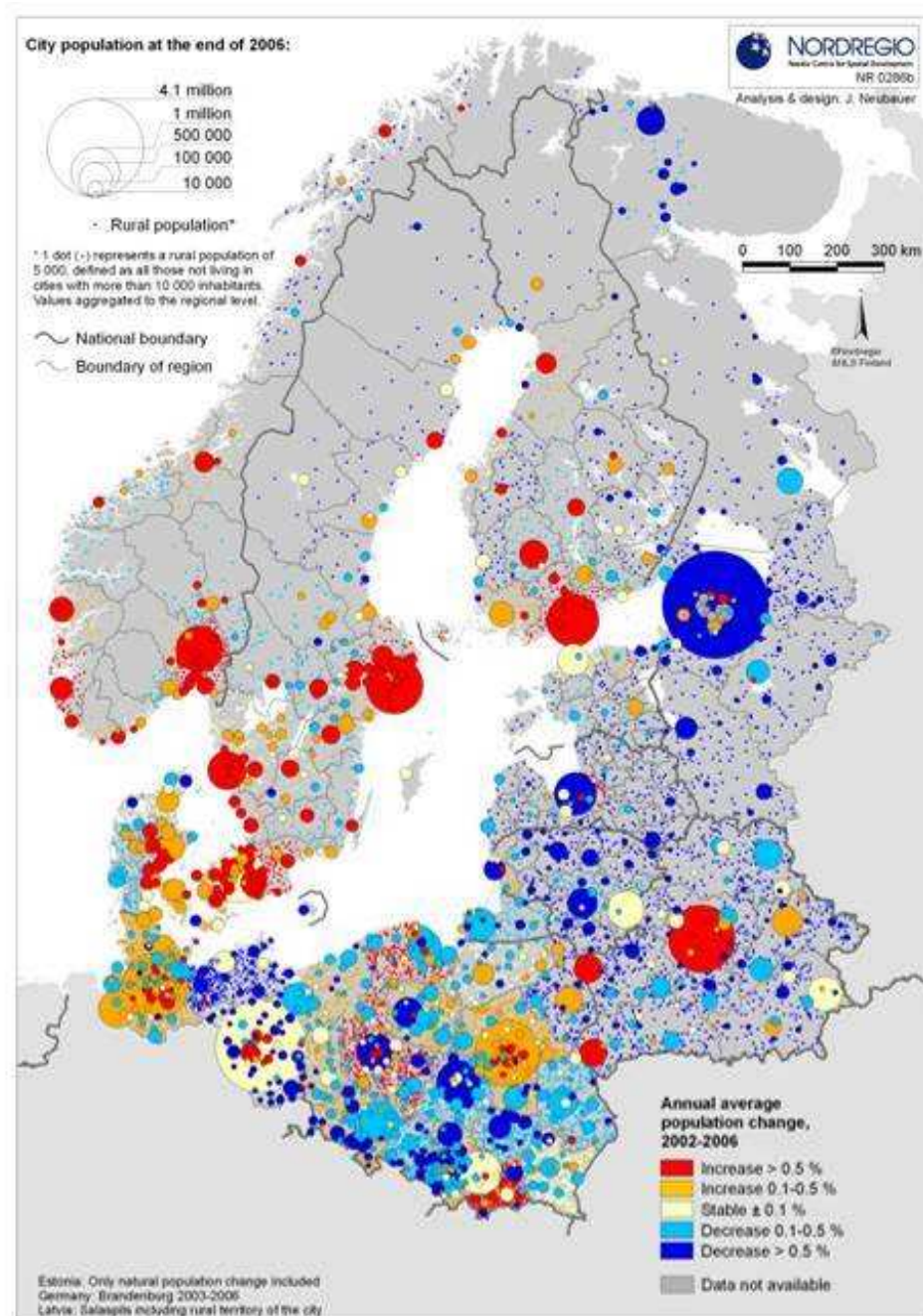


Figure 8: Overall population change in BSR cities (2002 – 2006)

Source (Schmitt P. et al., 2008)

Much of the migration to the largest cities is generated by younger people still in their working life, thus contributing to a positive development of the metropolitan labour markets. Nordregio observes that even though many larger cities in the BSR lost population between 2002 and 2006 they increased their numbers of employed persons during the same period (Schmitt P. et al., 2008, p. 58). This trend is especially clear in Poland, Lithuania and Latvia.⁸ The migration of labour force in turn leads to shrinking labour markets outside the metropolitan regions with an ageing labour force.

⁸ Data from Estonia not available.

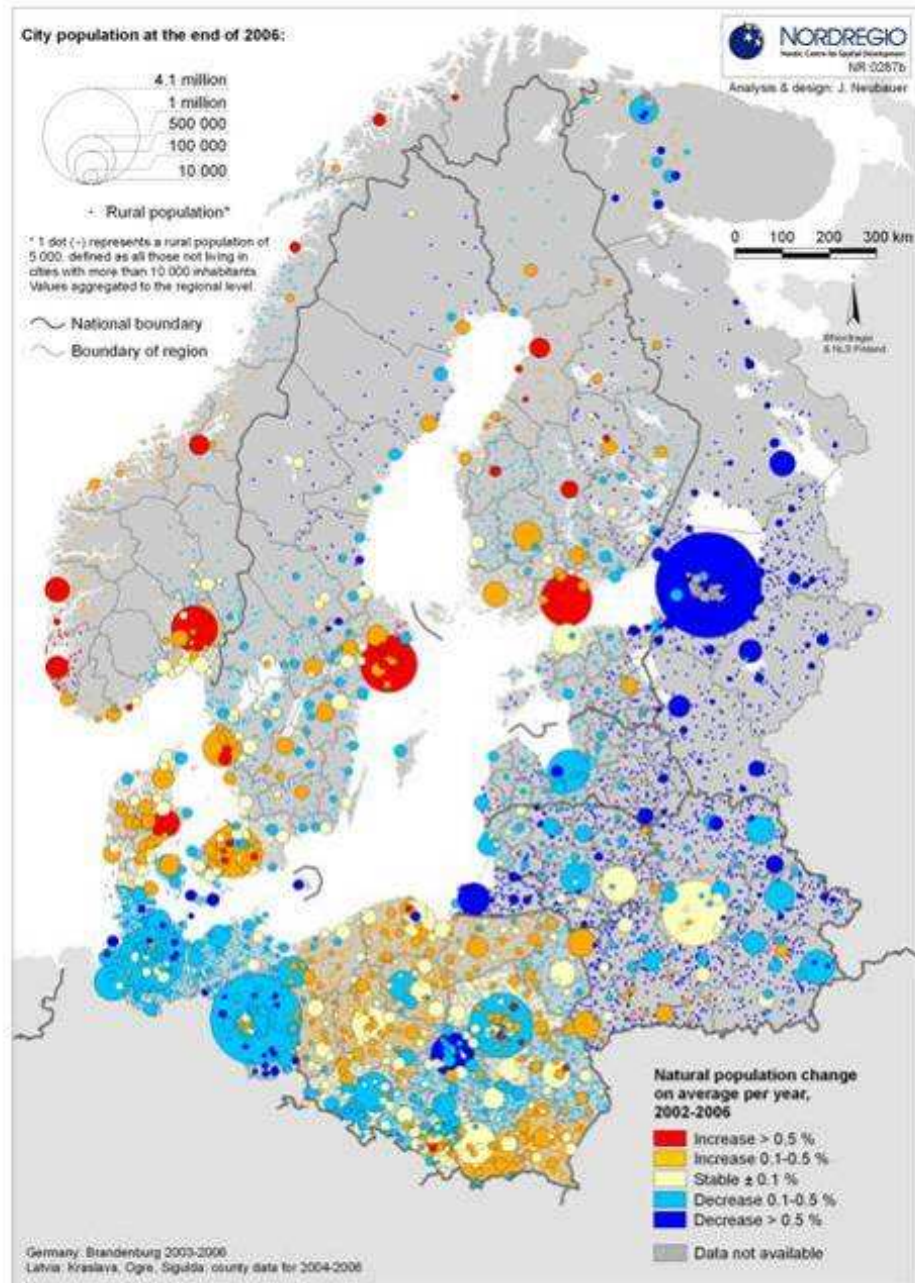


Figure 9 Natural population change in BSR cities (2002 – 2006)

Source: (Schmitt P. et al., 2008)

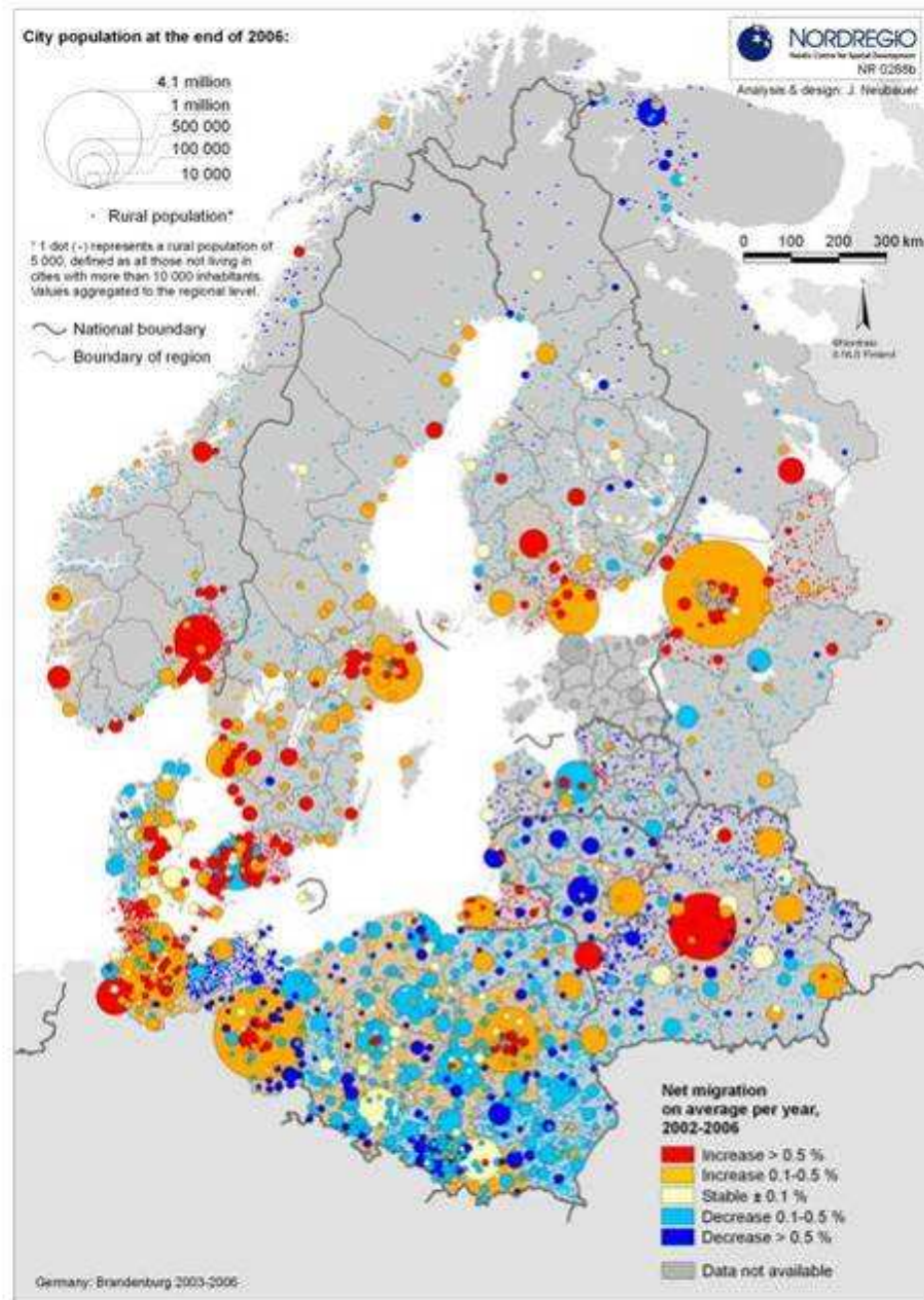


Figure 10 Net migration in BSR cities (2002 – 2006)

Source: (Schmitt P. et al., 2008)

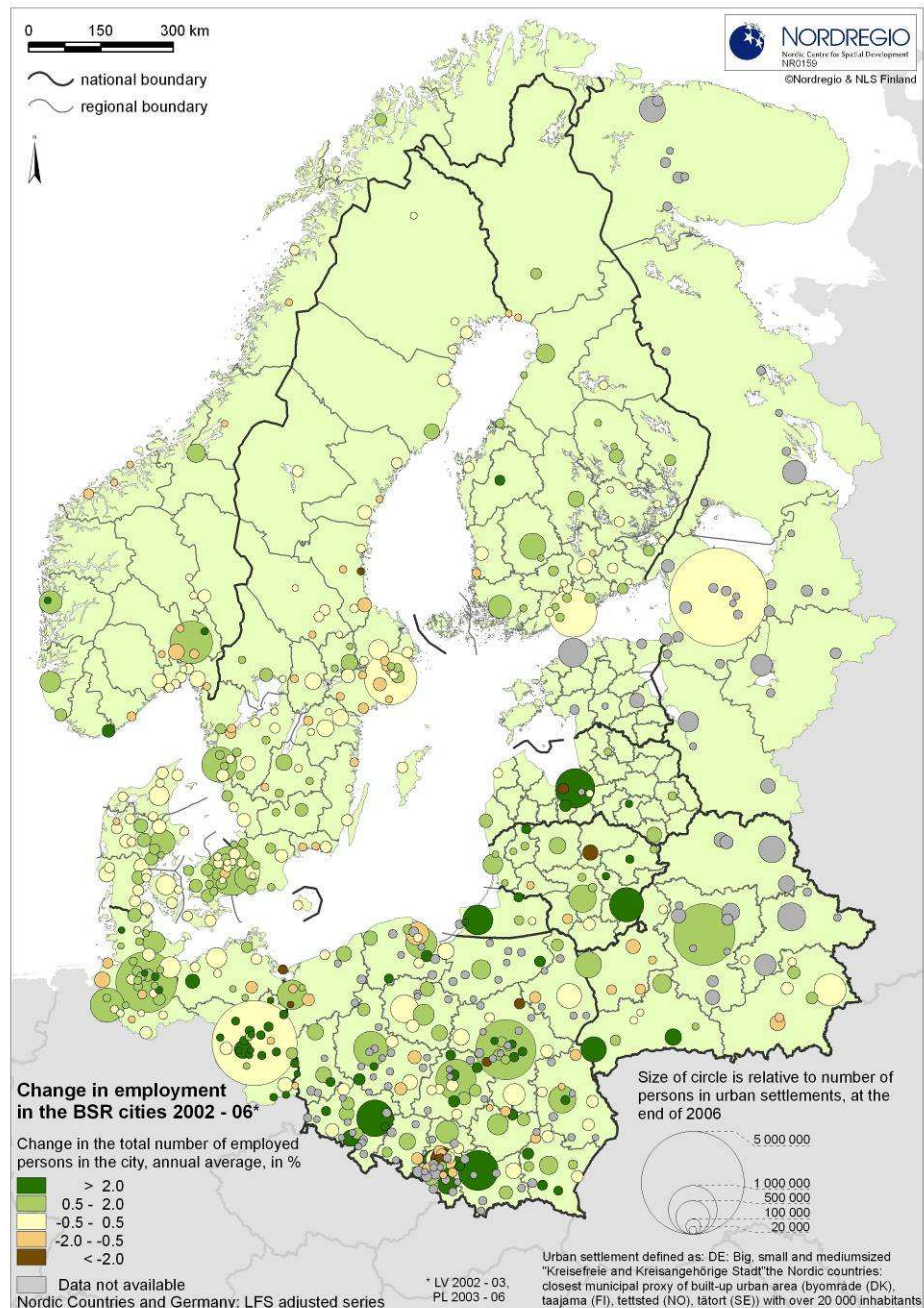


Figure 11 Change in employment rate in BSR cities 2002 – 2006

Source: (Schmitt P. et al., 2008)

Figure 11 reveals the change in employment rates in the BSR cities 2002 - 2006. Generally, the employment rates are increasing in the smaller German cities surrounding Berlin and Hamburg, as well as in several cities in Poland and a few cities in Lithuania, Latvia and Belarus. In Poland and the eastern parts of BSR Germany, the employment rates are increasing at a back-drop of high unemployment – as shown in figure 12.

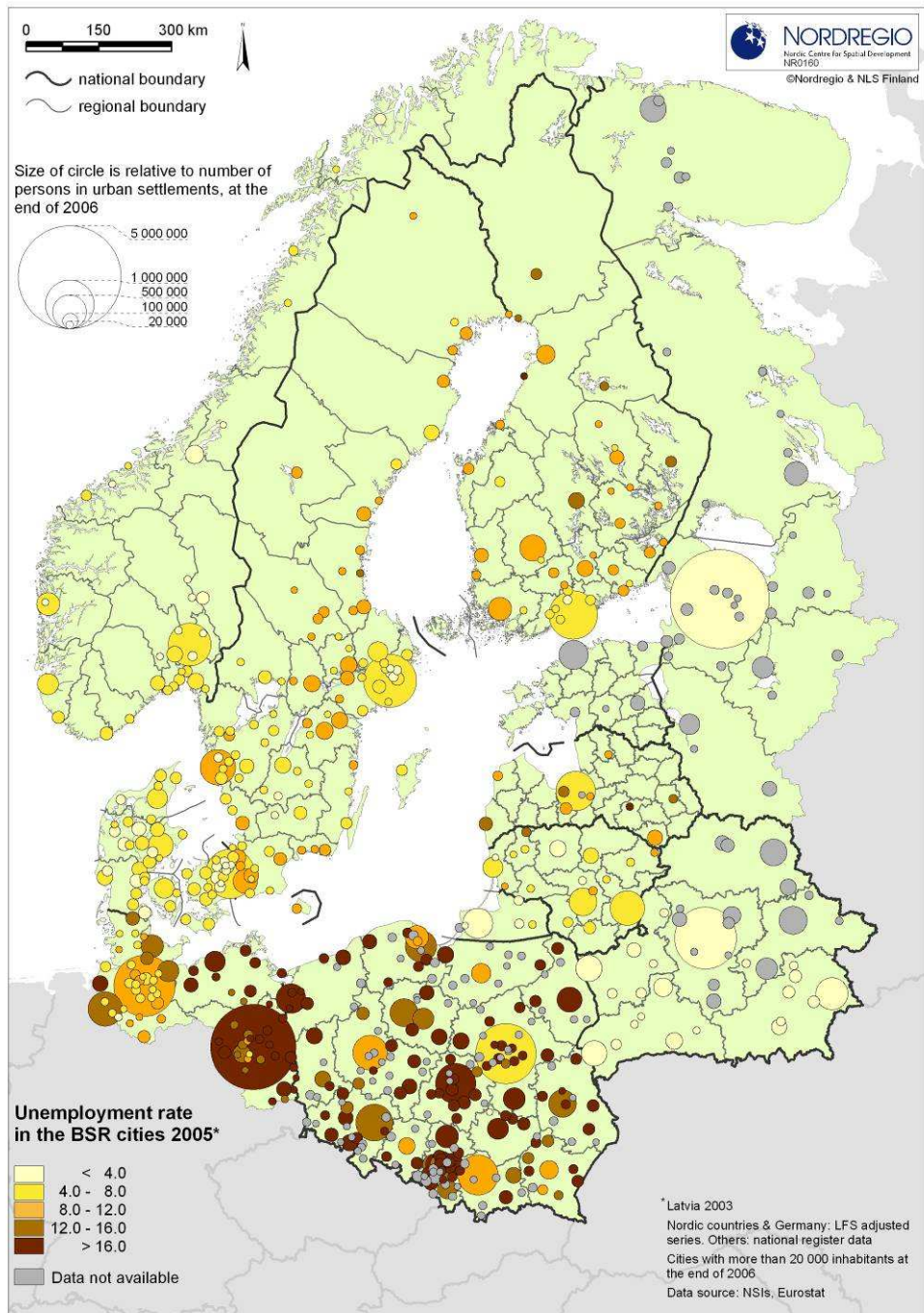


Figure 12 Unemployment rate in the BSR cities 2005

Source: (Schmitt P. et al., 2008)

A certain regional specialisation in primary production, manufacturing and services, respectively, is taking place in the BSR, as revealed by figure 13. In comparison with a similar study (Hannel & Neubarer, 2005) based upon data from 2001 – 2003 Schmitt et al. observe that the share of employment in manufacturing has been rather stable, close to 27%. The share of employment in public and private services has remained stable (63% in 2001, 64% in 2003). Also, Schmitt et al. observe that changes from manufacturing-dominated to service-dominated employment has taken place only rarely at regional level.

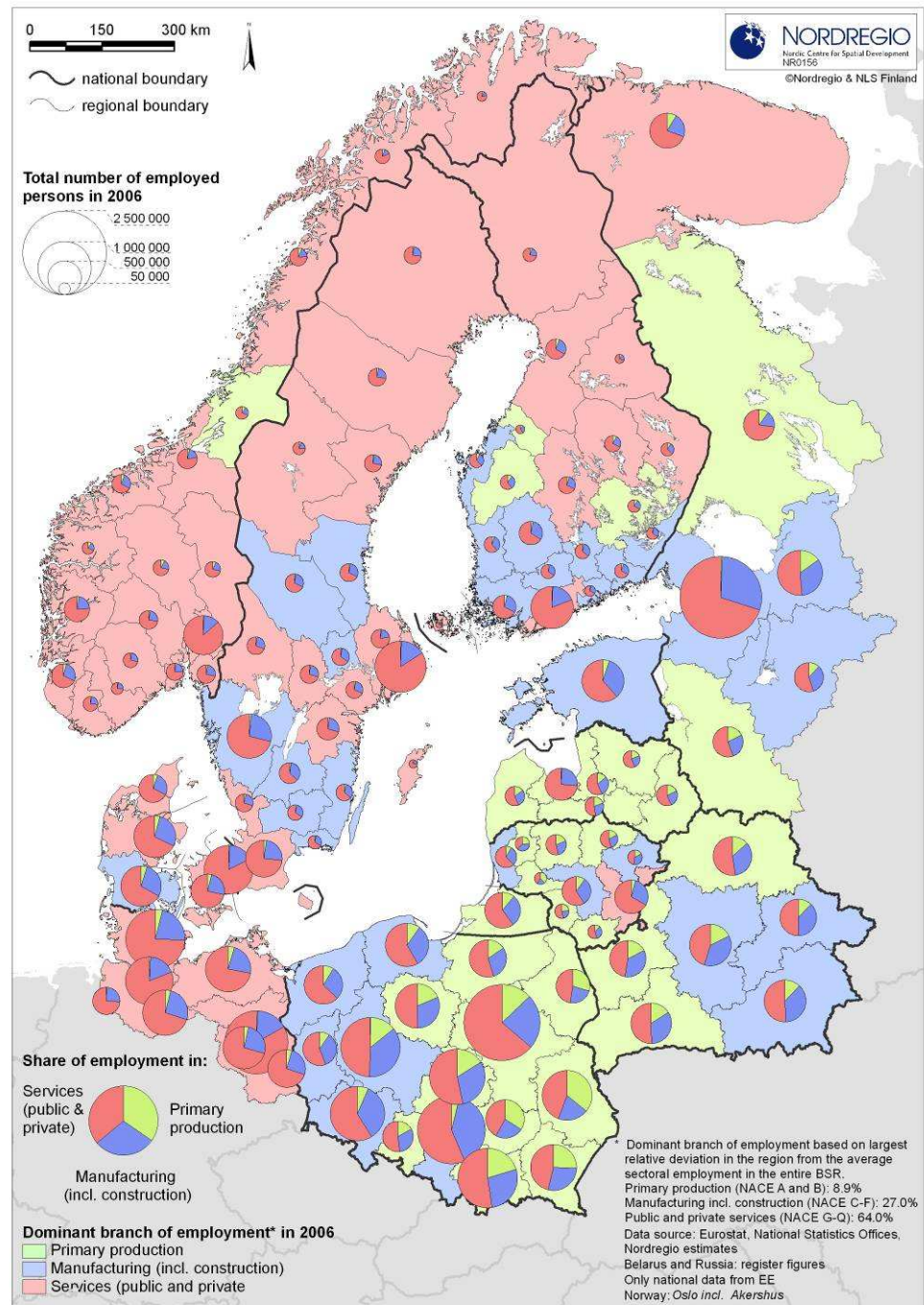


Figure 13 Dominant branch of employment in the BSR at the regional level

Source: (Schmitt P. et al., 2008)

Future demographic trends

In the future, BSR faces major challenges due to changes in the demographic situation. An evaluation of future demographic trends by Nordregio and national experts concludes: ‘Apart from the Nordic countries, one can anticipate a general decrease of the overall population that goes hand in hand with a kind of emptying of rather peripheral areas, as well as areas which are characterised by somewhat isolated SMESTOs and their rural hinterlands.’ Stable or increasing populations can be expected in the larger metropolitan regions, however, though these will often be concentrated at the fringes rather than in the metropolitan core areas (Schmitt P. et al., 2008, p. 68).

As mentioned above, the crucial problem in the BSR is the decreasing natural population in many regions due to low fertility rates, especially in Germany and the Eastern BSR countries; this is shown in table 5.

Table 5: Averaged fertility rates in the BSR (2000 – 2005)

Denmark	1,75
Norway	1,72
Finland	1,72
Sweden	1,64
Poland	1,48
Estonia	1,37
Russian Federation	1,33
Germany	1,32
Lithuania	1,28
Latvia	1,26
Belarus	1,24

Source: table based on UNO World Population Prospects: The 2004 Revision (Schmitt P. et al., 2008).

The shrinking and ageing labour force following the decreasing natural populations ‘and the question in how far this might be compensated by immigration from other countries as well as the question of safeguarding a certain level of provision of services to the inhabitants and to business activities within “greying societies” are burning policy issues for the future’ (Schmitt P. et al., 2008, p. 68)

The trends of demographic transition may be summarised as follows: It is expected that population increase will occur only in the Nordic countries. In all BSR countries, the proportion of people over 65 years of age will increase. With the exceptions of Norway and Sweden, the youngest (0-19) and those of working age (20-64) will decrease their share of the population. The estimated figures are shown in figure 14. It is worth mentioning that such estimates are sensitive to changes in the underlying demographic parameters, which in turn depend upon social and cultural factors connected to the formation and dissolution of families, aspirations of young people to attain a higher professional status in their own country or abroad, job oppor-

tunities, availability of housing, social welfare, other family-relevant services.

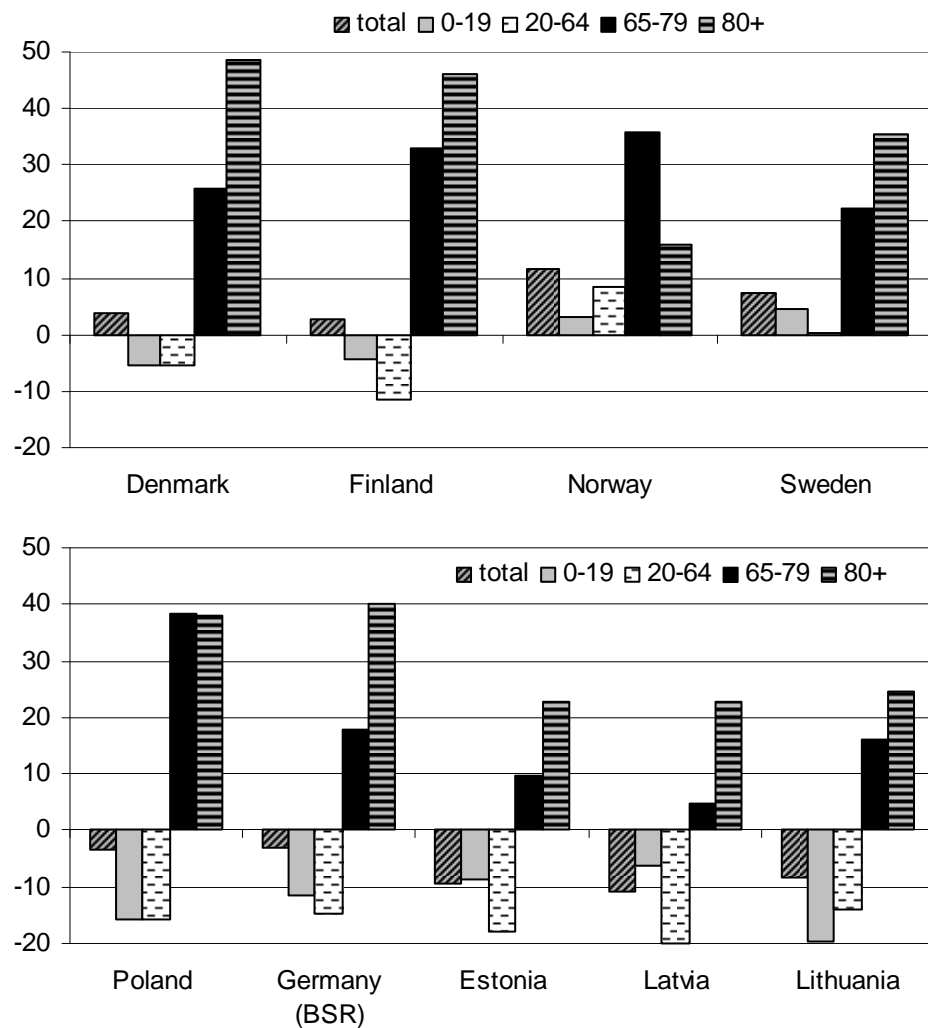


Figure 14 The relative change in total population and for 4 age-groups, in percent for the countries and areas in the BSR 2010-2030

Source: Estimations based on Eurostat, calculated by Rauthut (2008), (Schmitt P. et al., 2008).

The contrasting trends between the Nordic countries and the other parts of the BSR as shown in figure 14 seem most favourable to the Nordic countries as concerns the supply of labour; hence the attractiveness of the Nordic countries for future economic development. We are, however, only speaking in relative terms, since the increasing population in the Nordic Countries is due primarily to a pronounced increase in the number of elderly people (65+). In line with current observations, the ageing of the population is strongly correlated to rural and peripheral regions, thus aggravating the current imbalance between metropolitan areas and other regions.

In relative terms, however, the importance of the Nordic Countries in the BSR will increase in the future.

The relative decrease of young people and people of working age in the southern and eastern parts of the BSR is likely to result in a shortage of la-

bour, which will in turn cause a structural change in the economy in those areas (Schmitt P. et al., 2008, p. 70)

In the 'Southern Arc' of BSR (Germany, Poland and Belarus) Belarus shows the most positive future scenarios. However, this is based upon speculative assumptions that strong in-migration will compensate for the natural decrease of the population. The situation of the medium-sized cities, especially those situated in the eastern part of BSR-Germany, is likely to be dramatic in the future. Stable developments of the metropolitan regions in BSR-Germany and Belarus are likely to be expected in the future, due to domestic migrations towards those centres at the expense of the medium-sized cities and rural areas outside the metropolitan regions. In Poland, the pattern seems to be opposite. It is expected that current migrations to small and medium-sized cities and rural areas will continue. In addition, the current out-migration from Poland is expected to continue, which shows the need to offer attractive jobs and living conditions for those people (Schmitt P. et al., 2008, p. 79). For the eastern-most parts of the BSR, the three Baltic States, Kaliningrad and the Northwest Russia, a major reduction of the population can be expected. A few positive islands of development are to be found especially at the fringes of the larger metropolitan regions, whereas the metropolitan regions themselves will shrink or eventually stabilise their populations. The 'losers' are small and medium-sized cities and rural areas outside the metropolitan regions (Schmitt P. et al., 2008, p. 84).

Small and medium-sized cities in national policies

The rather negative prospects for the small and medium-sized cities outside the metropolitan regions call for political responses. Political measures are needed which can either allay the negative trends or try to integrate those cities into the new knowledge economy. Based upon case-studies from the national experts, Schmitt et al. analysed the extent to which medium-sized cities are taken into account in national policies on innovation, research and development. The overall conclusion is that medium-sized cities are not given special attention in national policies in the BSR in this field. On the other hand, medium-sized cities are not ignored. Therefore, we shall briefly summarise the findings.

In the Nordic Countries, there has been special emphasis on improvement of education and research at the universities. One of the tools has been the merger of universities in order to strengthen national rather than regional competitiveness in the knowledge economy. The Finnish Regional Centre Programme, however, is explicitly targeted at small and medium-sized cities. In the 'Southern Arc' of the BSR (Germany, Poland and Belarus) the national policies vary from one to another country. In Germany, there exists no specific national innovation policy with regard to small and medium-sized cities. However, the individual states (*länder*) are trying to stimulate regional innovative capacities. Rather than just turn the focus on the small and medium-sized cities, the political discourse has more recently turned to

the question of how the small and medium-sized cities can profit from the development of the metropolitan regions. In Poland, as in the Nordic countries, innovation and research policies are about strengthening the role of national knowledge institutions. Rather than merging universities, regional – usually younger -- universities should concentrate on teaching.

In Belarus, the tradition of developing and sustaining the national hierarchical urban system has recently been reinforced by a number of plans and programmes. These plans and programmes have focused upon service rather than research and innovation in order to guarantee a certain level of living standards.

Latvia shows a rather strong political awareness to improve living standards in the entire country. The importance of Riga as the national driving force is fully acknowledged; thus, no distinct policies are targeted to mobilise innovative potentials of the small and medium-sized cities.

In Russia, the concept of ‘science-towns’ is a well-established instrument for the territorial organisation of innovation. Most cities having ‘science town’ status are located in the Moscow region. In Northwest Russia, Peterhof is an example of a ‘science town’ that belongs to the metropolitan region of St. Petersburg.

Urban-rural relations and partnership

Closely related to the disparities between large and small cities are the disparities between urban and rural settings. Therefore, we not only paid attention to policies aimed at small and medium-sized cities, but also policies on developing urban-rural relations, especially in the Russian context.

Urban-rural relations are considered any relations between urban and rural areas such as commuting, recreation, energy, water or food supply etc. Urban-rural relations are the basis for any urban-rural partnership which adds organisational or cooperation structures, governance or financing models to mere relations. The geographical scopes of urban-rural partnerships differ. They are mostly focussed on cooperation between cities and their immediate surrounding areas. Under conditions of globalisation, however, which foster the development of metropolises and metropolitan areas, new concepts are being discussed of extending the cooperation to larger areas between different metropolises.

Despite the fact that Russian science, especially economic geography, municipal engineering and urbanistics, paid attention to urban-rural relations, no serious scientific work was carried out, nor sufficient practical experience gained, in the field of urban-rural partnership. First of all, this can be explained by the fact that urban-rural relations were considered mainly in the context of the perspective development of big cities, for which rural areas were viewed as the ‘territorial expansion-basis’ for the cities. On the other hand, however, cooperation between urban and rural areas is often subsumed under inter-municipal cooperation. An example of this coopera-

tion are the Chelyabinsk and Tver regions. An agreement on mutually beneficial inter-municipal cooperation between Tver city and adjacent Kalinin and Rameshkov districts was signed in Tver region in 2008. Such agreements are concluded in many regions in Russia, step by step, although their geographic focus is on cooperation between several municipalities or between cities and their surrounding areas. The development was also facilitated through legal efforts on the Russian Federation level, such as the law 'On main principles of organization of the local self-government of the Russian Federation' in 2003.

In Northwest Russia, large disparities persist between urban and rural areas. The settlement system is characterised by one metropolis (St. Petersburg) and only a few larger cities with more than 100,000 inhabitants (Kaliningrad, Murmansk, Nowgorod, Pskow, Petrosawodsk). Large distances exist between those cities. Accordingly, the density of the network of smaller towns is low, and the functionality of the smaller towns towards the surrounding villages is weak and in need for further strengthening. Outside St. Petersburg, the population density varies between 63 inhabitants in Kaliningrad region to less than 10 inhabitants in Murmansk region and the Karelian Republic. The current and future demographic situation leads to increasing disparities.

The current development in Northwest Russia shows a dynamic growth in large cities such as St. Petersburg and Kaliningrad. This applies especially to their neighbourhoods, as in most metropolitan regions. Accordingly, rural areas surrounding the big cities are among the most dynamically developing territories of the region. Such successful development of rural territories takes place mainly in spheres outside agricultural production. Therefore, the high rates of increase of population in the metropolitan rural areas are only nominally rural. Due to expansion, typical intensive apartment building along the borders of the city has turned suburban settlements into bedroom communities for commuters working in the city. The largest and most profitable enterprises are not agricultural and are not situated in rural municipalities; consequently, they do not add any income to the local budgets. In contrast to such rapid suburban development, those rural areas more remote from the main growth centres face considerable population decline and economic stagnation.

Russia in the Baltic Sea Region

In order to provide more detailed information about the relations between Russia and the Baltic Sea Region, it was decided to include two case studies on the two most important gateways between Russia and the BSR, St. Petersburg and Kaliningrad. The case study of St. Petersburg was conducted by the Leontief Centre, and the study of Kaliningrad was conducted by Immanuel Kant State University of Russia. Each of the case studies has been published separately, (Oding N. et al., 2008) and (Fedorov G. et al., 2008), respectively. The findings of this chapter are based extensively on the two case studies. The case studies followed a common topical template, as revealed by the structure of the chapter. While most of the documentation is based upon the case studies, many of the conclusions are the responsibility of the editor.

Russian foreign policy and trade

Russia and European Integration

In economic terms, the European Union (EU) is the Russian Federation's (RF) primary trading partner, while the RF ranks third among the EU's partners. For the RF, the EU represents a key partner mainly due to its capacity of technology and investment, as well as its status of stable consumer market. In fact, this relatively stable relation is a consequence of the Partnership and Cooperation Agreement (PCA) signed in June 1997; this agreement was reinforced in May 2003 by the creation of four Common Spaces to further strengthen their strategic partnership.

Even though RF and EU relations have become more developed, the RF is much in favour of national bilateral strategic arrangements as a complement to the institutionalised supranational cooperation. Former RF president Vladimir Putin highlighted the state of EU/RF relations: 'In this regard I agree with Romano Prodi's formula of our relation with the EU: "everything but institution" that shows his wish to continue these relations based on strategic partnerships rather than the implementation of a supranational form joining the EU and the RF (Pursianen C., 2007 p. 19).

Nonetheless, essential political cooperation exists. The Northern Dimension, for example, is a regional expression of the four EU/RF Common Spaces, involving also both Iceland and Norway. As a consequence, political cooperation at regional level, also via cross-border cooperation, contributes to the development of non-governmental organisations and contacts between political and social forces at various levels, e.g. Union of Baltic Cities (UBC), the Helsinki Commission (Baltic Maritime Environment Commission / HELCOM) and Baltic Sea States Summit (BSSS).

The integration process, however, remains limited. There remain strong protectionism tendencies within the RF, as express by a quotation from Pur-

sianen (Pursianen C., 2007): ‘strategies, policies and decision-making structures are clearly characterized by state-regulated protectionism and fear of losing its decision-making autonomy and sovereignty’; furthermore, it is complemented by a strong RF feeling that it has its own ‘special’ way of development so that EU/RF relationships correspond more to cooperation rather than integration.

Russian Economy in 2007

Economic growth

In 1999, the overall Russian economy started growing again, facilitated by the Russian rouble depreciation in 1998. From 2002, the economic growth was stimulated mostly by the increased private and government consumption financed with the rapidly increasing revenues from oil and gas exports. By 2006, a new growth factor has reached the Russian economy in 2006, net capital inflow. Russian banks and companies are, again, attracting funds from abroad.

Nevertheless, this growth situation occurs at the same time as high inflation rates (11.7% in 2007), so that the economic situation for low-income households is becoming increasingly difficult.

External trade

Russia has had a positive net export rate since 1992 (not including the CIS); Russia’s exports are dominated by natural resources and commodities such as gas, oil and oil products, while imports consist of manufactured goods, machines and equipment. Russian external trade is thus characterized by a predominance of inter-industry trade and is thus non-integrative.

As mentioned earlier, the RF’s main trade partner is the EU (51%, in 2007); followed by Southeast Asia (19%) and CIS (15%).

Looking specifically at the Baltic Sea Region (BSR), we find that Germany is Russia’s most important trade partner for both export and imports, followed by Poland and Finland. When it comes to relating data of trade vis-à-vis gross national income (GNI), figures show that the three Baltic States, especially Lithuania, are more dependent on trade with Russia for both imports and exports than the other Baltic Sea States. It is also worth mentioning that exports to RF is substantially lower than import; the RF’s energy exports to the BSR represent an important part of the overall external trade.

Russian companies have shown a tendency to focus more on the domestic market rather than international one. Due to the size of the domestic market, Russian companies are not forced to seek customers abroad. Furthermore, it is natural to maintain and develop relations with local authorities in order remain prominent in local markets. This orientation towards the Russian

domestic market also allows Russian producers to produce lower quality goods than they would had they been pushed to pursue international standards. Many Russian firms simply do not see it as their first priority to become competitive at the international global markets, a situation also revealed by interviews with Russian corporate entrepreneurs and managers. According to Pursiainen: 'in some sectors [international economic] integration is seen as a threat rather than a possibility, since these sectors do not have a realistic potential of penetrating European markets (for economic, political or quality-related reasons). These sectors thus concentrate on domestic markets and support protectionism' (Pursiainen C., 2007 p. 14).

Investments

In 2007, total accumulated investments increased by more than 50% within a year and reached USD 220.6 billion. These consisted of both foreign investments and loans and credits, while portfolio investments are relatively minor. Major investing countries, except Germany, are located outside the BSR. This includes, however, most of Germany. In sum, FDI does not facilitate BSR integration. The largest sector of FDI is consumer services, focused on the vast RF consumer market; further there are only few effects of FDI on technology transfer.

As concerns the RF's outgoing FDI, the accumulated investments reached USD 32.1 billion in 2007, which corresponds to 1/7 of incoming accumulated FDI in the RF. Within the BSR, RF investments are channelled mainly into the energy and transportation sectors. The main investment object is the North Stream Pipeline project between the RF and Germany.

Foreign Direct Investments (FDI): Economic Growth, Poverty and Scientific Progress

One of the main aims of attracting FDI is to seek the kind of stable economic growth that would help reduce poverty. In fact, FDI affects economic growth rates of the recipient country's economy, while also contributing to its integration into the world economic system as already mentioned earlier. Although FDI can reduce poverty, effects can only be seen in the long-term perspective. Nonetheless, improvement of labour conditions appears in a short-term perspective in the receiving country, thanks to the desire of the investing company to maintain a certain standing. Furthermore, transfer of technology and know-how are also encouraged by FDI; this is even more important for scientific-technological parks, which facilitate both the establishment and the development of new businesses.

According to Deutsche Bank Research, Russia has become the second largest foreign direct investor among emerging markets (behind Hong Kong) and the largest investor among the BRICs (Brazil, Russia, India and China) (Nestmann T., 2008). Russian outward direct investments (ODI) reached USD 48 billion in 2007, more than the double amount of the preceding year. The ODI was concentrated in a few destinations, as shown in figure 15.

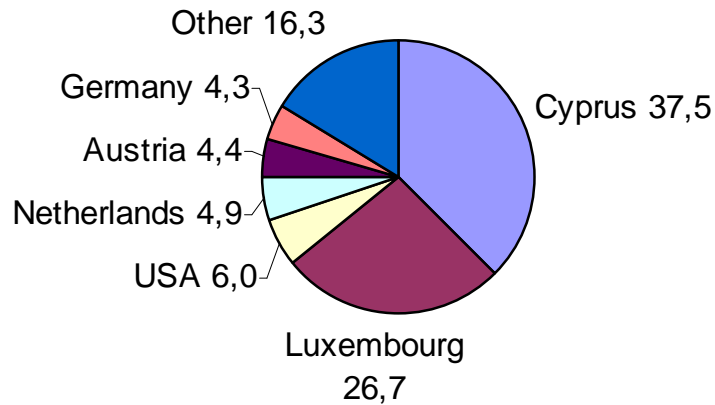


Figure 15: Russian ODI flows. % share of total Russian ODI flows, 2006.

Source: (Nestmann T., 2008)

The large shares held by Cyprus and Luxembourg - accounting jointly for 64% in 2006 – partially flow back to Russia as FDI or are redirected to other countries. As an example, a stakeholder of the Latvian oil pipeline to Ventspils is Euromin Holdings, Ltd. from Cyprus, a company that is part of the Vitol group.

Russian investments abroad began predominantly in the CIS in the 1990s, subsequently moving to the developed markets as well as more recently to Africa. Resource-based industries continue to dominate outward investments. However, financial, telecom and retail trade companies are also venturing abroad. According to Nestman, expansion abroad provides Russian companies with ‘access to new technologies, know-how and resources’ and in turn help to modernise the local economy (Nestmann T., 2008).

Russian FDI in BSR is relatively low. As mentioned in the previous section regarding investments, Russian FDI in the BSR is concentrated in sectors such as energy, transportation, industry and trade. In fact, the Russian FDI in the BSR is very much strategically motivated by Russian interests in obtaining access to the EU and other international markets. Characteristic examples of these efforts are the port of Sillamae in Estonia, co-owned by a Russian company; the oil pipeline from Russia via Belarus to the Latvian harbour of Ventspils, also co-owned by a Russian company; and the North Stream Pipeline project that goes from Russia directly to Germany.

The moderate position of the BSR in Russian foreign investments is indicated by a list of large mergers and acquisition projects in which Russian corporations were the buyers, cf. table 5. The list shows 27 mergers and acquisitions spread over 19 countries and 3 continents. It is evident that the Russian companies now operate world-wide and no longer focus on the CIS and the former Soviet Republics in the BSR. The Russian companies, specialised within the resource-based sector, cooperate with relevant partners no matter where they are around the world. They act as part of a global spe-

cialised networks not restricted to any kind of regional imperative. Thus, only a very few of the large mergers and acquisitions listed in table 5 took place in the Baltic Sea Region.

Table 6: Large M&A projects with Russian corporations as purchaser*

	Purchaser	Sector	Target	Country	mln USD
2005	Alfa Group	Telecom	Turkcell	Turkey	3.000
	Lukoil	Fuel&Energy	Nelson Resources	Bermuda Kazakhstan	2.130
	Severstal	Metallurgy	Lucchini	Italy	511
	Evrax Group	Metallurgy	Vitkovice Steel	Czech Rep.	287
	VimpelCom	Telecom	URS	Ukraine	231
	Amtel	Chemical	Vredestein Banden	Netherlands	201
2006	Evrax Group	Metallurgy	Oregon Steel	United States	2.300
	Novolipetsk Steel	Metallurgy	Duferco	United States EU	806
	Evrax Group	Metallurgy	Highveld steel	South Africa	678
	VimpelCom	Telecom	Amentel	Armenia	496
	Rusal	Metallurgy	Eurallumina SPA	Italy	420
	Norilsk Nickel	Metallurgy	OMG nickel assets	Australia, Finland	408
	Rusal	Metallurgy	Alscon	Nigeria	250
	Interros	Fuel&Energy	Plug Power Inc.	United States	241
	VimpelCom	Telecom	Unitel	Uzbekistan	207
2007	Norilsk Nickel	Mining	LionOre Mining	Canada	5.234
	Rusal	Metallurgy	SUAL, Glencore	Schwitzerland	3.600
	Gasprom	Fuel&Energy	Beltransgas	Belarus	2.500
	Renova	Energy	Energetic Source SPA	Italy	700
	Evrax Group	Metallurgy	Claymont Steel Holdings Inc.	United States	564
	Lukoil	Fuel & Energy	Jet Petrol Stations	Czech Rep. Poland, Hungary Finland	560
	Global Inform. Services Holding	Machinery	Altis Semiconductor	France	449
	MTS	Telecom	K-Telecom	Armenia	434
	Mirax Group	Hotels	Sungate Port Royal	Turkey	340
	Severstal	Mining	Celtic Resouces Holding Plc	Ireland	315
	Evrax Group	Metallurgy	Highveld Steel & Vanadium	South Africa	238
		Novolipetsk Steel	Metallurgy	Winner Steel inc	United States

*Only stakes above 10% and dedls over USD 200 mln included.

Source: (Nestmann T., 2008)

Case-studies

With special focus on St. Petersburg and Kaliningrad Oblast, two case-studies were undertaken by the Leontief Centre in St. Petersburg (Oding N. et al., 2008) and the Immanuel Kant State University of Russia, Kaliningrad (Fedorov G. et al., 2008). The findings are discussed below.

General characteristics of St. Petersburg

A review of the economic and strategic development of St. Petersburg through the last decade shows that the city is consolidating its position as one of Russia's most important cities, unique as a cultural city and strategically important as Russia's hub towards the EU. As with Russia, St. Petersburg reveals strong trends and strategic efforts in global economic integration, with the Baltic Sea Region playing a moderate, though strategic role. The Baltic Sea Region is more important in sectors of cultural, institutional and technical cooperation.

Economic Development in 2001-2007

For a long period the economic growth rate of St. Petersburg has exceeded the growth rate of the Russian economy as a whole. Service production takes up about two-thirds of the economy. Within the manufacturing industry, food production and the machine-building complex are the two most important branches, as in figure 16 below.

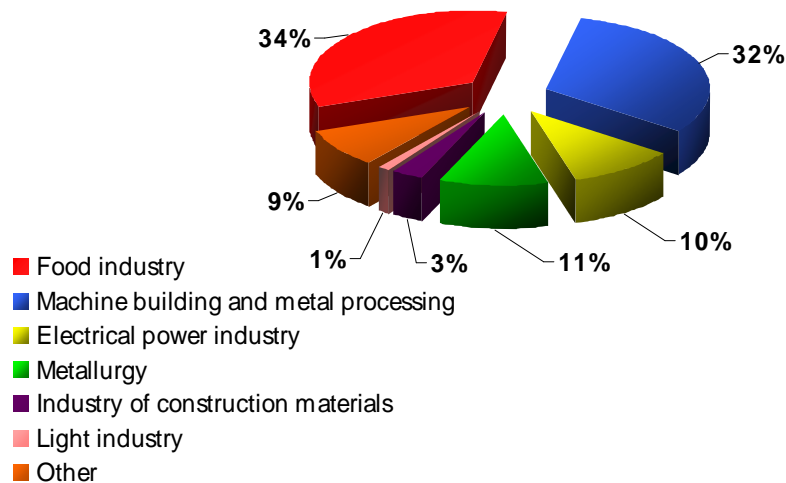


Figure 16: Manufacturing industry of St. Petersburg

Source: (Oding N. et al., 2008 p. 20)

The positive dynamics of the industrial production seem not to be driven by modernisation of the industries: 'Despite of the positive dynamics achieved for the last five years, no deep modernisation of all sectors has occurred

(Oding N. et al., 2008 p. 20). Thus, in an era of globalisation, this might leave those industries in more difficult positions when faced with international competition, which would in turn lead them to focus on their domestic rather than international markets.

Attracting investments

Assisted by the federal government, St. Petersburg makes use of different tools for attracting investments. The city is undertaking these measures in a positive climate of steeply increasing FDI. Thus, FDI in 2006 reached USD 643.4 million, i.e. 2.6 times more than the year before. In 2007, the growth of FDI is expected to continue and to reach USD 1.5 billion. The total foreign investment in 2007 is expected to reach USD 6.3 billion (Oding N. et al., 2008 p. 22).

In order to further facilitate the investments, the City Government has declared that it will increase the competitive capacity of the city through a modernisation programme, including

- the improvements of the city transport (new port territories, access to ports, warehouses and terminal logistic zones);
- lay-out of IT-parks and a special economic zone in order to facilitate a transition to innovative economy.

Social and demographic situation

The positive development of foreign investments takes place on the backcloth of a social situation characterised by social inequality. However, unemployment is one of the lowest in the Russian Federation. Furthermore, the population has decreased continuously, from 5,035,000 in 1990 to 4,565,000 in 2007. This is due to negative development of birth- and death-rates and a positive net migration being unable to cover the natural loss of population. The geography of migration has changed. Migration of Russians to the Baltic countries has ceased, as has emigration to the United States, Germany and Israel. An increasing in-migration from the CIS countries and other regions of Russia to St. Petersburg has compensated for the aforementioned declines.

Public utilities

Public utilities, water supply, sewerage and waste are in an unfavourable situation and need improvement. The basic source of water supply to the city and part of the suburbs is the Neva River. Other suburbs are supplied by water from their own systems. The regular control of the water quality indicates an unfavourable situation and the need to improve the quality of the water supply.

The length of the sewage networks is more than 6,000 kilometres. There is a continuing discharge of untreated sewage water flowing directly into the Neva and the Gulf of Finland. This poses a threat to the sanitary state of the Neva Bay and damage to the ecology of the coastal waters and to the Baltic Sea in general.

New recycling plants for waste have been constructed in order to improve waste treatment. Currently, the households 1.5 million m³ of waste are handled by two waste recycling plants, whereas 3.5 million m³ are disposed at dumping areas. About 1.5 million m³ of waste from small business, commerce, etc. are handled under fee-based arrangements with companies. However, much of this waste is dumped illegally in the suburban woods.

In 2006, an ecological project was launched, and it has been decided to build six new waste sorting and reloading plants.

Documents of strategic Development

A number of strategic plans and programmes have been prepared during the last decade, many of which are aimed at improving the social situation.

In 1997, a *Strategic Plan of Development of St. Petersburg* was approved. In 2004, a new system of national planning, unique for St. Petersburg, was established to resolve problems of socio-economic, financial, urban planning and other aspects of urban development. The new system includes the following documents and statements:

1. The Concept of Socio-economic Development (20-year horizon, 5-year update)
2. General work plan (20-year horizon, 10-year update);
3. Program of socio-economic development (3-6-year horizon, 1-3-year update);
4. Budget;
5. Annual Governor's message.

Three directions are the focus of 'The Concept': (1) positioning St. Petersburg as a 'world city', (2) developing St. Petersburg as a national commercial and traffic centre and as (3) a centre of innovation and administration.

World city

The positioning of St. Petersburg as a world city is generally about integrating the city into the world economy (not just the economies of the Baltic Sea Region). Closely related to this policy strand is to develop St. Petersburg as a venue for summits, conferences and forums and to enhance its nationwide federal functions. The goal is also to develop the city's position as a cultural capital of Russia (holding festivals, exhibitions and concerts) and as a leading European centre of international tourism.

Commercial and traffic centre

More than 50% of Russia's export turnover and import is expected to pass through St. Petersburg on its way to and from the EU.

In order to achieve this situation, the development of St. Petersburg calls for infrastructure investments, the most important of which are the Large Port

of St. Petersburg, the Circular Road, a high-speed train to Moscow and the upgrading of the airport.

Centre of innovations and administration

The goal of developing St. Petersburg as a centre of innovations includes innovation of new products, effective marketing and adjustment of serial production, and further integration and competitiveness with the outer world. This, in turn, implies that the ‘antagonism to the tendency to strengthening protectionism and the all-round support of the measures on the federal level that assist to liberalization of foreign economic relations must be a priority-oriented direction for the city authorities (Oding N. et al., 2008 p. 37) .

Business climate

Earlier, it was mentioned that St. Petersburg has profited from a recent, steep increase of FDI. It was also mentioned that measures have been taken to facilitate foreign direct investments.

We shall briefly comment on the business climate in St. Petersburg and Russia from the perspective of attracting foreign companies and investments. A catalogue of incentives has been established since 1998 in St. Petersburg, including local as well as federal incentives.

Administrative and legal measures taken by the St. Petersburg city include the creation of an investment concession systems, transparency of tenders and launching a clearly defined city development strategy.

The contribution from the federal government includes the introduction of governmental guarantees and assistance in designing, auditing and implementing municipal investment programs.

The following governmental incentives are aimed especially at foreign investors:

- personalized support for investment projects;
- tax privileges for investors;
- provision of real estate objects for designated purposes as an exception from general auction principles;
- Special Economic Zones (SEZ).

The amount of tax privileges depend upon the size of investments, gradually scaling up from USD 6-12 million, USD 12-120 million and finally, more than USD 120 million of investments. Projects in the latter category are classified as *strategic projects* and the investor as a *strategic investor*. Strategic investors are offered a reduced profit tax from 24% to 20% and exempt from property taxes for a five-year period. Besides the criteria of size of investments, the strategic projects must also fulfill some performance criteria (e.g. positive benefits for the adjoining zone and economic effectiveness).

Special Economic Zones have been set up for the period 2006--2026. Within these zones, it is planned that they will be centres for the production of software, communication facilities and electronics, automation of engineering processes, military and civil avionics, medical electronics and the development of analytical instrumentation.

Incentives for investors in the SEZ are summarised in table 7:

Table 7: Special economic zone (SEZ) - Tax preferences for investors

Taxes	General conditions	Within the SEZ
Joint social tax	26%	14%
Customs duty	according to customs-tariff	duty-free
Land-tax *	Max 1,5%	0%
Asset tax	2,2%	0%
Transport tax	Max 200 rub.	0 rub.
Corporate tax	24%	20%

* of cadastral value

Source: (Oding N. et al., 2008 p. 42)

Special Economic zones are developed at two sites: Neudorf and Novoorlovsky Park. A major problem for the city is the lack of new territories containing suitable infrastructure. Forty-eight industrial zones are currently situated in the city, with more than 700 companies. The main industrial zones and the two special economic zones are shown in figure 17.

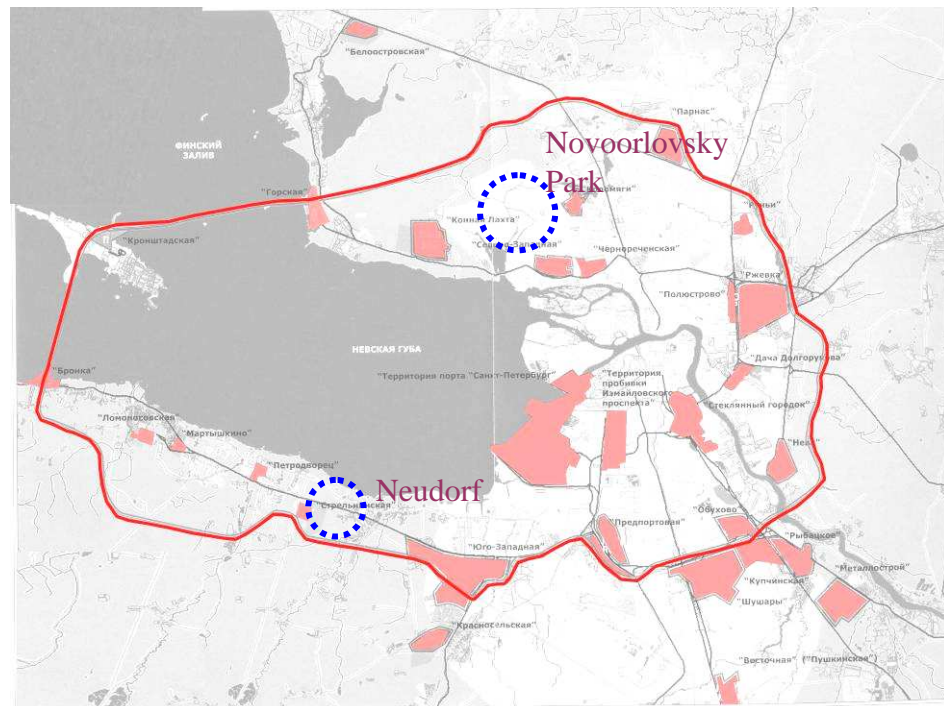


Figure 17: Special Economic Zones in St. Petersburg: Neudorf and Novoorlovsky Park and major industrial areas (red colour). The red perimeter shows the municipal boundary and approximately the position of the Ring Road.

Source: (Oding N. et al., 2008 p. 43)

The total demand for industrial sites is expected not to increase, but the structure and location will change. Thus, industrial sites in central districts will be reduced and the number in the outskirts will increase.

In figure 18, a number of industrial zones designated for special innovative purposes are shown.

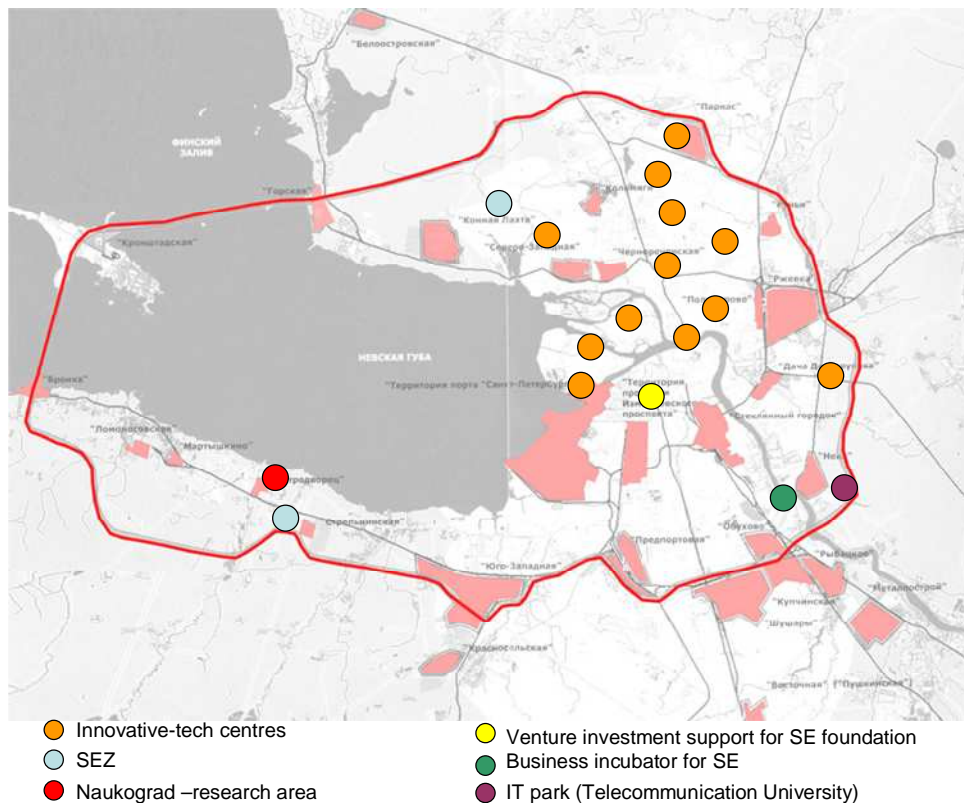


Figure 18: Infrastructure for innovations

Source: Committee on the Economic Development, Industrial Policy and Trade (Leontief Centre, power point presentation)

International cooperation

Institutional and political relations do not strictly follow the patterns of the economic market relations. The market relations of Russia and St. Petersburg tend to integrate Russia and St. Petersburg into the global economy, whereas proximity within the Baltic Sea Region seems to influence the institutional and political relations. Within cultural life, the BSR relations are strong. Probably, it has to do with the fact that tourism is influenced by nearby markets and family relations.

International contacts

Two kinds of international institutional networks have been developed in recent years: networks related to urban and municipal authorities and networks within culture. We will not go into detail, but simply list the names of the networks in order to show the geographical context of the cooperation.

Urban policy networks:

St. Petersburg is a member of:

- the Union of Baltic Cities
- Baltic Cities Conference «Baltic metropoli»
- Organization of the Subregional Cooperation of the Baltic Sea States
- Tourism Commission of the Baltic Sea Countries.

The city cooperates with the following intergovernmental organizations:

- Council of the Baltic Sea States
- the Council of Ministers of Nordic Countries
- Forum of the regions of the European Seashore
- Baltic Development Forum
- Baltic Sea Chambers of Commerce Association.

Since 1998 St. Petersburg is an associated member of

- the Association of the European Cities «Eurocities»
- the International Association of Congresses and Conferences.

The following international organizations are represented in St.Petersburg:

- Inter parliamentary Assemble of the CIS
- Information Bureau of the Nordic Council of Ministers
- international funds and unions, UN organizations.

Finally, St. Petersburg is involved in Technical Assistance programmes:

- Russo-Finnish intergovernmental agreement on cooperation of border regions – 42 projects
- EU-TACIS – 50 projects with a focus on south-east Finland and the Baltic States

International cooperation in cultural and educational spheres

The city is a home of international cultural institutions:

- German Cultural Goethe Institute
- Institut Francais
- American Center for Education and Testing
- Suomen Pietarin Instituttti
- Dutch Institute
- Danish Institute of Culture
- Israel Cultural Center
- Italian Cultural Institute

Major international initiatives of cultural institutions

- State Hermitage Museum
- Mariinsky Theater

- Major initiatives of the city administration in the sphere of arts and culture
- Creative Industries Development Partnership: Shared commitment between St. Petersburg, Manchester and Helsinki to promote creative industries
 - The CulTourism Interreg project on cross-border tourism related to cultural activities in St. Petersburg and the Estonian Ida-Viru region.
 - St. Petersburg hosted the International Festival of Baltic Cities in 2006 for the first time with special contributions from St. Petersburg, Kaunas, Tartu and Turku.

Attitudes on international cooperation

The above-mentioned examples of political and institutional cooperation indicate that politicians, governing boards and managers of cultural institutions have a positive attitude about international integration. But to what extent is international cooperation and integration part of the vision for the future?

Based upon interviews with 17 entrepreneurs (i.e. business owners) and company executives from St. Petersburg in December 2005 – January 2006 (Oding N. et al., 2008 p. 57), we can provide further evidence of this issue as seen from the perspective of the Russian business community.

The authors of the survey acknowledge ‘that the life-values of the respondents have been formed in the Soviet-economy environment, while their economic activities spanned three distinct periods in the modern Russian history: the traditional Soviet economy, the Perestroika, and the market-oriented reforms.’ (Oding N. et al., 2008 p. 57). The respondents express critical opinions about relations between the state and the business community due to dependence on bureaucrats, corruption and lack of respect for private property. In spite of the critical attitude, some respondents prefer the further development of business-state partnerships whereas others prefer a complete separation. Related to the traditionally close relationship between the state and business are the informal paternalistic relations between managers and employees. Most of the respondents agree that such relations are inefficient and dangerous for business. Rather than informal relations, so characteristic in Russian business life, the respondents prefer more transparent and formalistic regulations leaving less room for corruption and bureaucracy. Many of the respondents are positive about what they have seen in the West, and they are positive to change the Russian system in the direction of Western systems. Also, they are positive about the WTO. However, ‘more than half of the respondents view Russia as a unique country and cannot see any model of the existing business-state relations in other countries that could be borrowed by Russia’ (Oding N. et al., 2008 p. 58). Thus, generally they are convinced that Russia should go its own, special way without e.g. joining the European Union.

The survey of business leaders reflects a more general Russian attitude toward international integration that one finds outside the business commu-

nity. The respondents' view that Russia is a unique country and must proceed on its own path, may be a more general view, as indicated by the fact that only six of the respondents felt that they belong to Europe.

These culturally embedded attitudes indicate that besides the political, institutional and economic factors, one has to consider cultural values and ideas as important to international cooperation and integration. The divergent attitudes about government-business relations indicate that some business leaders would accept international cooperation to be developed in concert with national policies, whereas other leaders are strongly in favour of total separation from the state, implying a wish for total freedom in establishing international business relations. In both cases, however, the opinion of most of the business leaders, i.e. that Russia must follow its own path, implies that international integration of Russia should leave room for keeping distinct and unique Russian characteristics.

General characteristics of Kaliningrad Region

The Kaliningrad Region is the westernmost region of the Russian Federation, separated from the mainland Russia by two neighbour states, Lithuania and Poland, as well as by Belarus. The region was established after the second World War on the former territory of East Prussia, sovereignty of which was transferred to the Soviet Union at the Potsdam conference.



Figure 19 Kaliningrad, exclave of Russian Federation

Due to its isolated geographical position from the mainland, the exclave enjoys special attention in Federal politics in order to prevent Kaliningrad

from drifting away towards the West, a situation which became acute when Lithuania and Poland joined the EU.

The Federal government has accorded high priority to the socio-economic development of Kaliningrad with the designation of the entire region as *Special Economic Zone* and by the enactment of the Federal Target Program: *Development of the Kaliningrad Region for the period up to 2010*. Further, the region often enjoys privileges of being a testing ground or pilot region for project initiatives of all-Russian importance within health care, education, housing, agriculture and programmes for repatriation. The federal government is especially supportive of the development of the tourist sector in Kaliningrad.

Key economic indicators

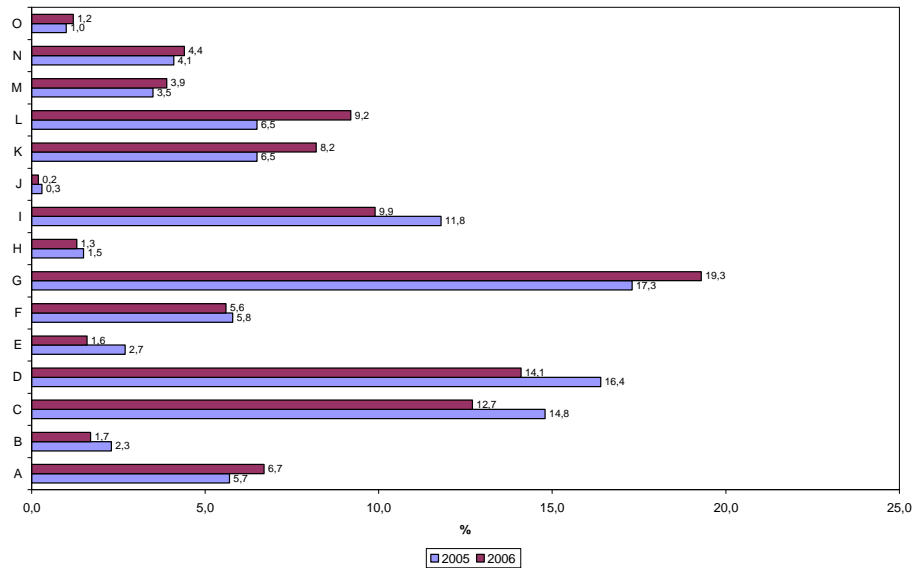
The economic situation of the Kaliningrad Region is below the average of the Russian Federation. In fact the region has a low index of Gross Regional Product, GRP/capita (85,7000 rubles) compared to the 125.8 thousands rubles for the Russian Federation. Like the GRP, however, indexes are increasing in the Kaliningrad Region; these include wholesale and retail trade, repair of motor vehicles, motorcycles, domestic goods and articles of the personal use. Imports exceed exports, which, due to a low degree of international competitiveness consist of 70% raw materials, A further slow down of the net export it is stipulated. The structure of the economy is shown in figure 20.

Strategic development plan

Thanks to its strategic location, the Kaliningrad Region development strategy attempts to maintain good relations with both the Russian Federation (RF) and the European neighbouring countries. Two main documents have been produced, precisely the 'Programme of socio-economic development of the Kaliningrad Region for the period 2007-2016' and the 'Strategy of socio-economic development of the Kaliningrad Region for the mid- and long-term perspective'. The documents focus on two strategies: increasing the economic competitiveness of the Kaliningrad Region as well as the improvement of the quality of life of its inhabitants. The strategy identifies key factors that can be used to increase the development of the Kaliningrad Region, by the way of developing clusters within transport, tourism, agro-industry and power infrastructure sectors. Furthermore, four scenarios for the socio-economic development of the Kaliningrad Region have been produced: two of them have been identified as most favourable for the region's future; they correspond to the 'European outsourcing' and the 'macro-regional lead' scenarios, contributing to strengthening the regional integration with its surroundings.

Business climate

It is mainly exemplified by the Special Economic Zones (SEZ) status given on the whole territory of the Kaliningrad Region. The SEZ status accords the region preferential tax treatment, mostly for large investors in predefined sectors, as stated in the latest SEZ law of 2006.



A	Agriculture, hunting, forestry management
B	Fishing and aquaculture
C	Mining operations
D	Processing industries
E	Production and distributing of electric power, gas and water
F	Construction
G	Wholesale and retail trade; repair of vehicles, motor cycles, domestic wares and articles of the personal use
H	Hotels and restaurants
I	Transport and communications
J	Financial activity
K	Operations with the real estate, a lease and grant of services
L	State administration and providing of military safety; obligatory social security
M	Education
N	Health Protection and social services
O	Granting of other communal, social and personal services

Figure 20: Structure of the gross added value by types of economic activity in 2005-2006. Kaliningrad region.

Source: (Fedorov G. et al., 2008)

Meanwhile, it the SEZ provides both an access to the Russian market as well as a proximity to the European one. Consequently, the business climate is developing dynamically, via an increase in the total number of enterprises, due mainly to new establishment of small and medium enterprises, see table 8.

Table 8: Number of Enterprises in the Kaliningrad Region in 2004-2006.

Index	Number of enterprises (at the year end)			Growth %
	2004	2005	2006	2004-06
Total number of enterprises	41.240	46.343	45.984	11,5
Number of Small enterprises	6.621	9.045	10.778	62,8
Share of Small enterprises %	16,0	19,5	23,4	46,0

Source: (Fedorov G. et al., 2008)

According to Fedorov, the Kaliningrad region occupies the leading position among Russian regions in terms of the level of small enterprise development (Fedorov G. et al., 2008 p. 13). The development of SMEs is supported by the state regional institution 'Foundation for the Support of SMEs in the Kaliningrad Region'. However, the development of large enterprises has also been supported by a new revision of the law on SEZ.

A number of infrastructural problems hamper Kaliningrad region's economic development. Nevertheless, new types of activities are appearing, such as real estate, audit, marketing, financial services, equipment and car leasing.

The major actions taken to improve the entrepreneurial and investment conditions include several institutional measures, some of which are harmonizing with the technical regulations and quality control with norms accepted in the EU, adjustments of management standards at key enterprises with European and international level, adjustment of Russian legislation to WTO norms etc. These and other activities aim at improving the legislative environment for the SMEs.

Due to the focus on institutional measures, efforts to improve the business climate in Kaliningrad seem generally to be in line with the proposals of the business entrepreneurs and managers from St. Petersburg, as referred to earlier.

The actions taken to improve operating conditions for SMEs are not a part of the SEZ measures, which are directed towards helping large enterprises. As will be discussed later, smaller companies investing in Russia and the Baltic states are more likely to originate from the BSR than are the large investors. In Kaliningrad, investors are often SMEs coming from Poland and Lithuania (Fedorov G. et al. p. 15). Thus, it is likely that economic integration in the Baltic Sea Region is being driven by smaller companies rather than large enterprises.

The integrative effects of the SEZ have been questioned by those who stress that the main impact of the tax free zone was that Kaliningrad began to specialize in the re-import of European goods to mainland Russia. This kind of economic activity is having a 'negative influence on the regional economy, as it did not promote development of innovative production that could be competitive on international level' (Fedorov G. et al., 2008 p. 14). However, the most recent regulations aim at integrating the investors in the local economy by claiming: that at least 70% of the tax-subsidised production must take place within the SEZ territory; that 90% of owned and leased assets and all investments must be allocated within the SEZ territory; and, finally, that 50% of the workers must be inhabitants of the region.

Barriers and conflicts

Several barriers continue to limit the effectiveness of the business sector in the Kaliningrad Region. The uncertain status of this Russian enclave between the RF and the EU does not encourage current investments. Meanwhile, the import dependency of the region and the low-technology production result in a low level of competitiveness of the Kaliningrad Region within BSR. There is also a real lack of infrastructure (in energy, in transport, etc.) as well as a lack of skilled labour that limit economic development within the Kaliningrad region, which is divided into a more developed western part and the less developed eastern part). This situation is also due to an ineffective use of land resources: much land is still owned by the Ministry of Defence and is off limits to development projects.

International cooperation in the Kaliningrad Region of Russian Federation

Documents, common programmes

Many contacts have been developed between the Kaliningrad Region and other territories in sectors such as the economy, culture and civil security. The most important networking orientation for the Kaliningrad Region corresponds to cross-border cooperation. Many programs have been developed with Lithuania and Poland based on agreements concluded in the early 1990s. Also worth mentioning is the importance of both Euroregions, involving the Kaliningrad Region and the impact of the TACIS (Technical Assistance to Commonwealth of Independent States-CEI) projects. In addition, the Kaliningrad Region hosts several foreign representations and institutions such as the General Consulate of Germany, Consulate General of Sweden, General Consulate of the Republic of Lithuania, General Consulate of the Republic of Poland, the Consular Section's Chancery of the Embassy of Latvia and an office of the Nordic Council of Ministers. Concerning the current EU programming period 2007-2013, the European Commission expresses its wish to pay special attention to the Kaliningrad Region, as this territory can be seen as a pilot region for bilateral cooperation and dialogue between the EU and the RF.

Infrastructure projects

Due to its status as Russian enclave, isolated from mainland Russia, the region's dependence on imported goods for consumption and its position as an exporter of goods to mainland Russia, Kaliningrad is very dependent upon infrastructure connections with the outside world. Therefore, the main infrastructure projects are associated with cross-border activities. Four strategic nodes have been identified and prioritised by the EU in order to improve the integration of the Kaliningrad Region with its neighbouring countries, while at the same time facilitating the improvement of pan-European transport corridors. The border crossings are described in table 9 and shown in figure 21. They are used for delivery of raw materials and semi-manufactured

products to supply import-substituting enterprises of the Kaliningrad Region, which then deliver the finished products to other regions of Russia. The border crossings are important for trade and tourism as well. Maritime border crossings play an important part in export-import transport for both the Kaliningrad Region and the whole of Russia. However, infrastructure projects also serve as a catalyst for other initiatives such as water quality improvement, administrative training, tourism development, etc. Finally, urban planning in Kaliningrad Region has also evolved thanks to exchanges with foreign experts.

In addition to the above-mentioned border crossings currently being given priority by the EU, it should be noted that four other border crossings are of great importance to Kaliningrad: the international airport Khrabrovo, the trade seaport in Kaliningrad city and the ports of Svetly and Baltijsk. The port of Baltijsk is an important connection to the ports of Leningrad region and Germany. Khrabrovo airport is an aviation hub connecting several routes from Kaliningrad to Russian towns and with routes from Kaliningrad to European airports.

Universities, cultural institutions, exhibitions

Universities are seen as a key factor for development and integration of the Kaliningrad Region (Brunat E., 2006). By improving the English teaching and by introducing EU-related elements within various course specialities, universities in Kaliningrad Region would be more competitive. The main outcome so far is the establishment of the Euro Faculty in Law and Economics in 2000, seen as one of the most important successes of the Baltic Sea cooperation, including Kaliningrad Region.

In the field of cultural cooperation, cooperative initiatives take place with the twin cities of the Kaliningrad Region in Germany, Lithuania and Poland. In addition, artists from other parts of the world also stop in the Kaliningrad Region throughout the year. One of the major cultural events is the Mikael Tariverdiev International Organ Competition, held bi-annually in Kaliningrad. Parallel projects in the cultural field have been developed with the assistance of the Neighbourhood Programme Lithuania-Poland-Kaliningrad Region, such as 'Poetry- art without limits, good without duty'. Other projects include the Internet Festival of Literature, Euroreading 2007' the Polish-Russian school of cultural heritage protection (STUDZENKA 2007) and the project 'History of wars of 20th Century in memorials for their participants'.

Table 9 The four main border crossings in Kaliningrad

Pan European Transport Corridors	Border crossing cities / Main nodes at the corridor		
IA	Sovetsk (Kaliningrad Region)	1	Panemune (LT)
	Mamonovo (Kaliningrad Region)	2	Grzechotki (PL)
	Bagrationovsk	3	Bezledy
	St. Petersburg - Helsinki – Tallin – Riga – Kaliningrad – Gdansk – Lübeck		
IXB	Chernyshevskoye (Kaliningrad Region)	4	Kibarti (LT)
	Kaliningrad – Vilnius – Minsk – Kiev		

Source: (Fedorov G. et al. p 23-24)

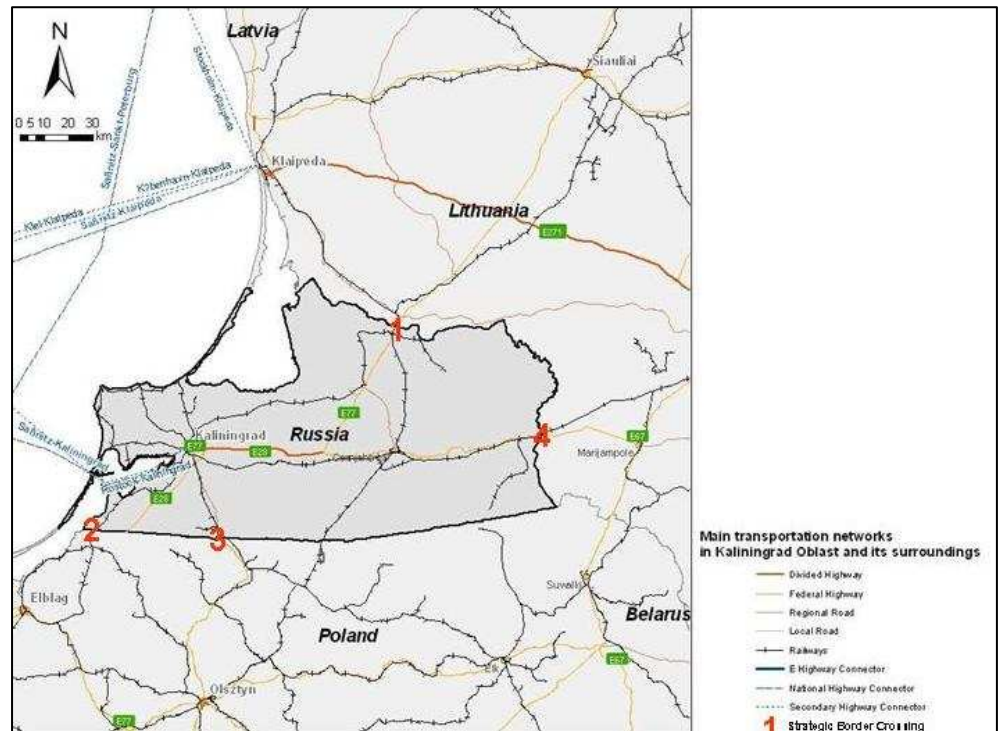


Figure 21 Main transportation networks and border crossings

Assessments of EU cooperation

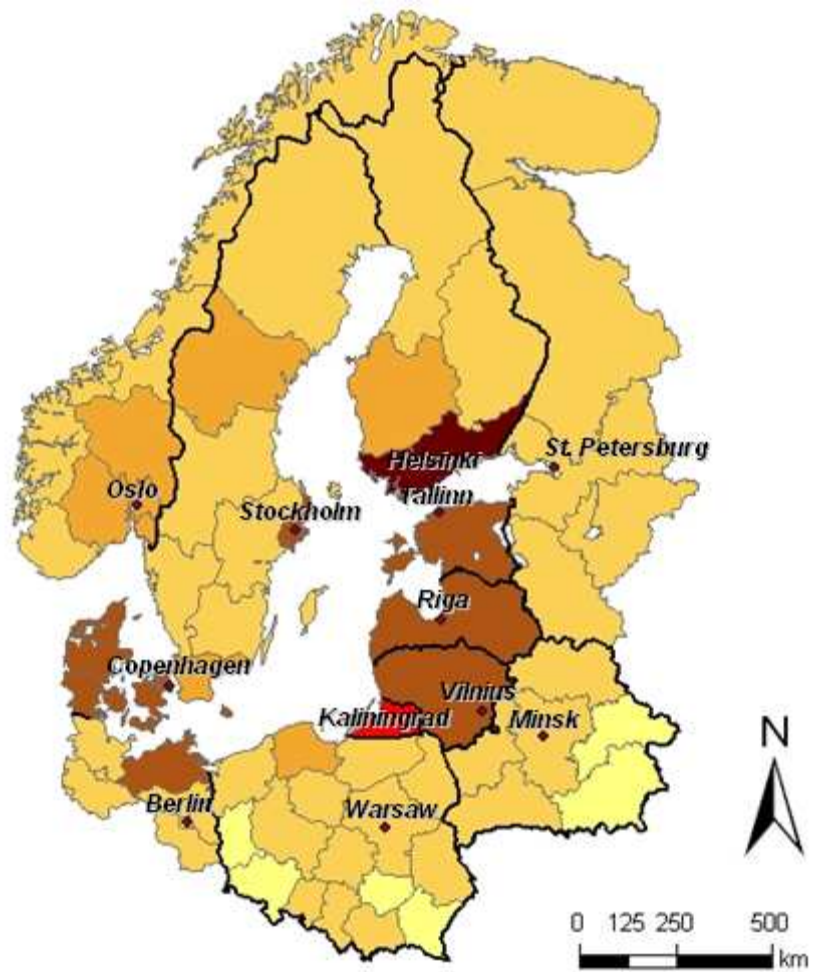
A total of 100 TACIS projects have been carried out; the early large TACIS technical assistance projects involving the Kaliningrad Region were implemented directly by the UK, France, the Netherlands and other more remote countries, while Denmark, Sweden and Poland were also present but not so active. The complicated procedure for selecting the contractor was conducted almost without participation of the region itself.

The availability of funding less complicated projects initiated by Kaliningradians has attracted more local cooperation partners. Partners from the bordering countries, Lithuania and Poland, have joined these less complicated projects. Proximity is thus encouraging cooperation. Cooperation in the other direction, however, between the Kaliningrad Region and the northern part of the BSR, remains rather weak. Most contacts are estab-

lished within the southern part of the BSR (northern Germany, Denmark, southern Sweden, Poland and Lithuania) (see figure 22). A similar pattern of proximity relations is revealed by the Interreg IIB cooperation with St. Petersburg (see figure 23).

In parallel to the more than 100 TACIS projects, over 60 projects financed by the Neighbourhood Programme have been developed.

It is worth emphasising that the EU cooperation observed in Kaliningrad is reflects two parallel integration processes: the trans-local and the local networking. Trans-local networking is characteristic of professional cooperation and strategic cooperation, whereas local networking is characteristic of regional and local development initiatives, cluster synergies, cultural and institutional cooperation. Both kinds of networking are operating in the BSR. Hence, regional integration driven by proximity relations should be perceived as working in parallel with the trans-local cooperation driven by 'globalisation'. A most crucial point is whether local cooperation can benefit from the strong trans-local networking. One such example, mentioned below, is the most recent set of SEZ regulations in Kaliningrad aimed at attracting large international investments while at the same time enhancing local commitments and responsibilities of the tax-subsided investors.



Intensity of cooperation between Kaliningrad Region and other BSR-territories (Interreg IIIB project partners)

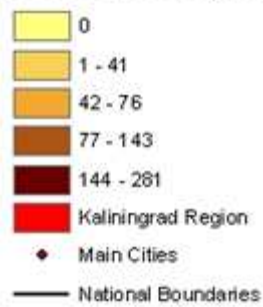
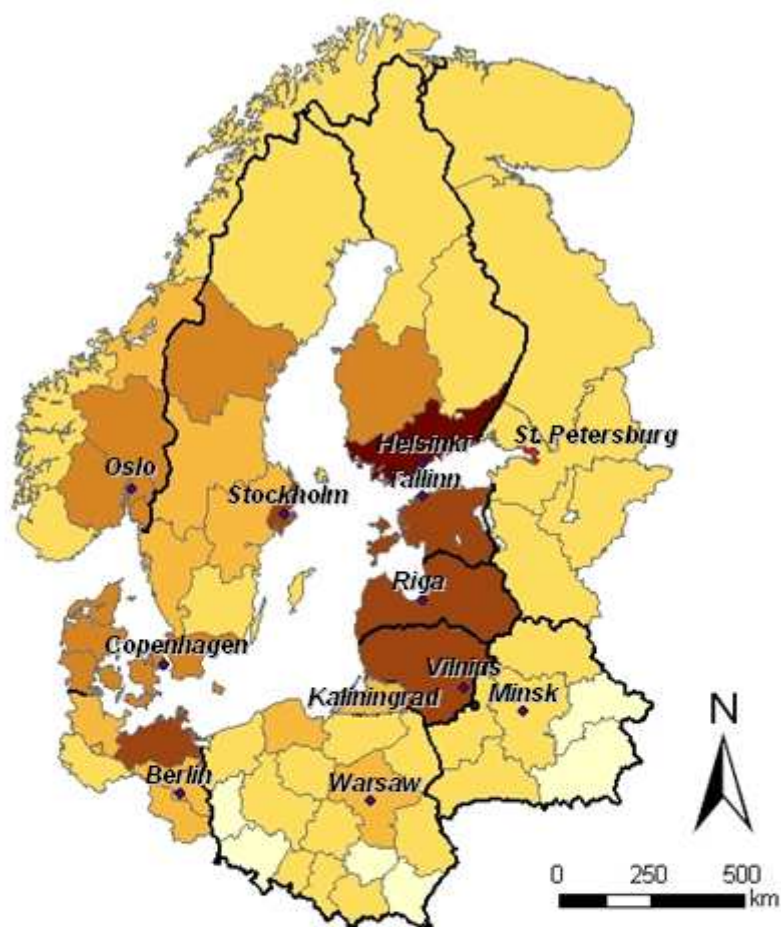


Figure 22 The intensity of cooperation between the Kaliningrad Region and other regions of the Baltic Sea Area established within the projects implemented under the Interreg IIIB BSR Neighbourhood Programme.

Source: (Fedorov G. et al., 2008)



Intensity of cooperation between St. Petersburg City and other BSR-territories (Interreg IIIB project partners)

Number of cooperation

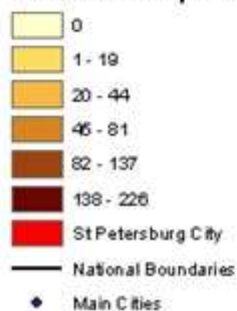


Figure 23 Intensity of cooperation between St. Petersburg and other regions in the BSR established within the projects implemented under the Interreg IIIB BSR Neighbourhood Programme.

Source: (Fedorov G. et al., 2008)

Trade and foreign investments

St. Petersburg – trade and FDI

Foreign trade

As a hub of Russian foreign trade, St. Petersburg has benefited from the major increase in foreign trade in Russia in recent years. As shown in figure 24 (Oding N. et al., 2008 p. 65), foreign trade to and from St. Petersburg has increased dramatically since 2004. In 2000, imports and exports balanced. Since then, imports have exceeded exports.

The structure of imported and exported goods reveals the same patterns as for the Russian Federation, i.e. the major share of exports are mineral products, while imports consist largely of processed goods, c.f. figure 25. This kind of trade is inter-industry, being less integrative than intra-industry trade.

About one-third of Kaliningrad's foreign trade takes place between St. Petersburg and other BSR countries. The total foreign trade turnover by country in 2007 is shown in figure 26 (Oding N. et al., 2008 p. 68). Yellow colour indicates trade partners situated in the Baltic Sea Region. In total, 34.8 % of the turnover took place between St. Petersburg and BSR partner countries. Of exported goods, 39.5 % were sent to neighbouring BSR countries, while the BSR accounted for only 30.7% of imports. Since most of Germany is situated outside the Baltic Rim, the BSR share of the total turnover of foreign trade is overestimated. Taking this into consideration means that Finland is probably the most important trading partner for St. Petersburg.

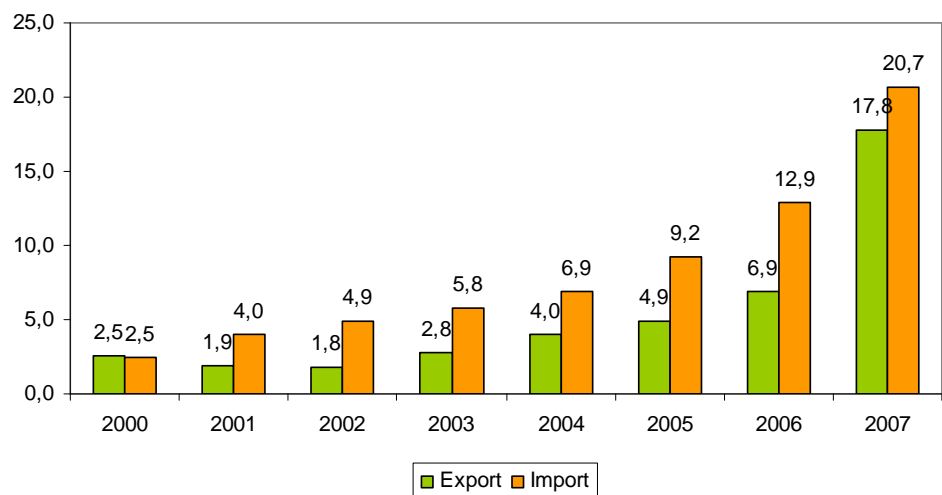


Figure 24: Foreign Trade of St. Petersburg in 2000 – 2007 (USD million)

Source: Site of Saint Petersburg Administration www.gov.spb.ru; Socio economic situation of Saint Petersburg and Leningrad region in January, 2008. (Oding N. et al., 2008 p. 65).

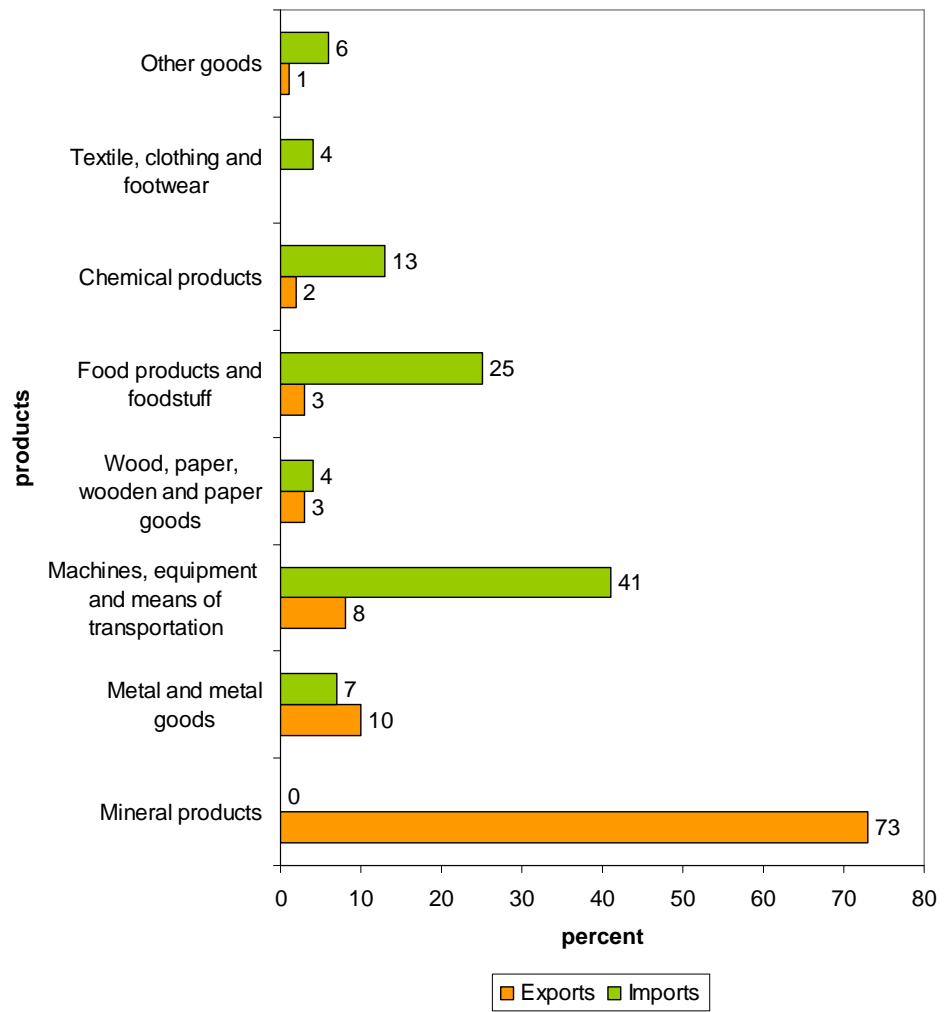


Figure 25: Goods structure from St. Petersburg in 2007

Source: Socioeconomic situation of Saint Petersburg and Leningrad region in January, 2008. Petrostat: 2008. (Oding N. et al., 2008 p. 72-73).

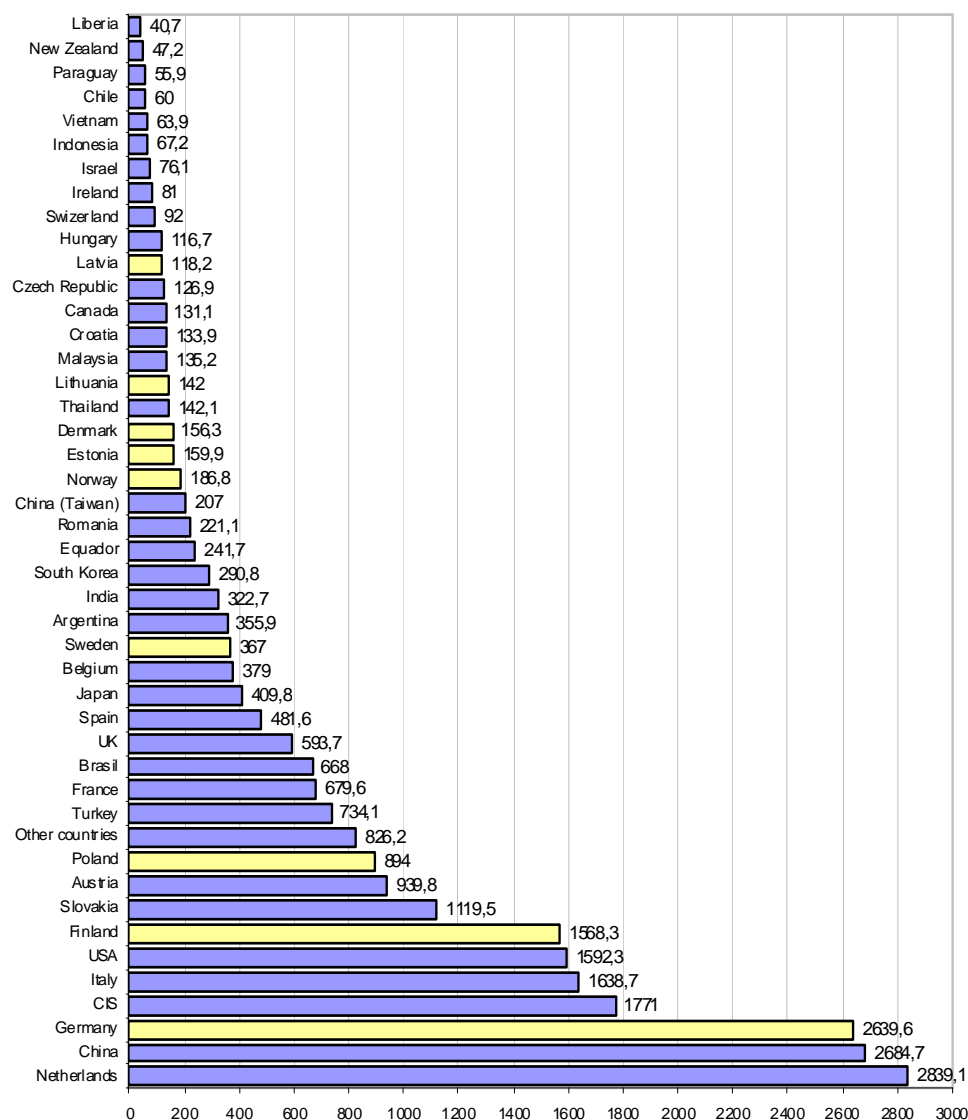


Figure 26: Foreign Trade Turnover of St. Petersburg in January- December 2007 (USD million)

Source: Socioeconomic situation of Saint Petersburg and Leningrad region in January, 2008 (Oding N. et al., 2008 p. 68).

The export/import structure varies between the BSR-trade partners. Thus, countries like Germany, Finland, Norway and Denmark are net exporters to St. Petersburg, whereas the former Soviet-bloc countries, Poland, Estonia, Latvia and Lithuania are net-importers. This pattern may be interpreted as BSR-integrative, since trade relations with eastern countries have been maintained while new trade relations with west-BSR neighbours have been established. The figures for exports and imports are shown in figure 27.

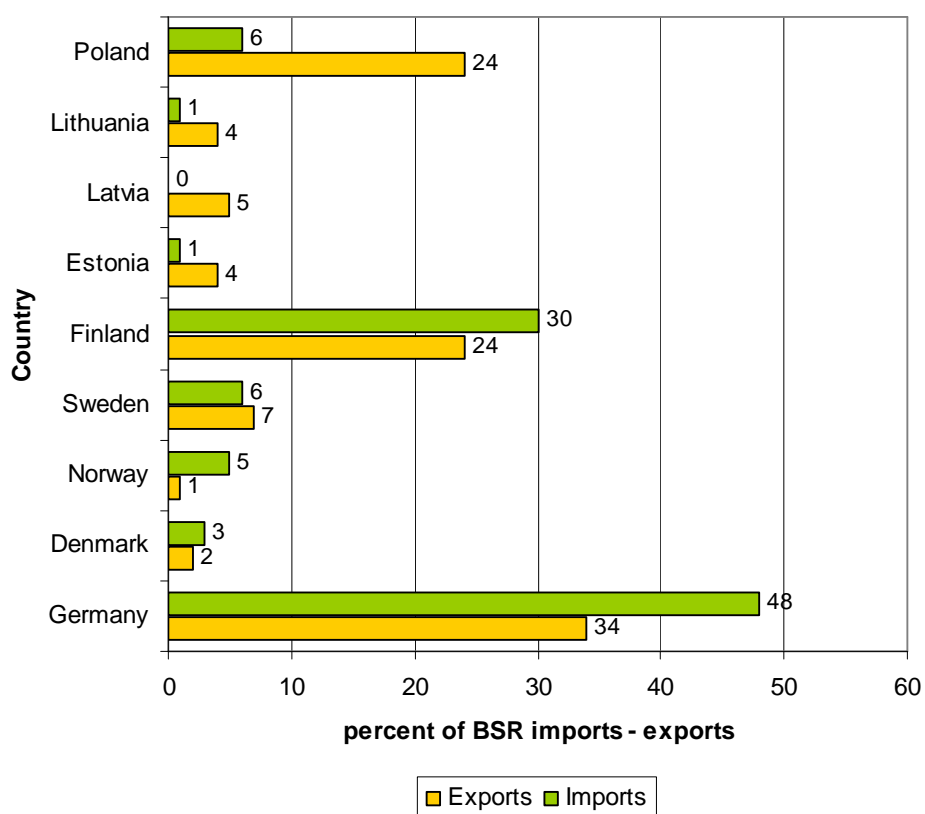


Figure 27: Import and export relations between St. Petersburg and BSR countries in 2007

Source: Socioeconomic situation of Saint Petersburg and Leningrad region in January, 2008 (Oding N. et al., 2008 p. 70-71).

Foreign investments in the economy

St. Petersburg and Leningrad Oblast have experienced a pronounced influx of FDI in recent years. Here we focus upon the direct investments. Although the direct investments represent only a minor share of all foreign investments (12 % in 2007 and 2008), including portfolio and trade and other credits, the foreign investments are of special interest as a driver of urban development, from social, economic as well as spatial perspectives.

From 2000 to 2007, foreign investments in St. Petersburg increased from about USD 100 million in 2000-2004 to USD 700 million in 2007. During this period, the origins of investments varied considerably, as shown in figure 28. The only BSR countries that can be considered major investors are Germany, Belarus, Finland and Sweden. The four countries represented 24%, 40% and 6% of incoming foreign investments in 2005, 2006 and 2007, respectively. Investments from other countries also varied, indicating that the ranking depends very much on the registration of large-scale investment projects.

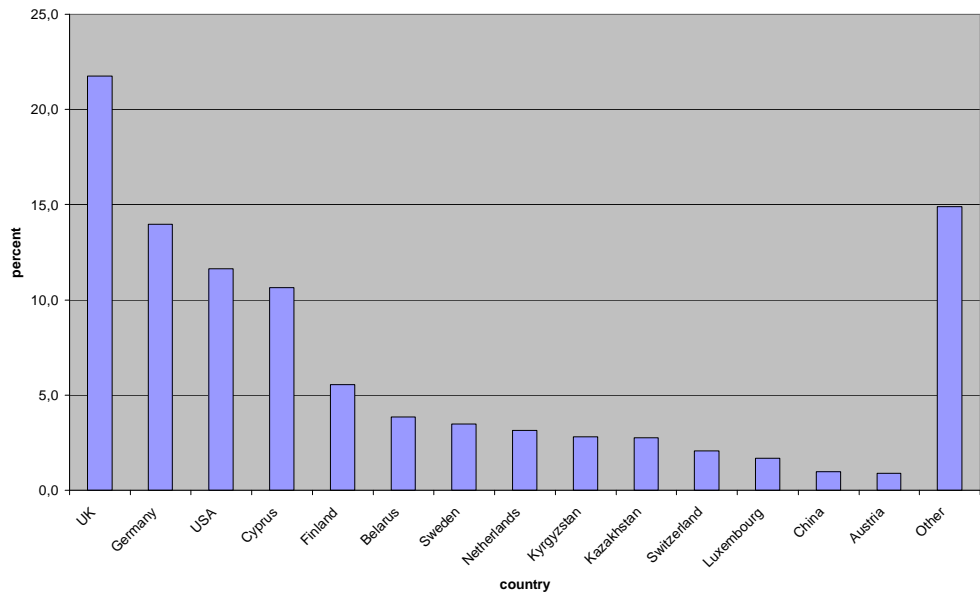


Figure 28: Major countries investing in St. Petersburg 2005-2007, yearly average.

Source: Socio-Economic Situation in St. Petersburg and Leningrad Oblast in January 2008 (Oding N. et al., 2008 p. 79-80).

Generally, companies involved in foreign direct investments are driven by the prospects of obtaining access to the huge Russian consumer market, rather than the cheaper Russian labour force or other factors of production. Thus, the new subsidiaries in St. Petersburg are producers of consumer goods, from automobiles to beverages. More recently, an automobile cluster has developed, including firms such as Toyota, Nissan, Suzuki, Hyundai, Ford and General Motors and producers of automobile components such as Acertec Holdings, Ltd. and Magna International Europe, AG. Other international companies with facilities in St. Petersburg are Bosch, Siemens, Knauf and Elcotec, Gillette, Henkel, Coca Cola and Wrigleys, cf. table 10. The investments are facilitated by Russian investments in transport and logistics, such as a recent agreement by the owners of the St. Petersburg Big Seaport on a development programme that will create new terminals for container and automobile cargoes and improve transport access to the port.

Two-thirds of the listed companies produce consumer goods (e.g. automobiles, beverages, tobacco, personal care and household items), whereas the remaining companies are subcontractors, or are in sectors of transport equipment, construction and infrastructure. The focus of these investments are obviously the Russian consumer market and next to it, the market for housing and infrastructure development. The list of companies does not indicate the presence of special clusters of international excellence. Only future investments will show whether St. Petersburg will succeed in building up the planned new high tech clusters and innovative technological centres, as mentioned above.

Table 10: Foreign direct investments by larger companies in St. Petersburg since 1994

Company	Branch	Country of origin	Year started
Nissan	Automobiles	Japan	2007
Suzuki	Automobiles	Japan	2007
Hyundai	Automobiles	Japan	2007
Foxcon	Electronics and computer components	Taiwan	2007
Magna Intern. Europe AG	Car parts	Canada	2006
General Motors	Automobile factory	USA	2006
Shanghai investment industrial company	Infrastructure project Development	China	2005
Bosch-Siemens	Domestic appliances	Germany	2005
Toyota	Automobiles	Japan	2005
Izora Pipe plant Uralmash-Izhora Group OMZ	Pipe products for gas and oil industry	Russia	2005
Alcan Packaging	Food / Tobac. packaging	USA	2005
Russian Standard	Alcohol drinks	Russia	2004
Knauf	Gypsum	Germany	2003
Smurfit Kappa Group	Cardboard	Ireland	2003
Merloni / Ariston	Water Heating equip.	Italy	2003
General Electric	Diesel Engines	USA	2003
Scania	Trucks	Sweden	2002
Ford Motor	Automobiles	USA	2002
Gillette	Domestics / Raser blades	USA	2000
Kraft Jacobs	Food / coffee	USA	2000
Wrigley	Food / chewing gum	USA	1999
International Paper	Paper Mill	USA	1999
Elcoteq SE	Domestic electronics	Finland	1997
Pepsi-cola	Beverages	USA	1996
Philip Morris	Tobacco	USA	1996
Lucent Technologies	Domestics / Tele equip.	France	1995
JTI / Japan Tobacco Intern.	Tobacco	Japan	1995
Coca Cola	Beverages	USA	1995
BAT / British Am. Tobacco	Tobacco	UK	1994
OTIS	Elevators	USA	1994
Henkel	Domestics / chemicals and personal care production	Germany	1993

Source: (Oding N. et al., 2008 p. 81-82)

In table 11, the companies are listed by the amount of USD investments and by three categories of origin, *global* (i.e. outside the BSR), the *BSR* or *Russia*. Most of the investment, USD 4,872 million, comes from global companies, whereas only USD 296 million are invested by BSR companies. Russian investments are in-between (USD 585 million) due to a large investment by Izora Pipe plant Uralmash-Izhora Group OMZ. Thirteen investments exceed the investment criteria (USD 120 million) of being a strategic investment. Measured by the number of companies, the 23 global companies far exceed the five BSR companies. Only one BSR investment satisfies the investment criteria of being strategic.

It is not surprising that the largest investors are global multinational companies situated outside the BSR. As mentioned earlier, the business development strategy of St. Petersburg accords priority to these large companies, and hence to global rather than BSR integration. Thus, only one of the 13 investments originating from the BSR was large enough to be considered 'strategic'.

Table 11: Foreign direct investments by larger companies in St. Petersburg since 1994 categorised by origin

Company	Year started	Investm. mln. USD	Global	BSR	RU
Shanghai inv. Ind. Comp.	2005	1500	1.500	0	0
Izora Pipe plant	2005	560	0	0	560
Ford Motor	2002	480	480	0	0
Japan Tobacco Internat.	1995	440	440	0	0
Hyundai	2007	400	400	0	0
Philip Morris	1996	330	330	0	0
General Motors	2006	300	300	0	0
International Paper	1999	250	250	0	0
Nissan	2007	200	200	0	0
Toyota	2005	150	150	0	0
Coca Cola	1995	150	150	0	0
British American Tobacco	1994	130	130	0	0
Elcoteq SE	1997	120	0	120	0
Suzuki	2007	115	115	0	0
Magna Int. Europe AG	2006	100	100	0	0
Knauf	2003	90	0	90	0
Wrigley	1999	70	70	0	0
Bosch-Siemens	2005	55	0	55	0
Foxcon Electronics	2007	50		0	0
Gillette	2000	45	45	0	0
Pepsi-cola	1996	45	45	0	0
Alcan Packaging	2005	35	35	0	0
Merloni / Ariston	2003	30	30	0	0
General Electric	2003	30	30	0	0
Smurfit Kappa Group	2003	25	25	0	0
Russian Standard	2004	25	0	0	25
Henkel	1993	23	0	23	0
OTIS	1994	18	18	0	0
Kraft Jacobs	2000	15	15	0	0
Lucent Technologies	1995	14	14	0	0
Scania	2002	7,5	0	8	0
		Mln USD	4.872	296	585
		Companies	23	5	2

Source: (Oding N. et al., 2008 p. 81-82)

The locations of some of the largest companies in St. Petersburg are shown in figure 29. The companies are situated all over the city, however, close to the boundaries and, hence, close to the new ring road, currently under construction.

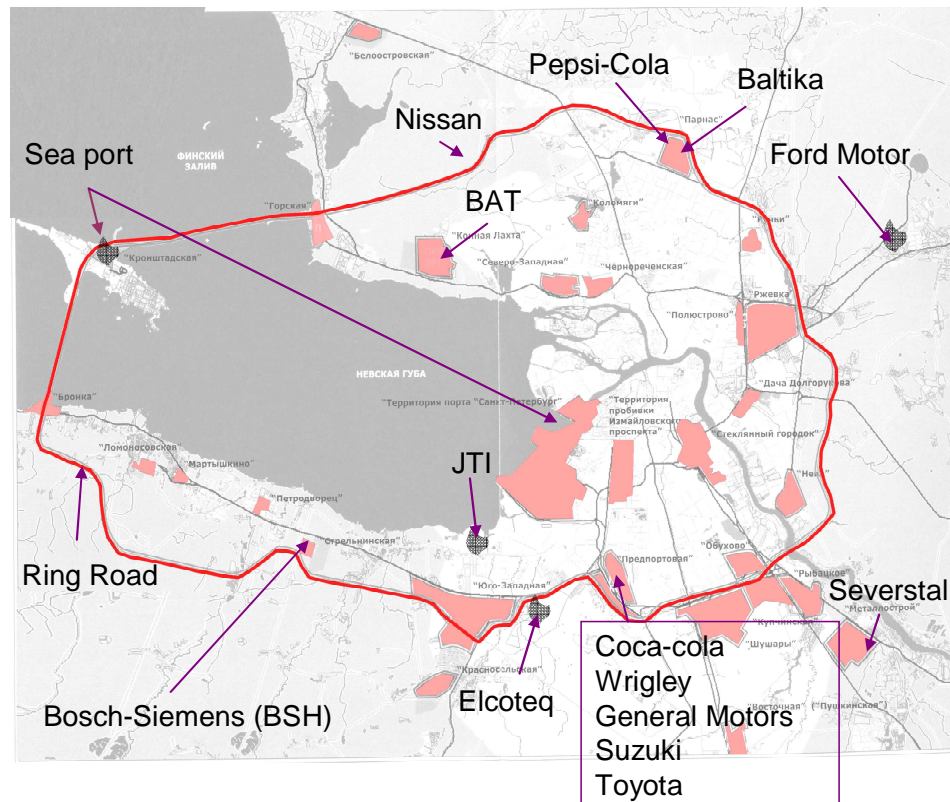


Figure 29: Key Industrial investments in St. Petersburg

Source: (Oding N. et al., 2008 p. 44)

The tendency for investing companies from the BSR to be smaller or medium-sized, is confirmed by the Danish experiences. Thus, interviews with Danish manufacturing companies revealed (cf. table 12) that there is more outsourcing from small companies (20-50 employed) tends to the new EU countries than from the larger manufacturing companies (> 50 employees), as the latter tend to focus on the old EU countries.

Table 12: Destinations for outsourcing activities from Danish Companies 2001 - 2006

Employed	Old EU countries	New EU countries	Other countries	All
20 - 50	17 %	43 %	40 %	100 %
> 50	23 %	28 %	49 %	100 %

Source: (Statbank, 2008b, OUT 7)

Common drivers of outsourcing of large as well as small companies within industry and business service are access to *lower factor costs*, access to *improved quality or introduction of new products*, *shortage of labour* and – especially within business services -- access to *specialised knowledge and technology*. Small companies within industry maintain a stronger focus on the core activities of the company than do the larger companies. Also small companies, especially within business services, are motivated by access to *new markets*, a motive accorded lower priority by larger companies. Larger companies are more driven by decisions taken by the *mother company* than smaller companies (Statbank, 2008a, OUT 10).

If the outsourcing behaviour of the smaller Danish companies is generally valid in the Baltic Sea Region, they should be given special attention in policies for urban development and regional integration in the BSR. Bottlenecks, e.g. border crossing, that might hamper the advantages of proximity to North Western Russia should be given attention, as should local business incentives. Thus, according to Russian experts, the priority given to large 'strategic' investors by the city of St. Petersburg tends to be accompanied by ignorance of smaller companies which in turn direct their activities toward locations in the hinterland of St. Petersburg, Leningrad Oblast or the city of Pskov.

FDI strategies of the companies

What are the motives of foreign companies to invest in Russia and St. Petersburg? Are they driven by cheaper labour, cheaper resources or other factors of production? Or – as supposed above -- are the companies driven by the prospects of gaining access to the huge Russian market?

In order to be informed by the motives and strategies of the companies, interviews were conducted with five managers of international companies established in St. Petersburg. The companies interviewed operated within these industries:

1. consultancy in the area of commercial and residential real estate;
2. fish processing;
3. tobacco production;
4. non-alcoholic beverages;
5. hygiene goods.

The interviews showed quite convincingly that the key purpose of foreign companies and investors to come to St. Petersburg is to gain access to the local but huge Russian market. The optional market-access by far outdoes another theoretically identified purpose, i.e. access to cheap labour and resources. The eventual exploration of external markets occupies only a secondary and much lower position.

For the local economy, a crucial question is whether the companies establish business relations with local suppliers. However, the interviews dealt only briefly with this topic.

The interviews also touch upon the fact that the Russian economy is in transition and that the Russian market is thus an 'emerging' market. Investing companies focus upon the local market potentials. They do not come to Russia and St. Petersburg to compete or innovate but to exploit the local market. Thus, when discussing options for integration of Russia in the BSR, one should keep in mind that foreign companies in the BSR are focused on Russia rather than the BSR as a region. Therefore, the foreign companies tend not to be BSR-integrative. This situation was revealed by the interviews.

The Baltic Region is considered by respondents as one of the sources of raw materials, equipment, to some extent as base for improvement of skills. We cannot say that respondents seriously consider the Baltic Region as a potential market for their products and services (products and services of other companies in Russia), not due to quality of products, which may be rather good, but due to perception of European market as already filled and divided. Under conditions of rapidly growing and non-explored internal market, both Russian and foreign companies are oriented firstly to the Russian market. There is interest of companies from the Baltic Region to Russian and St. Petersburg market, to cooperation with local companies' (Oding N. et al., 2008 p. 92).

Company No 2 (fish processing): "We are oriented to all Russian regions, not to foreign countries, to some extent to CIS countries. We are not oriented to Baltic States, as a sales market, and we do not have such plans. On Western markets there is nothing for us to do; we do not have competitive advantages there. And we did carry out evaluation of reasonableness of access to European market and came to a negative conclusion" (Oding N. et al., 2008 p. 88).

Company No 3 (tobacco): At first we were oriented to the Russian market, but nowadays we are exporting abroad, primarily to CIS countries, and also to other countries. Export is growing. We do not export to Baltic States, because our company also has factories there" (Oding N. et al., 2008 p. 88).

The interviews showed that the perception of problems and prospects of running a business in St. Petersburg and Russia in general coincides with the perception of Russian companies. All of them note problems with administrative barriers, corruption, inconsistent application of laws by state authorities and deficit of qualified labour force. At the same time, however, they talk of rapid growth of own sales, good prospects for development of business and the large capacity of the Russian market. Thus, the growing FDI in recent years indicates that the problems of running a business in the city or the country are compensated by high profits and income.

In comparison with other regions, the business climate and conditions for operating a business in St. Petersburg is no better than in a number of other Russian regions. Although respondents note that in some Russian regions business climate is not worse and may even be better than in St. Petersburg, their answers regarding different aspects of running of business, such as transport infrastructure, real estate, etc., show a certain degree of balance of benefits and disadvantages.

The respondents also commented upon attitudes and strategies of Russian companies. Generally, they perceive Russian companies as locally oriented, focusing upon the Russian market and not trying to be internationally competitive and hence innovative. Thus, most of the respondents agreed with the statement: 'Exploration of European markets does not seem realistic to Russian companies, because due to some reasons their products are not competitive on European markets.' This lack of interest in international trade and competition also means that Russian companies will not be the drivers of regional and economic integration in the BSR.

Kaliningrad Region – trade and FDI

The foreign trade turnover of the Kaliningrad Region was USD 8.2 billion in 2006, an increase of 32.4% compared to 2005. Imports consisted mainly to engineering production, manufactured goods and products of the chemical industry, while exports are largely raw material. Both imports and exports have increased, with a more rapid increase of exports; this accords with the desire to attract foreign investments. In the Kaliningrad Region, 3,215 companies have a foreign capital participation (6.8% of the total), mainly in wholesale and retail trade.

The investments are located mostly in the city of Kaliningrad (82% in 2006). In comparison with the Russian Federation (RF), the volume of foreign investments per capita in the Kaliningrad Region is four times lower than the Russian average. Investments come from 24 countries, the most active being the Netherlands, Lithuania and Switzerland, while the three countries with the greatest amount of foreign direct investments (FDI) were Lithuania, Poland and Great Britain. The increase of foreign capital coming from the Scandinavian countries is also worth mentioning. Even though FDI has increased since 1999, FDI in the Kaliningrad Region remains the lowest within the BSR.

According to (Liuhto K., 2006), the FDI stock per capita was USD 92 at the end of 2005. In Russia, the FDI stock per capita was USD 689 per capita the year before. However, the stock of FDI in Kaliningrad increased considerably (428%) during 2000-2004, far exceeding the growth of FDI in the other BSR countries. In Russia, the FDI stock increased 306% during the same period. Thus, it seems that the SEZ has had its intended effects.

In his discussion of Kaliningrad's industry, Usanov (2006) observes that due to the introduction of the SEZ, the industrial production in the enclave has developed into two independent sectors, an export-oriented sector characterised by raw materials and a low level of processing, and an import-oriented sector heavily dependent on imported raw materials and components directed towards the Russian domestic market. The import-oriented sector is characterised by relatively modern production equipment. Whether this import-sector could develop into an internationally competitive, BSR-integrative sector remains an open question. The sector competes mainly on the Russian domestic market rather than on international ones. According to (Fedorov G. et al., 2008), FDI in the Kaliningrad Region is mainly allocated to processing production (over 50% in 2006), followed by financial activity (26%). (Lapin F., 2006) observes that the 'increase of import is determined by the establishment of local enterprises dealing with automobile and household appliances assembling, manufacturing of ready-made fish and meat production and rapidly developing construction industry' (see table 13).

Table 13: Foreign direct investments in Kaliningrad by economic activity in 2006

	Received 1000 USD	In % to total
All	21.210,2	100,00
Processing productions	11.568,8	54,50
Financial activity	5.533,5	26,10
Wholesale and retail trade; repair of vehicles, motor cycles, home appliances and articles of the private use	2.261,8	10,70
Transport and communications	1.031,2	4,90
Operations with the real estate, a lease and grant of services	422,9	2,00
Granting of other communal, social and personal services	243,9	1,20
Construction activity	77,5	0,40
Agriculture, hunting, forestry management	6,5	0,03
Hotels and restaurants	3,9	0,02
Fishing and fish-breeding	-	-

Source: (Fedorov G. et al., 2008 p. 41)

Concerning the investments abroad from the Kaliningrad Region, the total amount reached USD 0.5 million in 2006, with almost 80% invested in Cyprus for both oil and gas extraction.

The main investing countries are listed in table 14 in descending order of direct investments in year is 2006. Of interest here is the close connection with Lithuania and Poland, a cooperation that also characterises cooperation on EU projects.

Table 14: Main investing countries in Kaliningrad 2006, thousands USD

	Total investments	%	.. of which direct Investments	%
All	80.814	100	21.210	100
<i>Including:</i>				
Lithuania	17.858	22	9.924	46,8
Poland	6.944	8,7	6.176	29,1
Great Britain	3.800	4,7	2.001	9,4
Channel Islands	1.040	1,3	900	4,2
Germany	1.969	2,4	715	3,4
Denmark	1.338	1,7	623	2,9
Other countries	4.126	5,2	466	2,2
Cyprus	9.090	11	213	1,0
USA	547	0,7	145	0,7
Netherlands	21.368	26	45	0,2
Switzerland	12.210	15	-	0,0
Virgin Islands (USA)	2	-	2	0,0
Estonia	522	0,6	0	0,0

Source: (Fedorov G. et al., 2008 p. 42)

Marketing strategy of the foreign companies

Interviews with European companies located in the Kaliningrad Region have been carried out in order to identify their reasons of investing in the region. The main advantages cited are low labour cost, the Special Economic Zone (SEZ) status, access to the Russian market and the absence of competitors in the Kaliningrad Region. Some opportunities were also pointed out, such as the development of the transport branch or the increase of land availability. Nonetheless, important weaknesses were also identified,

such as the administrative barriers and the lack of infrastructure for both transport and energy. The lack of highly skilled labour also places limitations on investing in the Kaliningrad Region.

With Kaliningrad Region being part of the BSR, companies locating there benefit not only from the Russian market but also from the BSR one, which gives a further advantage for companies to invest in the Kaliningrad Region.

Estimation of the conditions for business

Several criteria have been developed for the interview in order to obtain an overall picture of the conditions for business in the Kaliningrad Region. The average value is 5.4, with the maximum being 10. However, values are different from one respondent to the other, it can be easily seen that the transport and real estate conditions in the Kaliningrad Region are rather advantageous for investing within its territory, while administrative barriers still remain an important weakness. See the detailed results in table 15 below.

Table 15: An estimation of conditions for business in the Kaliningrad Region

Criterion	Respondents						Average value
	1	2	3	4	5	6	
Real estate	6	10	8	8	5	3	6,7
Transport;	7	9	9	5	7	2	6,5
Infrastructure	5	8	6	6	5	2	5,3
Land	4	7	8	8	5	0	5,3
Labour;	5	3	5	8	4	4	4,8
Administrative barriers.	4	0	8	3	6	1	3,7
Estimation of conditions for business	5,2	6,2	7,3	6,3	5,3	2	5,4

Source: (Fedorov G. et al., 2008 p. 45)

In short, investing in the Kaliningrad Region continues to be viewed as somewhat risky for foreign companies. Nonetheless, support from regional authorities to investors reduces this risk.

Potentials of economic integration

We have previously made a distinction between economic and institutional integration. Also, we observed that institutional political and cultural cooperation is nourished by proximity within the BSR, whereas economic cooperation tends to be global and displayed outside the region. Since this study has focused mainly upon the economic relations, we shall concentrate here upon the potentials for economic integration.

As we have seen, Russian industry has been characterised as oriented towards the domestic market and therefore uncompetitive internationally. Therefore, it is crucial to look for those sectors and industries most ripe for further innovative development. In this chapter, the most competitive industries are considered. In the next chapter, we focus upon technological innovation.

St. Petersburg - potentials for integration

One of the conclusions of this study is that economic integration of Russia within the BSR is formed by policies and economic drivers that deal primarily with the integration of Russia and St. Petersburg in the global economy. It is, thus, within this political and economic framework that Russian integration in the BSR takes place. The BSR is not the focus of Russian international relations. However, parts of the BSR, for historical reasons, have enjoyed important trade-relations with Russia and have become a gateway to the EU.

In this study, St. Petersburg and Kaliningrad are the only representatives of Russia. Worth recalling is the role which the two cities play vis-à-vis their Russian regional hinterlands, due to the fact that economic competitiveness is not restricted by the boundaries of St. Petersburg and Kaliningrad. From an administrative point of view, St. Petersburg and Kaliningrad belong to one of three Russian macro-regions endowed with gateways to the outside world: the Northwest Region, the Southern Region (Azov and Black Sea) and the Far East Region (see figure 30). As the centre of the North-West region, St. Petersburg and Kaliningrad are gateways to the most populated and economically strongest regions of the EU member states.



Figure 30: North-West Russia

Source: www.gov.karelia.ru

The economic position of St. Petersburg and Kaliningrad in the North West Region is indicated by figure 31, showing the total volume of shipped products within manufacturing industry.

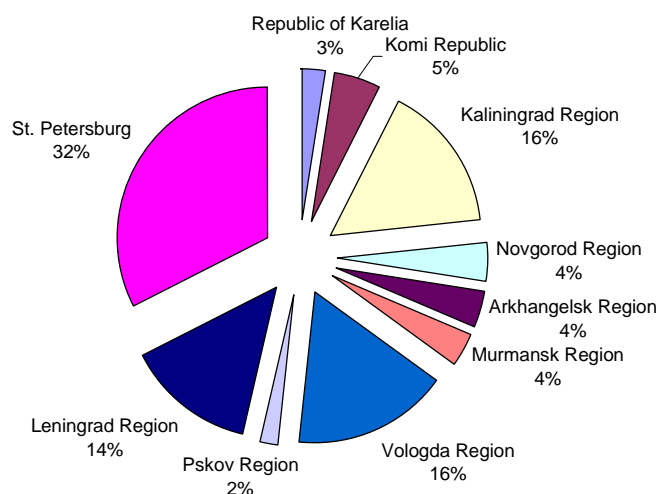


Figure 31: Specific weight of the Russian Federation constituents included into the North-West Federal District in total volume of shipped products by activity type "Manufacturing industry"

Source: (Oding N. et al., 2008 p. 114)

As shown in figure 31, the share of shipped manufactured goods from St. Petersburg is close to one-third of that of the Northwest region of the Russian Federation. The share of shipped manufactured goods from St. Petersburg and its two neighbours, the Leningrad Oblast and Kaliningrad Region, is 62% of that of the Northwest Region. Listed in table 15 are a number of promising sectors or branches of potential transnational clusters in the BSR and their relation to the NWRF.

Table 15: Promising sectors of transnational clusters in the BSR related with NWFR

Promising sectors or branches of transnational clusters in the BSR	Common projects established in the NWRF within these clusters, examples	Share of GRP
Metal and Metal processing	Bosch, Caterpillar, Toyota, Ford	n.a
Forestry and wood Processing		n.a.
Transport – logistics	Sea ports, terminals	34,6 %
Energy	Fortum, Northern Stream, The Baltic Pipeline System	Power plant: 4,1 %
Shipbuilding		2,9 %
Food industry	BBH, Kraft and Jakobs, Japan Tobacco, Phillip Morris, Rothmans	9 %
Information and Telecommunication	Sonera, Elcoteq, Nokia, Wacon	5,2 %
Instrument-making		2,3 %
Tourisme		2,6 %
Education		4,3 %

Source: (Oding N. et al., 2008 p. 117-118)

Three clusters in St. Petersburg deserve special attention as potential drivers of competitive industrial development: transport, automobile production and ICT.

Transport

Over the last decade, St. Petersburg has strengthened its role as a transportation centre. A significant share of Russian international trade passes through the city. Growth of internal transportation operations stimulates the economy and facilitates export- and import-dependent economic sectors. Thus, recently, several plans and projects have been elaborated: unified port space, embracing St. Petersburg and Leningrad region, has been arranged and a specialisation of ports is taking place: transport of bulk goods is directed to ports located within territory of Leningrad region, while St. Petersburg is starting to develop transportation of container cargos and passenger transportation (cruise). Within the territory of St. Petersburg, dock-side transport infrastructure is being constructed, including terminals, logistics depots and warehouses. The Pulkovo airport has been reconstructed, including the new terminal Pulkovo-3, and logistic functions are planned around airport zone. Work on reclamation of new territory in the western part of Vasilyevsky Island is taking place in order to facilitate the construction of a Marine Passenger Terminal. Finally, a high speed railway will be constructed for passenger and freight traffic with Moscow.

Besides the gateway functions located in St. Petersburg and Leningrad Oblast, one should recall that important gateways are situated in the three Baltic States, several of which are operated and owned partly or entirely by Russian transport companies.

Automobile cluster

As described earlier, FDI in St. Petersburg has greatly contributed to the arrival of several automobile producing companies in the city. The investments center primarily on automobile assembly. However, some suppliers of spare parts are also present, i.e. Magna International Inc. and Nokian Tyres plant in the Leningrad Region. The automobile cluster is still very young.

The concentration of carmakers will evolve into a cluster only if vertical integration can be established, including local supplier relations to the carmakers.

ICT

A third potential cluster, in ICT, was identified in 2002 by the Finnish institute ETLA (Oding N. et al., 2008 p. 119).

St. Petersburg is an important data transmitting hub for Russia (e.g. connecting to Finland) and one of the main offshore programming centres in Russia. The significance of North-West Russia in ICT is confirmed by investments

of international companies, e.g. SONERA (data transmission and the Megafon GSM project), ElCOTEQ (ICT equipment) and Motorola Company and Lucent Technologies (software development). Important Russian companies are, for example, Fort-Ross, Ltd. and Lynx.

At present, the North-West Russian ICT industry faces problems that can become serious obstacles for its future development. Indeed, the Russian IT industry is still young and not yet developed: It is characterized by an absence of transparency and lack of organization and competition. Also, a significant share of income by the Russian IT companies is earned by sales of foreign components rather than unique Russian products. The difficulties faced in attracting foreign investments may be compensated by cooperation, as when the two Russian companies, Exteria and EPAM Systems, in 2002, merged and became a leading developer of custom-made software within the territory of the former USSR. EMAP Systems was established in 1993. Its headquarters is located in Princeton, New Jersey (USA) and they have a development centre in Minsk with about 300 employees. Exteria, located in Moscow, was established in 1999.

Due to its geographic proximity to the Finnish ICT industry, the Russian ICT industry has the prospect of partnering with Finnish companies engaged in off-shore programming along with Estonian programmers. Also, telecommunication services are able to stimulate the development of production chains. The ETLA study suggests that if a large foreign company locates its branch in Estonia and its sales offices in Russia, demands for communication providers and operators and assembly of electronic equipment will grow along with demands for output of cable, metal and construction services.

Russian Investments in the Baltic Sea Region

Although the Baltic Sea Region is not a huge market for Russia, the region is of strategic importance for logistic and historical reasons. Major communication lines from Russia to the Western Europe pass through the Baltic Sea and the three Baltic States, hence making the region a strategic transit hub for international transport from Russia. In addition, due to the former close connections between the Soviet Union and the Baltic States, Russian capital is still present and active in the Baltics, and relations are greatly facilitated by the presence of a large Russian-speaking population.

The Baltic Sea Region is attractive for Russian investors due to its huge development potential. It is through this area that the path lies from Eurasia to Western Europe. Through the territory of the Baltic Countries go the major communication lines; they possess beneficial legal environment, transparent tax and labor legislation, predictable bureaucratic procedures and, importantly, the greatest number of Russian speaking specialists in the EU. Russian speaking specialists work mostly in the private sector in the enterprises oriented towards Russia. Russian investments into the economy of these countries could significantly widen the "Window to Europe" for Russia and become a bridge into Russia for the rest of the world (Oding N. et al., 2008 p. 122).

Russian investments in the Baltic countries are shown in table 17. The table shows that Russian investments continuously increase from 2000 to 2004

and then stabilize for three years. The largest share of investment goes to Germany, with Lithuania in a second position. Taking into consideration the different sizes of the national economies (measured by GNP in 2005) an index showing average investments per year per million USD GNP indicates that the major portion of Russian investments are flowing into Lithuania. At a much lower ranking, we find Latvia, Estonia, Germany, Denmark and Finland - and in a third rank - Sweden.

Table 17: Russian investments in the economy of the Baltic Countries

Country	GNP 2005 bln USD	Investments mln USD								Average invest. per year mln USD	Av. inv. per year per mln GNP 2005 index
		2000	2001	2002	2003	2004	2005	2006			
		Total	of them Direct Invest.								
Germany	2.852	393	544	863	1.341	1.858	3.109	3.037	137	1.592	0,56
Denmark	257	5	50	99	149	161	134	124	104	103	0,40
Latvia	16	15	-	0	-	1	59	5	-	11	0,73
Lithuania	24	3	302	295	1.223	1.316	2	22	-	452	18,75
Poland	271	6	14	15	17	19	25	37	-	19	0,07
Finland	196	2	13	4	6	73	153	110	10	52	0,26
Sweden	371	10	40	28	69	6	8	4	-	24	0,06
Estonia	12	2	1	-	6	10	20	12	0	7	0,60
All		436	964	1.304	2.811	3.444	3.510	3.351			

Source: Rosstat, 2007, (Oding N. et al., 2008 p. 122)

The strategic importance of transit routes and export of Russian energy and raw materials are revealed by the numerous projects involving Russian investments. The biggest investment project is the Nord Stream Pipeline across the Baltic Sea, from St. Petersburg to Germany, fig. 33. The investors are Russian *Gazprom*, the German firms *BASF/Wintershall* and *E.ON Ruhrgas* and the Dutch *N.V. Nederlandse Gasunie*.

Examples of important Russian investments in Estonia, Latvia and Lithuania are shown in table 18. Investments in Latvian and Lithuanian manufacturing industries are shown in the table. Most striking, however, are the numerous investments concentrated upon the transport and energy sectors. These investments reveal the role of Russia as the prime supplier of energy for the three Baltic states. The investments also reveal Russian stakes in Baltic sea ports, rails and pipelines to the seaports. Figure 33 shows the most important pipelines connected with the seaports.

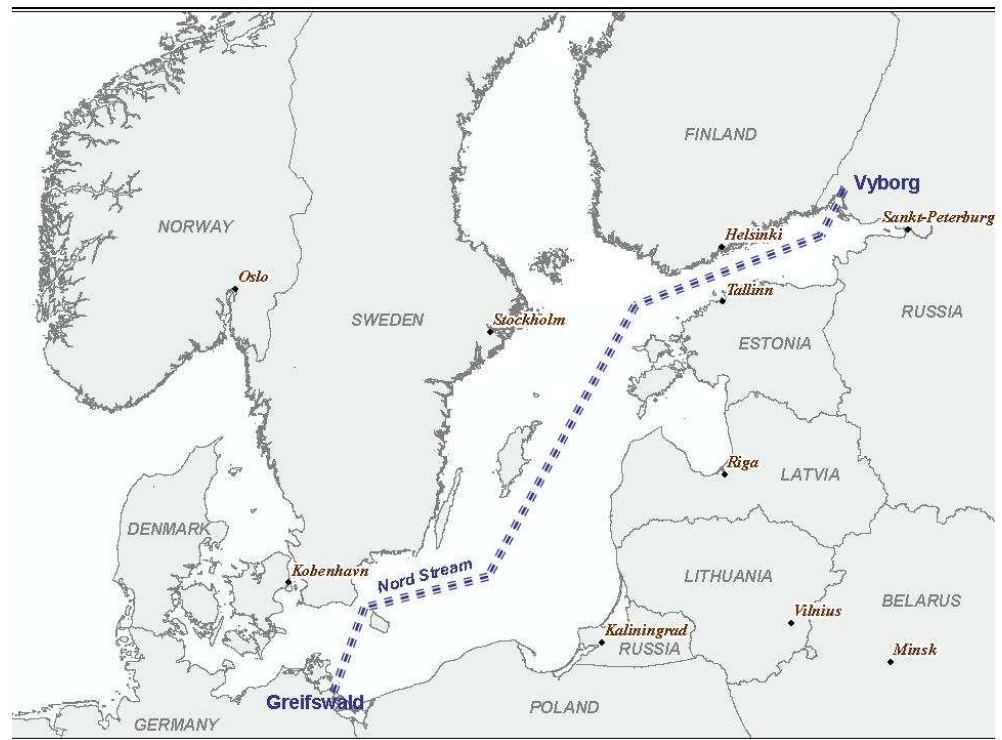


Figure 33: The Nord Stream pipeline for natural gas between Russia and Germany
 Source: (Wikipedia, 2008)

Russian investments in the seaports, rails and pipelines in Estonia, Latvia and Lithuania as gateways to western Europe reveals, so it seems, are examples of investments with pronounced spatial integrative effects. The energy context in the region, however, is rather complex, not least due to efforts of Russia as well as of the three Baltic states to eliminate unilateral monopolistic dependencies on access to seaports or energy supply. Thus, Russia decided shortly before the inauguration of the Butinge oil terminal, supplied by a branch of the Druzhba pipeline complex to build a new oil terminal on Russian territory situated in Primorsk in the Gulf of Finland, supplied by a new ‘Baltic’ pipeline. The strategy was explicitly intended to relocate Russian oil exports to national seaports. Since the Primorsk terminal started operating in 2002, much of the oil exports passing through the Baltic have been relocated to the new seaport. The state of oil export from major oil terminal in the BSR is shown in table 19. On their side, Estonia, Latvia and Lithuania have tried to establish alternative energy supplies. Examples are the Lithuanian preferences given to American and later Polish rather than Russian investors in the oil sector, the electric links established and planned to Finland, Sweden and Poland, and negotiations between Azerbaijan, Georgia, Ukraine, Poland and Lithuania on a new pipeline from the Black Sea to the Baltic Sea (Global Research, 2007).

Table 18: Russian investments and operations in the Baltic States

SECTOR	COUNTRY		
	Estonia	Latvia	Lithuania
Transportation and infrastructure	<i>Acron:</i> Baltic Chemical Terminal Sillamae port	<i>Lukoil:</i> Trade and traffic infrastructure	
	<i>Transoil:</i> Service railway operator Westgate Transport	<i>Transnefteprodukt:</i> LatRosTrans , oil pipeline from Russia to Ventspils	
	<i>Severstaltrans:</i> Spasecom railway operator	<i>Transstroy:</i> Construction of railway in Ventspils Sea port	
	<i>OTEKO:</i> Milstrand oil terminal Tallin		
	<i>Kuzbasrazrezugol and Transgrup:</i> ECT Coal terminal in Muuga Port, Tallinn		
Energy		<i>Gazprom and Itera:</i> Latvijas Gaze company	<i>Gazprom:</i> Kaunas Heat and Electricity Center
		<i>Lukoil:</i> Gas stations	<i>Gazprom:</i> Lietuvos dujos gas distribution company
			<i>Lukoil:</i> Lukoil-Baltija fuel company
			<i>Inter RAO UES:</i> Energijos Realizacijos Centras export of electricity
Manufacturing		<i>Severstal:</i> Largest centre of trade in metal waste	<i>Eurokhim:</i> Lifiosa Phosphorus fertilizers
		<i>Vladimirskiy Tractor Plant:</i> cooperation with Latvian Ferrus	<i>Mechel:</i> Nemunas metalware, Kaunas
		<i>Moscow's ZIL:</i> Trucks assembly in Jelgava with Ferrus	<i>GAZ:</i> Automasinu verslo centras in Rokiskis Assembly plant of Microbusses
		<i>EDS-Holding:</i> Electric Machine-making Plant (RER) Riga	
		<i>S.P.I Distilleries:</i> Jsc Latvijas Balzams , alcoholic beverages Riga	
Business development		<i>Severstal</i> Technopark in Riga	
Bank and finance		<i>Bank Moskvj:</i> Latvijas Biznesa Banka	
		<i>MDM-Bank:</i> Latvijas Tirdzniecibas Banka	
		<i>Konversbank:</i> Latvijas Krajbanka	<i>Konversbank:</i> Snoras Bank
ICT			<i>Euroset:</i> Techmarcet cell phone shops

Name of Russian companies (owner, shareholder) in Italic letters.

Source: (Oding N. et al., 2008 p. 123-125)

The development of the energy and infrastructure sectors reveals that spatial and regional integration is not a one-way process. Huge national interests are operating, and there are calls for ongoing reorientations and adjustments of former strategies which may lead to the disintegration of former relations and re-constitution of new ones, as shown in figure 34 below.



Figure 34: Pipelines bringing Russian Oil and Gas through the Baltic States for shipping in Tallin, Ventspils and Butinge harbours.

Source: (EIA, 2006)

Table 19 shows the size of the three seaports exporting Russian oil, only a few years after the new seaport in Primorsk was taken into operation in 2002. It goes without saying that Primorsk has developed as the largest crude oil seaport, hence enforcing the two remaining harbours to look for alternative sources of income.

Table 19: Major Baltic Seaport Oil Shipments

Terminal	Country	2005 Capacity bbl/d	2005 Flows bbl/d	Flows %
Ventspils	Latvia	360.000	143.000	40
Butinge	Lithuania	280.000	121.900	44
Primorsk	Russia	1.200.000	988.000	82

Source: (EIA, 2006)

Potentials of the Kaliningrad Region for international economic integration

The potential for economic international integration of the exclave of Kaliningrad is limited by the fact that production in the Kaliningrad Region is oriented largely towards the Russian market, especially for the food industry, domestic electronic appliances and furniture. However, customs and tax privileges introduced by the Special Economy Zone (SEZ) are supposed to increase the competitiveness of the Kaliningrad Region towards the European market. Exports remain limited; consequently, 70% of exports are mineral fuel, as mentioned earlier. Given this situation, it was relevant to ask experts to estimate potentials for developing economic sectors of the Kaliningrad Region into competitive sectors on the Russian market, the European one or both. The evaluation is shown in table 20.

Table 20. An expert estimate of potential competitiveness of the basic economic complexes of the Kaliningrad Region in a public division of labour in Russia, the countries of the Western Europe and the Baltic Sea Region.

EU and the BSR	Evaluation	Estimation of opportunities of existing complexes	Evaluation	Russia
Energy				
Can deliver electric power	+	Power industry with start up of thermal power station	-	Cannot compete
Can deliver oil	+	Fuel industry	+	Can act on the oil market
Mechanical engineering and metal working				
Can compete partly	++	Ship building	++	Can compete partly with St. P.
Surplus of capacities in Europe and the quality is higher	-	Ship repair	-	Cannot compete with St. P.
Surplus of capacities and higher quality	-	Transport mechanical engineering	+	Can compete in manufacture of cranes, wagons and assembly of cars
Bigger capacities and higher quality	-	Electronic industry	+	Can compete on assembly of import TVs
Surplus of port capacities in Baltic and EU	-	Port-industrial complex	++	Can partly compete to ports in Northwest or Russia
Can compete on cellulose, paper and furniture	+	Timber, wood manufacturing, pulp and paper industry	+	Can compete on manufacture of furniture, cellulose and paper
Can compete on separate kinds of fish-products and on canned fish	++	The food-processing industry, including fish and canned fish	+	Can compete on frozen fish and manufacture of canned food

Source: Ivchenko V.V. cif. (Fedorov G. et al., 2008)

The expert estimates of table 20 reveal special competitiveness within ship-building and food (fish) processing.

Some opportunities for territorial development have been identified in order to strengthen the economy of the Kaliningrad Region; they correspond to

the power complex (in case a co-generation plant is built in conjunction with a nuclear plant), the food industry and mechanical engineering as listed by the experts. Further, opportunities are identified within tourism and recreation, the amber sector as well as the transport-logistical complex thanks to several large projects.

Potentials of hi-tech industries

The necessity to improve innovative industries is dealt with in the 'Strategy of socio-economic development of the Kaliningrad region for the mid- and long-term perspective', according to which the shift towards the innovative economy in Poland and the Baltic states is a 'key challenges for the long-term development of the Kaliningrad Region. The resources which provided the economic recovery in Russia (raw materials, production facilities, infrastructure and cheap labour) can no longer ensure the sustainable economic growth. Labour and capital productivity are the key factors of economic competitiveness today and require the new resource portfolio, primarily the innovative technologies. This shift has to be accompanied by the integration of the Russian economy into the global system.' (Fedorov G. et al., 2008 p. 56). It is worth mentioning that the strategy specifically emphasises the dependence upon the two neighbouring countries, rather than just referring to globalisation. Once again, a pattern of sub-regional integration appears between Kaliningrad on the one hand and Lithuania and Poland on the other.

According to experts, the use of innovative potentials of the region will in the long run provide for the development of several sectors as hi-tech industries, establishment of techno-parks or small and medium innovative enterprises. Thus, it requires the involvement of all stakeholders from the different authority levels as well as researchers and enterprises. Some structures, such as the Foundation for Assistance to Small Innovative Enterprises (FASIE), assist these kinds of enterprises in establishing themselves within the entire Russian territory; however, most of the participants come from the academic sector, while the number of small enterprises receiving support is not great (Fedorov G. et al., 2008 p. 55). As mentioned earlier, the survey on personnel employed in the R&D sector, cf. figure 5, revealed that in the eastern BSR countries, R&D activities are dominated by university staff, whereas in the western BSR countries, it is private enterprises that take the lead in R&D. Therefore, we suggest that a key problem for Russian R&D is how to encourage private enterprises to take up R&D.

Regional integration through EU-projects

Cooperation with the EU is seen as a tool for organizational changes and, hence, for an administrative innovation process. Therefore, the Kaliningrad Region, as described earlier, is involved in many EU projects, such as the TACIS or Neighbourhoods Programme projects. On the BSR scale, many contacts have been established within its southern part, and especially with both Lithuania and Poland, thanks to the physical proximity as well as cross-bordering facilities.

Also worth mentioning is the fact that it is not only the city of Kaliningrad that is involved in EU projects; other municipalities of the Kaliningrad Region also take part in the cooperation projects with the EU.

Outsourcing activities

Outsourcing is seen as a tool for both integrating and strengthening the Kaliningrad Region position in a wider economy. Characteristics of the Kaliningrad Region, such as low-priced labour force and tax privileges for large investments and lower transportation costs compared to other regions in the Russian Federation, provides opportunities to increase outsourcing processes. As a consequence of EU companies setting up in the Kaliningrad Region, quality would increase owing to higher standards and labour qualification, enabling the Kaliningrad Region to become more competitive. Nonetheless, there is still a real need to alter the image of the Kaliningrad Region outside its border in order to be more attractive.

Innovations

In order to further evaluate the potentials for boosting the international competitiveness of the Russian technology, the two case studies provided estimates of the potential for future innovative development of the economy.

Technological innovation in St. Petersburg

Innovations are considered a key strategic issue of social and economic development in the Northwest Federal District of Russia (Oding N. et al., 2008 p. 127). However, comparative statistics on innovation in the Baltic Sea Region are not available. Comparative studies of innovative enterprises in the EU, the Community Innovation Studies, are being carried out regularly by EUROSTAT. In Russia, the Federal State Statistics Service (Rosstat) carries out studies on innovation. However, a common comparative statistic is not available. Therefore, we shall concentrate upon innovation politics and comments by experts on innovation.

The idea of innovation as a driver of economic development was acknowledged in the mid-1990s. Thus, in 1995 the first venture fund, Russian Technological Fund, was founded, followed up by the formation of 12 innovation and technological centres and other venture funds (Oding N. et al., 2008 p. 131). In 2005, Peterhof, hosting two campuses of St. Petersburg State University, was awarded the status of 'City of science' for the first time, together with six other Russian cities. The same year, the aforementioned Noidorf-Strelna and Novoorsky Park were awarded the status of special economic zones (SEZ). Nevertheless, the innovative sector of St. Petersburg and Russia is characterised by several drawbacks, some of which are the low level of demand for innovation, few innovative activities in the companies, inadequate or absent support of innovation and weak international integration.

The situation was commented by (Oding, 2007) when she notice that 'in order to close the development level gab between St. Petersburg and cities in leading EC countries, St. Petersburg has to ensure cardinal changes in its economy by significantly improving its efficiency based on innovations and expansive use of post-industrial technologies. So far, neither innovation activities, nor the use of the city's competitive advantages have produced any palpable results in the tourism, transit cargo shipment or science-intensive industry sectors.' The city has taken initiatives - such as the creation of IT-parks, a special engineering-implementation zone, a venture foundation and a business incubator for small programming, instruments-making and bio-technology businesses. However, until results are obtained 'the competitive power of St. Petersburg enterprises mostly relies on their comparatively low resource costs.'

In order to facilitate the development of new innovation clusters, the government of St. Petersburg initiated the 'Concept of Innovative Development of St. Petersburg' and the 'Complex Program of Actions for Realisation of Innovation Policy in St. Petersburg, 2008 – 2011'. The main problems faced are listed in these strategic documents, and a number of prioritised projects are listed. The four key projects are:

1. City of science
2. Special economic zone
3. IT-park
4. Regional venture fund.

The implementation of the projects has not yet been efficiently organised. To evaluate the innovation policies and the current situation of the innovative milieu, the Leontief Centre organised interviews with some innovative Russian companies.

Innovative potential and Innovative practice

Eleven in-depth interviews were conducted with owners and chief executives of innovative companies. Respondents came from following branches: software, biochemistry, microelectronics, optical equipment, radiological equipment and radiometric equipment.

Generally, the respondents consider the following industries as knowledge-intensive:

- Digital communication technologies and communications;
- Biotechnologies;
- Microelectronics, laser equipment, nano-technologies;
- Space engineering;
- Atomic and hydrogen energetic and alternative energy sources.

The volume of these industries in the economy of the Russian Federation and St. Petersburg, however, remains small, and the innovative level is not fully developed: 'Russian companies are significantly behind in digital and communication technologies; production of equipment for communications; biotechnologies; microelectronics, production of alternative energy sources. This technology gap began to reveal itself in the middle of 1970s. In these directions, Russia will hardly be able to catch up with leaders in the nearest

future' (Oding N. et al., 2008 p. 140). The most promising perspectives of Russian companies are within space and laser engineering, and to some extent in nano-technologies.

During the interviews, it was stressed that companies within instruments, microelectronics, software, automation and biotechnology are lagging seriously behind international standards. In this situation, Russian companies respond by various strategies.

Companies operate mainly on local Russian markets. 'In Russia, you can still live well delivering cheap products of moderate quality' (Oding N. et al., 2008p. 146). This strategy, however, does not promote innovation.

Within electronics, production for the military is very profitable due to rapid increases of the market. However, the production is only as subcontractors, since the market is mainly closed. 'But quality and especially production costs make products of such companies uncompetitive on the market. For example, the GLONAX positioning system, developed on order of the RF Ministry of Defence, is significantly poorer in quality than its American analogue; it is rather bulky and consumes more power. It will not be able to compete on the commercial market. When state order is over, these types of production will disappear as at the end of 1980s – early 1990s.' (Oding N. et al., 2008 p. 142).

Some companies focus on specific markets which are not of interest to large foreign companies, hence avoiding the competition. Within software, Russian companies deal mainly with adaptation and promotion of products of foreign companies.

Within the production of automation systems, Russian companies purchase cheaper, Russian systems although they may be of lower quality. Only when efficiency is crucial do Russian companies prefer imported systems. The situation for software platforms is that they are largely autonomous from the global market. Russian platforms are not exported, and foreign platforms are not imported to the RF (Oding N. et al., 2008 p. 144).

Another strategy involves *assembly of own products based entirely or partly on foreign components* and then selling the finished product on domestic markets. 'We do not produce competitive integrated circuits. Our companies mainly produces plates and mounts foreign components in them.' (Oding N. et al., 2008 p. 142).

A shortcut within design and construction of new products was mentioned by a representative from the electronics industry:

Our companies offer *reverse engineering*. Reverse engineering is analysis of an instrument in order to understand its operational principle and in turn to produce instruments with similar functions without strictly copying the instruments (Oding N. et al., 2008 p. 142).

Generally, the milieu for innovation is undeveloped and trapped in short-sighted policies focusing on how to avoid entrance on the competitive international market. According to the eleven entrepreneurs and managers interviewed, the key problems are institutional rather economic. Thus, they do not ask for funding but for improved institutional settings. First and foremost, this includes guarantees of ownership and intellectual rights, quality and judicial system.

We used to think that offshore programming would solve out problems. India with its billiard turnover in this business was taken as example. Nevertheless, for this purpose *we don't have normal institutional environment*' (emphasis added) (Oding N. et al., 2008 p. 143)

In brief, the key problems identified by the respondents are lack of institutional milieu, low quality of the product and isolation from international markets. Finally, they mention low standard of education, motivation and lack of team spirit of the workforce.

Concerning the innovation policies conducted by the authorities, the respondents are not impressed by the industrial parks and business incubators planned for the Special Economic Zones. They 'are the business for bureaucracy' (Oding N. et al., 2008 p. 149). Rather, the respondent prefers the following measures for innovative development conducted by the city and the federal government:

- The development of an accountable and uncorrupted bureaucracy ('for this purpose we need real political competition');
- An independent judicial system ('nowadays courts are conductors of administrative solutions or, when they do not make it – commercial enterprises');
- Clear protection of private ownership rights, including intellectual property rights;
- An independent system of scientific assessment;
- Independent governmental and private funds, endowments uncontrollable by the state.

A common focus of these recommendations is institutional change rather than economic assistance. Thus, what is needed for technological innovation is institutional innovation.

Innovation in the Kaliningrad Region

Plans and programs to develop innovative type of economy in the Kaliningrad Region

Due to a certain lack of natural resources throughout its territory, the Kaliningrad Region cannot be competitive vis-à-vis the Russian and the international markets in this field, but, rather, by developing innovation. However, a new shift towards the innovative economy can be identified in 2007 via the Strategy of Socio-economic Development of the Kaliningrad Region for the Mid- and Long-term perspective. This shift is oriented mainly towards Poland and the Baltic States and can therefore be seen as a means of integrating the Russian economy into the European (or BSR) one. Technological modernisation has been identified as the most relevant sector for developing innovative process in Kaliningrad Region, the goal being to become the logistics and distribution centre for the Baltic macro-region. Another option can be the development of hospitality infrastructure technologies (spa, congress tourism and business cooperation support). Three perspectives have been developed (short-, mid- and long-term) in order to identify the main issues during these three periods. As an example, the short-term perspective (2007-2008) aims at improving the system of professional education as well as continuing the conversion of large military industrial enterprises; the long term perspective (2011-2015) aims at creating favourable conditions for the development of science and research.

Innovative practice and innovative potential

Potentials for the Kaliningrad Region can be found within the areas of technology transfer, education, research and health care, mainly in cooperation with universities as well as some R&D centres and medical services. Furthermore, the SEZ status may help to encourage its innovative development by creating favourable tax conditions for large investments. The SEZ status is even more strategic for the Kaliningrad Region's innovative potential since 2006, due to its new focus towards both tourism and recreation sectors. Meanwhile, the SEZ status also limits innovation development; in fact, SEZ is dedicated only to large investments so that small and medium innovative enterprises cannot benefit from it (Brezinski H., 2007). However, several factors have been identified that limit innovative development in the Kaliningrad Region. For example, municipal and regional authorities are not always aware of the benefits to be gained from innovative development. In addition, municipalities and the region of Kaliningrad do not have a sufficient budget for supporting innovative projects on their territories. Finally, the lack of innovative infrastructures for its effective development also place limits on the innovative potential for the Kaliningrad Region. Finally, it has been acknowledged that universities correspond to the main actor for integration, innovation and economic development of the Kaliningrad Region within the BSR as well as on a more global scale.

Conclusion and recommendations

In this final chapter, we summarise what we learned about regional integration and what kind of initiatives we would recommend for further consideration.

Generally, it should be recognised that the economic growth in Russia has pronounced effects on the role and position of Russia in global as well as BSR settings. Globally, Russia is still characterised as an ‘emerging’ market. However, trade and investments attracted by this status are likely to change emerging markets into mature – and competitive -- markets.

Along with successful development in the global economy, Russian gateways and Russian infrastructure in the BSR will probably develop to meet the needs of efficient global trade. The development of the Baltic Pipe Line and new Seaports on Russian territory to compensate for the dependence on foreign gateways in the Baltic States is just one example, indicating that global integration might cause BSR disintegration. Thus, along with Russia increasing its role as a global player, the position of Russia in the BSR will change.

Structural changes will also take place. Accordingly, it is important not just to speak about integration of Russia into the BSR. It is equally important to consider how the BSR can benefit from cooperation with Russia, as Russia evolves into a strong global player. The idea of Russia paving its own way into the future was emphasised by the business entrepreneurs and managers who we interviewed. They insisted that Russia is not Europe, that Russia has to develop on its own unique path.

The study has generated only a limited set of operational recommendations with tools for development. Most recommendations address the problems identified by the study.

In five headings, we shall comment on those aspects relevant to regional integration.

Spatial integration

Pan-Baltic and sub-Baltic working in concert

Observation: The development of the Baltic Sea Region originates from overlapping sub-regional co-operation arrangements in different economic, demographic, cultural or political spheres. A few examples: The increase of annual turnover in the BSR harbours is concentrated within the eastern located harbours, energy links are being established between the three Baltic States, Finland and Poland, and bilateral trade connections are established between Russia and Finland, between Russia and Lithuania and between Russia and Germany. In the case of Kaliningrad, close relations with

Lithuania and the northern-most regions of Poland have developed within EU projects. Also, the strategy for innovative development in Kaliningrad relates to the dependency on and cooperation with the two neighbours.

R1: At the strategic and operational level of the long term development perspective of the Baltic Sea Region, it is recommended that consideration be given to the question of how the dynamics of current and future sub-BSR developments can contribute to the overall pan-Baltic development.

Institutional means

Observation. It has been observed that institutional relations as distinguished from economic relations are often profiting from geographical proximity at a variety of territorial scales. Examples are cross-border cooperation based upon local mutual interests or facilitated by co-operation programs such as the Interreg and Tacis programmes. Other examples are about cultural cooperation on events that need larger audiences than situated in the hinterland of individual cities or municipalities. Yet other examples are strategic cooperation between agencies and institutions of mutual interests, e.g. universities. The rich number of institutional co-operations is most probably an asset for further BSR integration.

R2: We recommend that the rich number of institutional co-operations on local as well as topical issues in the BSR should be addressed in order to identify territories endowed with strong institutional potentials for developing synergies on spatial integration as well as to identify territories in need for institutional co-operation on joint development issues. As examples we mention the possibilities of creating new Euroregions, the encouragement of Russian participation in EU programs involving Russia (especially INTERREG), taking into account that Russia co-finances these programs. Russian regions should participate more actively in the elaboration of priorities and selection of the proposed projects.

Observation: Usually, public and semi-public authorities and institutions are the most important participants in trans-border cooperation. Considering the importance of the private business sector in formation of regional clusters, unused potentials may be ripe for developing across borders.

R3: Efforts should be made to evolve trans-border cooperation in the direction of industrial cooperation e.g. through the use of subcontracting and establishing regional clusters as territorial zones of innovations, involving contacts and cooperation of research and technological nature. One example is to encourage industrial cooperation in connection with the organization of the special economic zone «Neudorf» in St.Petersburg. To develop such cooperation, information on the research and scientific potential of Russia's North-West and the innovation strategy of St. Petersburg should be made available to Russia's neighbours in the Baltic Sea Region. Another example is the development of the tripolar socio-economic system including Polish Tri-city (Gdansk-Gdyna-Sopot), Lithuanian Klaipeda and Kaliningrad. In

this system the cooperation is economically feasible in shipbuilding, oil refinery, TV sets and home appliances production, furniture making, fishery and amberprocessing. Also, coordination of transit automobile and railway flows through regional seaports and airports is of interest and so is the joint development of the largest touristic area on the Baltic using the sea cost potential as well as the historic heritage of the region. (see also R8 & R9).

World City co-operation?

Observation. The national planning document for St. Petersburg includes three strategic focuses, one of which is to develop St. Petersburg as a ‘world city’. Both the St. Petersburg and the Federal governments aim to integrate St. Petersburg into the world economy and to develop St. Petersburg as a place for summits, conferences, forums and nation-wide federal institutions, and – finally – to enhance the city’s position as a cultural capital of Russia and a leading European Centre of international tourism.

R4: Considering the huge potential of St. Petersburg, spin-offs in the BSR-hinterland must be considered. Thus, one might ask whether the strategy of St. Petersburg should be made a common target of the BSR.

East-BSR MEGA cooperation

Observation: The comparative study on MEGAs in the BSR reveals that in some sectors, Eastern BSR MEGAs show different characteristics as compared to Western BSR MEGAs. Often, these characteristics are considered as measures of lagging behind. However, they might also offer opportunities to the Eastern MEGAs to jointly form development strategies, based upon these characteristics; hence, not just to ‘catch-up’ with Western BSR MEGAs. As an example, compared to the western MEGAs, the universities in eastern MEGAs are more involved in research and development, which in turn might form an option for strategic co-operation between universities on R&D programmes.

R5: It is recommended that Eastern BSR MEGAs form strategic networks aimed at developing those urban functions essential to sustaining important characteristics of Eastern BSR MEGAs, as well as to develop new functions in sectors where it is deemed important to catch up with Western MEGAs.

Proximity potentials

Observation: The study of the development of intra-industry trade revealed a slow but steady increase of integrative trade in the BSR since 1988. It was further recognised that this integrative BSR trade-pattern is facilitated by geographical proximity that might be further enhanced by improvement of the physical as well as institutional infrastructure. From the two Russian case-studies, we know that the existing physical infrastructure could be used much more effectively to address administrative bottlenecks, improve control and reduce corruption.

R6: In order to further enhance economic integration in the Baltic Sea Region, improvements in infrastructure and removal of bottlenecks should be addressed. Actions should be taken to enhance the full capacities of roads, rails and border crossings by removing bottlenecks of administration that impede the proper use of the transport infrastructure.

Social cohesion

Baltic conference on demographic problems?

Observation: Low birth rates and migration to the largest cities are common demographic trends in all of the BSR countries. These trends tend to undermine social and spatial cohesion, since the movement of young people to the cities in the metropolitan regions leaves other regions and rural areas with a large proportion of elderly people and growing needs for social care.

Imbalances between countries in the BSR occurs due e.g. to higher birth rates in the Nordic countries and to emigration of labour from some countries.

The demographic problems are controversial national political issues. However, at BSR level they become more visible.

R7: In order to highlight the imbalances of demographic problems in the BSR countries it is recommended to establish a BSR dialogue on demographic trends and policies in order to cope with polarisation between metropolitan regions and other regions, migration trends, service provision and the development of labour markets.

Foreign Direct Investments

FDI cooperation with BSR banks?

Observation: The mapping of banks in the BSR shows that non-domestic banks from other countries in the BSR are well represented in most of the cities observed. Thus, a well-integrated network of business services able to offer transparent and reliable advice and information to BSR companies investing in another BSR country seems to be in place. The question remains as to whether unused potentials for active advice to companies considering outsourcing within the BSR are available.

R8: In order to fully profit upon the established BSR network of banks, it is recommended that consideration be given to developing a network of non-domestic BSR banks in order to further enhance targeted reliable and transparent information on outsourcing and foreign investments in the BSR.

Innovation and competitiveness

Institutional framework for innovation

Observation. Innovation is a key goal to the future development of St. Petersburg. Many initiatives are taken by the city. It seems however that plans and projects of the city and government are not fully appreciated by business leaders. They ask for institutional changes rather than IT parks and economic incentives. The key problems identified by the entrepreneurs and corporate managers are lack of institutional milieu, low quality of the product and isolation from the other countries.

R9. Following the recommendations by the entrepreneurs and corporate managers, Russian authorities should consider to complement current business policies by improvements of the institutional framework for business activities.

Need to improve frameworks and incentives for the quality and export of Russian products

Observation: Statistics and interviews with business entrepreneurs and managers indicate that the quality of Russian goods lags behind the standards of goods and products from the United States and Western Europe. Rather than trying to improve the quality of their products, Russian companies are tempted by their favourable access to the huge Russian domestic market and do not have the incentive to follow the most innovative business strategies. For their part, the cheaper, Russian products are widely accepted. Russian companies are thus tempted to remain internationally non-competitive. When special standards are required, Russian and Western products often develop each of their market shares. Since Russian official economic strategies call for the development of competitive production, changes are needed.

R10: It is beyond the framework of this project to address the problems with any specific recommendations. However, we recommend that consideration be given to providing incentives to introduce Russian products on the international markets.

Potentials for competitiveness (ICT cluster)

Observation: In search for competitiveness, potentials for the development of an ICT cluster in Northwest Russia – Finland – Estonia has been identified. If the cluster potentials are strong, the development of the cluster would contribute to sub-regional integration in the BSR.

R11: The ICT cluster potentials in Northwest Russia – Finland – Estonia, including Latvia, should be confirmed. If potentials are ripe and mutual interests are expressed by the ICT sector in Russia, Finland, Estonia and Latvia, the cluster should be given special attention as a priority of the VASAB Long Term Perspective.

Potentials for competitiveness (Automobile cluster)

Observation: A concentration of automobile assembly has recently developed in St. Petersburg, leaving an opportunity to develop a new industrial cluster in the city for the benefit of local as well as BSR subcontractors. There is a challenge for local producers to cooperate with transnational companies. Thus, to fully benefit from the integrative potentials of an automobile cluster, links to sub-contractors in the St. Petersburg region and the BSR are needed.

R12: The potentials for developing an automobile-related cluster should be considered, with emphasis placed on developing BSR-based networks of subcontractors and suppliers.

Potentials for innovation (university research)

Observation: Interviews focusing on innovative capacity and practice reveal that technological innovation in Russian companies lags behind Western Europe. However, Russian universities show sizable budgets for research and development at Russian universities. Thus, it seems as if Russian research and development activities are not being fed into technological innovation and new products. The study is only indicative. However, it is relevant to address the question of establishing 'food chains' from universities to business life.

R13: In order to improve the spin-off effects of Russian research and development at Russian universities, it is recommended that consideration be given to establishing 'food chains' for transferring technological and product innovation and design to Russian industry and business.

R14: In order to further develop the innovative potentials of university research, collaborative university research in the Baltic Sea Region should be promoted.

Potentials for innovation (beyond university research)

R15: In order to extend Russian research and development activities beyond the universities, it is important to support scientific communications. An alternative scientific information space must be formed which could include improved access to scientific journals supported by governments and municipalities, as well as specialized communication mechanisms based on modern network principles.

R16: It is further recommended to consider how to facilitate the dissemination of knowledge and technology transfer, as well as specialist training. Teaching Russian specialists English-language skills is important, as it will facilitate increased mobility of skilled labour and promote cooperation in the sphere of research and development.

Potentials for innovation (technology parks)

Observation: The development of innovation and technology parks is a key tool for cities dealing with business development. Usually, technology parks host incubators, innovative companies and knowledge centres. A huge potential may exist to develop innovative networks between companies located in the technology parks.

R17: It is recommended that consideration be given to organising networking between BSR-located technology parks in order to facilitate innovation networks in the Baltic Sea Region.

Further potentials for cross-border cluster initiatives?

Observation: The above-mentioned listing of potentials for establishing cross-border clusters between Russia and its BSR neighbours have concentrated on the potentials the St. Petersburg region. Potentials for developing further cross-border clusters might exist if other regions of Northwest Russia are considered.

R18: It is recommended that a cross-border cluster-based innovation dialogue be initiated between the BSR border regions of Northwest Russia and the regions of Murmansk, Karelia, Leningrad Oblast, Novgorod and Pskov in order to map cross-border potentials and facilitate knowledge and technology transfer across the border.

Territorial cohesion

Unused potentials of small and medium sized FDI?

Observation. Currently, FDI in St. Petersburg is greatly influenced by large transnational companies, most of which are from outside the BSR. Further, large investments (i.e. > USD 120 million) are categorised as ‘strategic’ and encouraged by tax and custom incentives. It follows that investments by small enterprises are made less attractive, which might be contradictory to the goals of BSR integration. Thus, experiences from Denmark indicate that outsourcing and foreign investments by small companies are more oriented to countries nearby (i.e., BSR countries) than those of larger companies. Investment patterns in St. Petersburg confirm that BSR investors are likely to be too small to meet the criteria for strategic investors. It is possible that BSR-integrative FDIs in St. Petersburg, despite being smaller, are neglected as compared to the large ‘strategic’ investments integrating Russia into the global economy. Thus, unused potential for BSR integration might be available.

R19: The effects of smaller and medium-sized investments on regional integration in the BSR should be considered as investments by SMEs are more

likely to focus on regional rather than global outsourcing. If unused potentials for regional integration are available, targeted instruments for facilitating small and medium-sized FDI should be considered, including economic incentives similar to those offered to larger, strategic investors.

Unused potentials of small and medium sized cities?

Observation: The polarisation between metropolitan regions and other regions calls for policies oriented to the role and potentials of small and medium-sized cities. This is especially due to the observation that national innovation programmes in the BSR do not include the small and medium-sized cities, focused as they are upon improving international competitiveness at national level.

Small and medium-sized cities are often well-integrated into national and international networks. This is exemplified by the observation that cities hosting international fairs include several second-order cities. Other functions, such as those provided by universities (especially newly established universities) are often located in second-order cities.

R20: The role and potentials of second-order cities as hosts for international functions and networking in the BSR should be considered.

Networking among SMESTOs on out- and insourcing?

Observation: A pronounced economic concentration has been observed in the BSR. From the USUN study, we know that the economic concentration includes foreign direct investments. Worth mentioning is that FDI in the retail sector is likely to become more decentralised due to the logic of being present in local markets. Initiatives have been taken to limit the concentration of FDI in the Metropolitan areas. One such example is the *Baltic Sea Solutions* established by 9 SMESTOs in Denmark, Poland, Russia, Germany, Estonia, Latvia and Sweden. The BASS tried to meet the request by companies for reliable and transparent information.

R21: Based upon experiences and ideas within business policy, it should be considered whether transnational BSR-networking between local business agencies could facilitate targeted spatial localisation of foreign direct investments, especially in SMESTOs outside the metropolitan areas.

Rural-Urban relations

Observation: Current economic and demographic development in Northwest Russia has led to considerable economic growth in the metropolitan and large cities such as St. Petersburg and Kaliningrad and their surrounding areas (parts of Leningrad and Kaliningrad Oblast). At the same time, especially the rural areas remote from main growth centres have experienced economic and population decline. As a consequence, disparities between urban and rural areas in Northwest Russia have increased, and many remote areas are in danger of remaining economically, socially and culturally underdeveloped.

The issue is threefold:

Development of urban-suburban cooperation. The development inside the metropolitan areas and agglomerations, i.e. between big cities and their surrounding areas, needs to be accompanied, managed and planned in a proper way in order to avoid major conflicts and uncontrolled growth of cities into the suburban zones, especially at the expense of nature areas and less-favoured settlements.

Development of rural areas. Rural areas more remote from growth centres need to be supported through development alternatives within and especially outside agriculture, diversification of functions and flexible solutions to basic social services adjusted to low population density.

Development of urban-rural cooperation and partnership in a larger context. In order to help rural areas make better use of development advantages in the large cities, there is a need for concepts and practical solutions on urban-rural partnerships to be developed, tested and implemented; these solutions should be adapted to the specific territorial conditions of North-West Russia.

R22a: The reform of local self-government should be continued and further adapted to the urban-suburban context, through more consistent application of the principles of subsidiarity (e.g. on issues to be solved at the regional level versus those at the municipal level, as currently discussed in Kaliningrad region). Spatial development concepts and concrete regional planning should be introduced and inter-municipal cooperation encouraged for city regions and agglomerations. Requirements of urban-rural cooperation should be incorporated into town-planning regulations and land use planning. Beside raising political awareness as to the necessity of urban-rural cooperation, concrete socio-economic issues should be tackled step by step in fields such as urban-suburban transport, health care, development of consumer and agricultural markets, housing, communal services, tourism and recreation, inter-municipal cultural exchange, promotion of a functioning settlement system (e.g. new growth centers outside the immediate surrounding areas). Better functioning urban-suburban cooperation also requires training and further education of respective experts. Moreover, the institutional framework could be improved through the establishment of a coordination centre for strategy development and overall management of inter-municipal (urban-suburban) cooperation e.g. in the form of a 'Board of Socio-economic Development' of the territories or an 'Agglomeration Board'. The regional authorities of North-West Russia and the Government of the Russian Federation could facilitate the implementation of urban-suburban cooperation through encouraging pilot projects and highlighting of 'good/best practice' examples.

R22b: Rural areas of Northwest Russia should receive more attention in development strategies. It is necessary to foster development alternatives inside agriculture (use of biomass, new products etc.), combination of agricultural and other activities (e.g. agriculture and rural tourism or public services) and new development opportunities outside agriculture (use of wind

power, alternative energies, rural and nature tourism, health care and spa treatment etc.). Basic social services should be adapted to the specific population and settlement structures of Northwest Russia e.g. through multifunctional service centres, tele-medicine, e-governance solutions, etc. The authorities of Northwest Russia and the Government of the Russian Federation should support pilot activities on such solutions and help transfer good examples from Russian and other European areas, including those from transnational Interreg projects being carried out in the Baltic Sea Region. Russian regions and municipalities should take part in these transnational projects.

R22c: In order to enhance urban-rural cooperation and partnership in a larger geographical context, Northwest Russian authorities should make use of concepts and results by organising conferences and transfer events. Moreover, Russian partners should take part in and evaluate transnational projects. The Government of the Russian Federation could support such a process by conducting demonstration projects for spatial development, as these have been developed in Germany.

Pilot regions

Observation: Kaliningrad occupies a special position as ‘pilot region’, the consequence of which is that various programs and initiatives of federal importance are tested in Kaliningrad before being introduced in mainland Russia. Being a pilot region implies that new, ostensibly innovative techniques, regulations and administrative procedures are introduced at an early stage in the region. Being a pilot region is thus especially attractive to remote or peripheral regions in that it helps them to get closer to the centre. A similar example, however, driven by bottom-up actions and focusing upon infrastructure and technical supply, is taking place in the municipality of Lolland, Denmark. A few years ago, the municipality launched the concept ‘community test facility’ and offered private companies and public agencies the opportunity to carry out full-scale tests. One such recent example is the testing of a hydrogen-based energy supply of 35 houses in a village of Lolland. In Finland, the introduction of solar-panels in small towns has been shown to be very successful. An important impact of being a pilot community is that the community may develop special expertise in the implementation of public infrastructure, administrative regulations and so on.

R22: The potential for further development of the concept of pilot region or pilot municipality should be considered as an option for including remote regions and municipalities into cutting-edge developments in society in the sectors of public infrastructure, political and administrative reforms.

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