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THE BALTIC STATES IN THE EU: YESTERDAY, TODAY AND TOMORROW

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Foreword by Jerzy Buzek

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FOREWORD

by Jerzy Buzek

Known under the common name of the Baltic States, Lithuania, Latvia and Estonia form a fascinating part of Europe and one of mutually best integrated regions of the European Union. After a period of amazing growth in the early 2000's, the "Baltic Tigers" did not make it through the recession completely unscathed, but their catlike agility did not prove them wrong. They all found their solutions to the economic slowdown. And the development has been truly enthralling to watch.

Already now, Estonia is slowly becoming the next Silicon Valley. Latvia's economy, after contracting by more than 20 percent from its peak, grew by about 5 percent last year, which makes it the best performer in the whole European Union. The country will soon follow the lead of its northern neighbour, and will become the 18th member of the Euro Area. Lithuania is a particularly active player on the stages of the EU's energy policy and eastern neighbourhood. The people of the Baltic can and should be proud of their innovative spirit that makes them excellent business and investment partners. Used to hardship and knowing all the cons of peripheral location, the nations are a real boost to the EU in the difficult crisis times.

'Interconnection' would be the term I would choose if I were to pick just one watchword to describe the moving force of the region. History gave this interconnection many faces. The earliest ones date back to the middle ages, when Baltic cities were interconnected with the west and north of Europe through the Hanseatic trade alliance. The more recent ones refer to the building of the countries' positive interconnection with the European and Euro-Atlantic community, after their successful civil revolution unbundled them from decades of functioning as Soviet republics.

There is one symbol of the interconnection we all remember particularly well: the 'Baltic Way', an event that took place in late summer of 1989. In my homeland Poland, the 'Decade of Solidarity' was culminating after the first free parliamentary elections. In Czechoslovakia, the 'Velvet Revolution' was gaining momentum, to erupt in late autumn following students' demonstrations. And while the darkest symbol of the division of Europe was collapsing in Berlin, in the Baltics the mobilisation of civil society and independence movement resulted in an amazing human chain in which two million people stood side by side along a 600-kilometre stretch from Tallinn to Riga to Vilnius. Today the three sister-states are connected by the asphalt chain of the 1000-km-long Via Baltica that brings them even closer together.

In the Study you are holding in your hands, experts provide a most valuable insight into this remarkable region. First, professor Kasekamp takes us on a journey along the three countries' long and windy road towards sovereignty and into the European Union. He describes the post-accession attitude of the Baltic states that evolved from initial reservations to a much more enthusiastic support of the Lisbon Treaty and commitment to joining the Euro Area. Always convinced that the place of the Baltic states is in the very core of EU integration, I personally welcomed this evolution with great satisfaction. The chapter closes with the current Lithuanian presidency in the Council of the European Union – a beautiful symbolic completion of a complicated, long-lasting process.

In the second part, economic researchers Mrs. Maslauskaite and Mrs. Zorgenfreija analyse the economic condition of the countries. The transition to independence and democratic stability was strengthened by a transformation of the economies. Market reforms were implemented with an impetus that gained the countries appreciation across the world. And yet, when I visited the three states in early 2009, shortly after taking over as president of the European Parliament, the main purpose of my trip was to express solidarity with citizens who, of all EU member states, were most painfully hit by recession and crisis. The way these countries – their governments and people – got to grips with this challenge and carried out the necessary reforms can serve as an example for many.

In the third and final part of the Study Dr. Grigas analyses the Baltic energy sector, demonstrating very well why it is in this field that our watchword 'interconnection' gains the most validity. Because while the issue of energy security remains fragile in the entire EU, in the Baltic states the insecurity of supply and prices takes a particularly dramatic form. As a legacy of Soviet times, the countries are almost totally dependent on a single external source of energy, detached from the rest of the grids of the European Union.

The existence of these Baltic "energy islands" provided, in fact, one of the strongest motives for the European Energy Community, an initiative that Jacques Delors and I launched in May 2010. Proposing this political umbrella for all existing and future actions in energy policy, we perceived the establishment of an EU internal energy market, following all other sectors covered by the 1992 Single Market programme, as the key to linking the separated networks.

A single market in energy – well-connected and liberalised – is much more than a precondition for affordable electricity and gas. It is a precondition for EU competitiveness, and thus for economic growth, for the creation of new jobs, and for an increase of the welfare of EU citizens. Together with innovation, it is one of the only two possible exit strategies from today's crisis. In practice, it means a balanced, competitive market where all players, from energy producers to distributors to consumers, play on equal terms. It means a diversification of Europe's energy mix and an opportunity for each member state to make full use of all available indigenous energy sources. It also means a capability to jointly coordinate external energy supplies and transit.

EU members committed to creating the Internal Energy Market by 2014. Today still more remains to be done than has been achieved, as I pointed out in a European Parliament's report on the state of creation of the market that I assembled earlier this year. First and foremost, member states must implement the necessary legislature. There is no need to create new law; all relevant provisions have been already included in existing legal documents. Secondly, it is obvious that there can be no internal market without Union-wide connectivity. This requires the set up of cross-border interconnectors, modernisation of existing infrastructure and the establishment of new generation, transmission, distribution and storage facilities.

We know what must be done, and we also know there is no time to waste. The establishment of an integrated market in energy will mean that a truly European approach finally prevails over today's wide spectrum of differing national approaches. But to the Baltic countries it will mean even more: Lithuania, Latvia and Estonia will have thus completed their long road towards a full interconnection with the rest of the European Union.

Brussels, July 2013

Jerzy Buzek, MEP
President of the European Parliament (2009-2012)
Prime Minister of Poland (1997-2001)

EXECUTIVE SUMMARY

2013 is a significant year for the Baltic states in their relations with European integration. On 1 July 2013, Lithuania became the first of the Baltic states to hold the rotating presidency of the EU Council of ministers. In addition, this year Latvia has been invited to join the Euro Area thus becoming the second Baltic state after Estonia to share the common currency. This Study aims to show that these developments are extremelly important for the young and small Baltic states, which continue to aspire to secure their place in the European "core".

Part 1 (pages 16-33) **discusses the difficult history of the three Baltic states and the rocky road on the way to joining the most prestigious international organisations in the Western world, including the European Union.**

- The general strategy adopted by the Balts was to join as many international and Western organisations as possible and to do so quickly, thus guaranteeing the survival of their independence by becoming embedded in the dense network of international bodies. One can recognise the same underlying logic today in such decisions as joining the Euro Area.

- However, integration with Western Europe appeared the least likely and utopian scenario after the collapse of the Soviet Union. Indeed, just after regaining independence from the Soviet Union, the Baltic states had to begin from scratch in their institution-building because they were the only three of the current Central and Eastern European EU member states to have been fully incorporated in the Soviet Union. In addition, the Baltic states were the most vulnerable economically; therefore, they had to make a lot of efforts to meet the Copenhagen criteria and to make sure that they would not be left behind.

- The Baltic states have niches or "pet projects", conditioned on their history and national interest, which they have tried to upload onto the EU agenda. Estonia, Latvia and Lithuania champion initiatives to strengthen energy security, the Eastern Partnership, the Single Market (especially free movement of services), and are staunch proponents of enlargement.

Part 2 (pages 33-64) **deals with the recent economic crisis and its consequences in the three Baltic states.**

- During the first half of 2000's, the Baltic states lived through their golden age of GDP growth, which was nevertheless coupled with a build-up of significant macroeconomic imbalances. As a consequence, in 2008-2009 the three Baltic states experienced double-digit recessions, which in terms of output loss could have only been compared to the downturn caused by the collapse of the Soviet Union.

- There were two ways out of the crisis: external (currency) or internal devaluation (and thus harsh austerity), out of which the second policy option was chosen in all three Baltic states. The way the Baltic states dealt with the crisis and the near-miraculous current economic recovery invites the austerity-supporters to proclaim the countries as an example, in particular for the Southern EMU member states caught in protracted recessions.

- However, austerity apart, it has to be pointed out that the unique economic and societal model of the small open economies as well as distinct historical legacy have all worked to their advantage when dealing with the crisis. In addition, even though GDP growth is back on track, the Baltic populations are paying a high price for the austerity policies in terms of poverty, unemployment and emigration.

Part 3 (pages 65-86) **analyses in detail the specificities of energy policy, which is among the top priorities of Lithuanian presidency, in the Baltic states.**

- This issue is given extreme attention in the region because the Baltic states are "energy islands" within the EU – still linked to Russian pipeline

and electricity network infrastructure and 100% dependent on Russian sources of gas and oil.

- As a consequence, Baltic energy dependence on Russia facilitates Moscow's influence in Baltic domestic politics as well as stokes tensions in bilateral relations with Russia and EU-Russia relationship. This in turn influences domestic transposition of EU energy policy initiatives.

- EU's energy policies of liberalisation and the Third Energy Package are being adopted to a different extent among the three Baltic states, with Lithuania most progressive and Latvia most passive.

- It seems certain that without EU institutional support and funding for integration of Baltic energy infrastructure and diversification of energy sources, the Baltic states will fail to become true members of the single EU energy market.

INTRODUCTION

The year 2013 will surely put the three small and young Baltic states, namely Estonia, Latvia and Lithuania, under international spotlight. On the one hand, Lithuania has taken over in July 2013 the rotating presidency of the Council of European Union and is now in the position to upload its priorities on the EU agenda. This is the first time that one of the three Baltic states is entrusted with this role, with Latvia and Estonia taking their turn in 2015 and 2018 respectively. On the other hand, Latvia has just received an official invitation and is set to become an eighteen member of the Euro Area in January 2014 even though, in the context of current Euro Area crisis, the Baltic willingness[1] to join the common currency area might come as a surprise to many.

During the 2nd semester of 2013 Lithuanians are to push for a "credible, growing and open Europe". This triple umbrella encompasses a number of policy initiatives that are dear for the Baltic states[2].

Firstly, these include strengthening of the EMU governance and ensuring sustainability of public finances ("credible"), with Lithuania presenting itself as an example of "one of the most successful countries to overcome the economic and financial crisis and return to sustained recovery and growth"[3]. Secondly, the Balts have always been ardent advocates for deepening the Single Market, especially in services and network industries, which are thus emphasized as presidency priorities too ("growing"). Thirdly, Lithuania is keen on strengthening both the external and internal dimensions of European energy policy. Lastly, Lithuania would like to advance the Eastern Partnership and free trade ("open").

1. Estonia joined Euro Area on 1 January 2011 and Lithuania has good chances of joining in 2015.
2. Estonian president recently announced that Estonia would focus on the same priorities as Lithuania. See: 15min.lt, "Estonian President: If Lithuania extends good offer on Visaginas NPP enterprise, Estonians will do it", 28 May 2013.
3. Lithuanian presidency of the Council of the European Union, "Focus Europe: Future Lithuanian Presidency of the Council of the European Union", 17 September 2012.

The aim of this *Notre Europe – Jacques Delors Institute* Study is to present and discuss the main realities of Estonia, Latvia and Lithuania in terms of history, politics and economy. The specific context in the three Baltic states, both as a region and as three separate sovereigns, can serve as a key for understanding the importance of the aforementioned European integration steps for the Balts. It may also explain why these specific priorities have been enumerated by the Lithuanian presidency.

Even though this Study treats all three Baltic states together, its aim is to streamline the similarities and the differences between these three countries when talking about different historical, political and economic dimensions.

Indeed, Estonia, Latvia and Lithuania are often seen as a single unit of the "Baltic states", which is justified when one talks about their recent history, their geo-political situation or simply their small size. After all, the three states have been fully integrated in the Soviet Union for more than half a century, they all have regained independence and built their nation states from scratch almost a quarter of century ago and they all have joined numerous international institutions, including the EU and NATO almost ten years ago. In addition, all three states are miniscule in terms of population and in terms of GDP on the European context *(see Annex)*.

However, these three countries are also different in many ways. Linguistically, all three states have their national languages, which are not only unrelated to Russian, but also distinct from one another. Their historical experience beyond the 20th century has been incomparable too, as discussed in Part 1 of the Study. In addition, their recent experience while dealing with economic crisis has been marked by differening levels of success, with Estonia showing the best performance *(see Part 2)*. Finally, even though the problems related to energy dependency from Russia are common, their extent is varying across the three Baltic states *(see Part 3)*.

The Study is divided into three parts written by experts coming from all three Baltic states. Part 1 by Prof. Andres Kasekamp (Estonian) gives a broad overview of the drivers of European integration in the region and deals with political and historical background. Part 2 by Kristina Maslauskaite (Lithuanian) and Liva Zorgenfreija (Latvian) analyses the developments and consequences

related to recent economic crisis in the three countries and the policy responses taken. The final Part 3 by Dr. Agnia Grigas (Lithuanian) thoroughly discusses the specificities of the Baltic energy policy and explains why energy security is one of the main priorities for the Lithuanian presidency.

PART 1
BALTIC STATES AND THE EU: A ROCKY ROAD FROM "OUTSIDE" TOWARDS THE "CORE"

by Prof. Andres Kasekamp

INTRODUCTION

The Baltic states of Estonia, Latvia and Lithuania were the only countries of the former Soviet Union to have integrated themselves into the European Union. Their success derives from that fact that their belonging to Europe was not only a geopolitical choice, but fundamentally in line with their values and identity. They have successfully overcome two upheavals in the past two decades: the wrenching transition from a command economy to a free market system after the collapse of the Soviet Union and the imposition of the most drastic austerity measures at the beginning of the current global financial crisis.

Though Estonia, Latvia and Lithuania tend to always be lumped together as the "Baltic states", the term is relatively recent and has changed over time. To give one example of national differences, linguistically, Lithuanian and Latvian form the Baltic branch of the Indo-European language family, but Estonian is closely related to Finnish in the Finno-Ugric language family. Nevertheless, historically and culturally Latvians and Estonians have much more in common with each other than with the Lithuanians. In addition to that, Latvians and Estonians are predominately Lutheran (though amongst the least religious in the world), while the Lithuanians are Christian Catholics.

The paper is structured in three parts. The first part explains the historical background, the reasons and the ways that led Estonia, Latvia and Lithuania towards their EU membership. The second part deals with contemporary policies and politics in the Baltic states. The final part gives a future outlook for the Baltic states and their priorities in the EU context.

1. Return to Europe

1.1. Historical Background: Threatened Statehood

Until the 20th century, the Baltic nations were quite distinct from each other and were not viewed together. Estonia and Latvia were subjugated by Germanic crusaders in the 13th century and a small German minority remained the dominant political, social and economic elite until 1917, despite years of Danish, Polish, Swedish, and finally Russian rule. Lithuania, on the other hand, became the largest state in Europe in the 15th century, controlling much of what today is Belarus and western Ukraine. The independent character of the Grand Duchy of Lithuania gradually declined after its Union with Poland in 1569 and its absorbtion by the Russian Empire in 1795.

In the 20th century Estonians, Latvians, and Lithuanians experienced a national revival. Estonia, Latvia and Lithuania successfully fought to achieve their independence from Russia after the end of the First World War, but were allowed to enjoy statehood only for two decades until the Nazi-Soviet Pact of 1939, which carved Eastern Europe into spheres of influence. Lithuania, Latvia and Estonia were simultaneously militarily occupied and then annexed by the USSR in 1940. A year of Soviet terror was followed by the Nazi German occupation during which the Jewish population was destroyed in the Holocaust. The return of the Red Army in 1944 was met with several years of armed resistance, particularly intense in Lithuania. Resistance was broken by the collectivisation of farming accompanied by mass deportations in 1949. The most dramatic legacy from the Soviet period was the drastic demographic shift in Estonia and Latvia. Estonia had been more than 90% ethnically Estonian, and Latvia nearly 80% ethnically Latvian in 1945. By the end of the Soviet period the percentage of Estonians had declined to 62 and the percentage of Latvians to just 52, putting into doubt their continued status as majorities in their own homelands. The desire to halt this negative trend became one of the drivers of the independence movement in the late 1980s[1].

1. Kasekamp, Andres, *A History of the Baltic states*, Basingstoke: Palgrave Macmillan, 2010.

Latvians, Estonians and Lithuanians seized the opportunity to express their desire for freedom during the Soviet leader Gorbachev's glasnost and perestroika, which began in 1986. This culminated in the peaceful Baltic "Singing Revolution" in 1988. The first democratically elected Lithuanian, Estonian and Latvian governments in 1990 announced their intention to restore independence, a step that was finally realised during the failed putsch in Moscow in August 1991. Since Western countries had not recognised *de jure* the Soviet annexation of the Baltic states in 1940, the re-admittance of the Baltic states into the international community proceeded swiftly.

1.2. The Road to EU Membership: One Option out of Three

After recovering their independence in August 1991, Estonia, Latvia and Lithuania had three choices for their geopolitical orientation: re-integration with the East, integration with the West or neutrality. The latter option, a path modelled on the success of Finland in safeguarding its independence while maintaining close relations with the Soviet Union, seemed to be the most realistic and also the one that friends in the international community recommended. It also fit with the slogan popular at the time of being a "bridge between East and West". Re-integration with the East also did not appear as unrealistic as it does from today's standpoint since in the early 1990s Yeltsin's Russia was moving toward democracy and a free market economy. Russian democrats had been the allies of the Balts in the struggle against the Communist regime; in addition, Russia and the Commonwealth of Independent States initially remained the most important trade partners of the Baltic states.

Integration with Western Europe appeared the least likely and utopian scenario at the time. History, however, argued against the other two options. First of all, in 1939, the Baltic states had declared their neutrality, but that did not save them from occupation by the Soviet Union and Nazi Germany. This lesson showed that the Baltic states should better avoid finding themselves isolated and without strong allies again. Secondly, the disastrous experience of nearly half-century of Soviet rule naturally drove the Balts West-wards. The Balts were determined to move as quickly and as far away as possible from Russia and the policies associated with it. Thirdly, post-Soviet Russia was sinking into chaos while Western Europe offered the hope of freedom and prosperity.

Finally, there was a general feeling of a "Return to Europe", a restoration of the values and connections that Estonians, Latvians and Lithuanians had prior to the cataclysm of the Second World War.

The general strategy adopted by the Balts was to join as many international and Western organisations as possible and to do so quickly, thus guaranteeing the survival of their independence by becoming embedded in the dense network of international bodies. This determination was driven by a sense of urgency; a window of opportunity existed that needed to be seized while Russia was still weak[2]. One can recognize the same underlying logic today in such political decisions as joining the Euro Area.

Some of the most significant milestones in the path of consolidating the Baltic states' sovereignty and integrating with the West were membership in the Council of Europe in 1993-95, the withdrawal of Russian troops in 1993-94, and Europe Agreements in 1995. Accession of Finland, Sweden and Austria to the Union on 1 January 1995 was the event which triggered the application of Estonia, Latvia and Lithuania to join the EU. By this time, Finland and Sweden were becoming the most important trade partners of the Baltic states, especially Estonia. This enlargement fundamentally re-ordered the geopolitics of Northern Europe. Thus it was no coincidence that Estonia, Latvia, and Lithuania, separately, but within a space of a few months from each other, formally applied to the EU later that same year[3].

As with nearly every round of EU enlargement, the new members begin to advocate on behalf of their neighbours, to expand the zone of stability and prosperity in their vicinity. To nearly everyone's surprise, Estonia was among the five Central and Eastern European countries (CEEC) invited to begin membership negotiations in 1997. Estonia was singled out because its free market reforms had been more rapid than those of the others. Latvia and Lithuania were initially upset that they had been left behind, but Estonian success gave them the motivation to redouble their efforts. Their efforts were soon rewarded and they began negotiations less than two years after Estonia. Initially it appeared that

2. Ehin, P., "Estonia: Excelling at Self-Exertion", in Bulmer, S., Lequesne, C. (Eds.), *The Member States of the European Union*, Oxford University Press: Oxford, 2013, p. 214.
3. Arnswald, Sven, *EU Enlargement and the Baltic states: The Incremental Making of New Members*, Programme on the Northern Dimension of the CFSP, vol. 7, Helsinki & Berlin: Finnish Institute of International Affairs & Institut für europäische Politik, 2011, pp. 35-38.

the EU would follow the "regatta" approach to enlargement, i.e. every candidate would conclude negotiations and join the Union individually based on its own merits. Therefore, Estonia, and particularly its foreign minister, Toomas Hendrik Ilves, began to emphasize its "Nordic" identity. The main reason for this was to distance Estonia from the "Baltic" identity and for the Baltic states to be treated individually, rather than being lumped together as a group. The fear was that if the Baltic states were not differentiated, then Estonia's accession would be delayed until the slowest reformer of the three Baltic countries – Lithuania – was ready[4]. Ironically, at the same time in pursuit of NATO membership, Lithuania, which had the strongest position of the three in that process, also tried to re-brand its identity from "Baltic" to "Central European".

1.3. The EU Accession Process

An important feature of the Eastern and Central European enlargement round, which was conducive to the Baltic states' aspirations, was the emphasis on "objective criteria", i.e. the Copenhagen criteria. Unlike Poland, for the Baltic states EU membership was not only a question of "when", but also "if". The Baltic states had a weaker starting position than the other CEECs: they were the poorest and least known applicants, their border of the former Soviet Union remained a geopolitical "red line", and there were fears of upsetting Russia who could meddle with the issue of the Russian-speaking minority in Estonia and Latvia. Politically, the Baltic states were the most vulnerable and could conceivably been have left out, but their strides in fulfilling the "objective" criteria ensured that they would not be left behind.

Unlike the former "Warsaw Pact"[5] countries who had been under Communist rule, but retained their sovereignty, the Baltic states had to begin from scratch. They had no army, ministry of defence, diplomats, national currency, central bank, border guards, customs officials, etc. On the one hand, this was a great disadvantage, but on the other, it allowed for the implementation of European best practices from the beginning. Indeed, sometimes it might be more difficult

4. Sillaste-Elling, K., "The Path to Receiving an invitation for Accession Negotiations – the Critical Years of 1996-1997", in Tael, K. (Ed.), *Estonia's Way into the European Union*, Estonian Ministry of Foreign Affairs, Tallinn, 2009, p. 26.
5. The Warsaw Pact included the Soviet Union, Albania, Poland, Romania, Hungary, East Germany, Czechoslovakia, and Bulgaria as members (Albania was expelled in 1962).

to reform entrenched bureaucracies than to train inexperienced, but enthusiastic young officials who were open to radical change in the system.

EU accession negotiations proceeded without any great stumbling blocks, yet some difficulties were present. First of all, perhaps the most complex single issue was the decommissioning of the Ignalina nuclear power plant in Lithuania[6]. Secondly, expensive environmental protection and phyto-sanitary standards were also generally where CEECs sought derrogations. Thirdly, the justice and prison systems required overhauling. Fourthly, for small, young states, administrative capacity was also a big concern. Finally and ironically, Estonia had to de-liberalise its international trade, introducing customs and tariffs.

Politically, the most difficult and sensitive area of the accession negotiations was the Russian minority issue. The main questions revolved around citizenship and language. Since the Baltic states were recognised legally as restored states, rather than successor states to the USSR, citizenship was not granted automatically to all residents. Instead, those who settled in the Soviet period needed to apply for naturalisation. The main criterion for citizenship was basic competence in the state language. Rather than taking the Estonian or Latvian language exam, many opted for Russian citizenship instead and a large number remained stateless. An Organisation for Security and Cooperation in Europe (OSCE) mission was in place in Tallinn and Riga from 1993 to monitor the treatment of the Russian-speaking minority. After most of the OSCE's recommendations had been implemented by the Estonian and Latvian governments, the missions were concluded in 2001[7].

Lithuania does not have a substantial Russian minority and therefore generously granted citizenship to all residents. The only significant ethnic minority in Lithuania is Polish, but it was not an issue during the accession negotiations. Poland and Lithuania managed to put aside their differences with the signing of a treaty of friendship in 1994, undoubtedly partly motivated by both

6. Maniokas, K., Vilipišauskas, R., Žeruolis, D. (Eds.), *Lithuania's Road to the European Union: Unification of Europe and Lithuania's EU Accession Negotiation*, Eugrimas, Vilnius, 2005, pp. 297-349.
7. Van Elsuwege, Peter, *From Soviet Republics to EU Member States. A Legal and Political Assessment of the Baltic states 'Accession to the EU*, Leiden: Brill, 2008, pp. 286-287.

countries' desire to remove a potential obstacle to the process of their integration into Euro-Atlantic structures.

A special matter of concern for Lithuania was (and remains) Kaliningrad, a Russian exclave (created on the ashes of German East Prussia after the Second World War) which remains the most highly militarised region in Europe. In 2002 for a brief period Kaliningrad rose to the top of EU-Russia agenda. President Putin demanded that Kaliningraders be able to travel freely across Lithuania to the Russian motherland without visas. The EU, however, refused to make any exceptions regarding future Schengen regime territory. In the end, a compromise was reached, whereby so-called Facilitated Transit Documents (in other words, simplified special visas) would be issued[8]. More recently, Kaliningrad has become a worry since Russia has reportedly moved tactical nuclear missiles into the exclave.

Together with Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Cyprus and Malta, the Baltic states successfully concluded their EU accession negotiations at the Copenhagen summit in December 2002. While it is true that EU conditionality and the *acquis communautaire* drove the reform process in the Baltic states, the Estonians, Latvians and Lithuanians also realised that these reforms were necessary for themselves. Furthermore, Soviet-era legislation had to be modernised in any case and thus having the *acquis* as a model to follow was much easier than drafting new legislation from scratch.

EU accession was elite-driven, and there was an obvious split between the opinion of the elites and the population. Estonia and Latvia were consistently the two CEEC countries that were the most sceptical regarding EU membership. Lithuanians, however, were much more enthusiastic and thus were among the first to hold their membership referendum in 2003 and achieved a result of 90% in favour. The Estonian and Latvian governments, on the other hand, tactically delayed their referenda until the other candidate countries had voted in favour in order to achieve a positive result. The Baltic states finally became EU members on 1 May 2004.

8. Paulaukas, Kestutis, "The Baltics: from nation states to member states", *Occasional Paper nº 62*, Paris: EU-ISS, 2006, pp. 15-16.

It is important to recall that the EU accession process ran in parallel with that of NATO. Though the two were not officially linked, one obviously gave additional impetus to the other. For Lithuania, Latvia and Estonia, NATO membership was even more enticing than EU membership. Security was understandably their priority since their entire recent history had been marked by an absence of security. The EU was at the time perceived to be primarily a Single Market and lacking in a security dimension. This was partly because joining the EU appeared to be an eventuality, whereas Baltic NATO membership was not a foregone conclusion since there was strong opposition to it by Russia and many Western opinion leaders.

1.4. The Political Systems: Best Practices from Abroad and National Legacies

Building in their new institutions, Estonians, Latvians and Lithuanians borrowed from European, especially German and Nordic, models and best practices, though they also revived many elements from their previous period of independence. The Baltic states have unicameral parliamentary systems. In Estonia and Latvia deputies are elected according to party lists and proportional representation, but Lithuania has a mixed majoritarian and proportional electoral system modelled after Germany. The Estonian and Latvian presidents are elected by the parliaments and have mainly symbolic powers. In Lithuania, the president has greater power, in part because she is directly elected.

Centre-right coalitions have been in power for almost the entire period of independence in Estonia and Latvia, though the political party system itself has been quite volatile. This instability is characterised by the fact that until 2006, every Latvian general election was won by a political party that had not yet existed at the time of the previous election.

The Lithuanian political party system is completely different, primarily because the successor party to the Lithuanian Communist Party managed to successfully transform itself into a European social democratic party. The reasons of this difference is that the Lithuanian Communist Party played an important role in the achievement of independence, whereas the Estonian and

Latvian Communist Parties were dominated by ethnic Russians and thus were perceived as an alien body.

Unlike in Latvia and Estonia, power has generally alternated in Lithuania between two large blocs – the left (social democrats) and the right (conservatives)[9]. An exceptional moment in recent political history was the impeachment of the maverick populist Lithuanian President Rolandas Paksas in 2004 after he had granted citizenship to his main campaign financer, a Russian arms dealer.

9. See Pettai, V., Auers, D., Ramonaite, A., "Political Development" in Lauristin, M. (Ed.), *Estonian Human Development Report: Baltic Way(s) of Human Development: Twenty Years On*, Eesti Koostöö Kogu, Tallinn, 2011, pp. 144-165.

2. The Baltic States as EU Members

2.1. Contemporary Politics: Moving towards more Stability

After EU membership, it was Latvia which encountered the greatest political turbulence. Latvian politics was peppered with allegations of corruption as "oligarchs" financed political parties. Public indignation culminated in 2011 when outgoing President Valdis Zatlers dismissed the parliament and his action was subsequently overwhelmingly approved in a national referendum[10].

In contrast, after short-lived governments during the transition years, the Estonian government is currently one of the most stable in Europe. Estonian Prime Minister Andrus Ansip, having come to office in April 2005, is currently the longest-serving prime minister in the EU, with the exception of Luxembourg's Jean-Claude Juncker.

Perhaps astonishingly in a European context, the Estonian and Latvian prime ministers who implemented austerity, Andrus Ansip and Valdis Dombrovskis, were both returned to office in general elections held in 2011. However, an unhealthy development in both countries is the grip on power in the capital cities of Riga and Tallinn by Nils Uskaovs' Harmony Centre and Edgar Savisaar's Centre Party, respectively. Predominantly supported by Russian-speaking voters, they have become the largest national parties and they are systematically building up an alternative centre of power in opposition to the national government.

In the Lithuanian case, the conservative government, headed by Andrius Kubilius, which successfully implemented austerity policies, was turned out of office by the Social Democrats in the elections of October 2012. Worrisomely, populist parties of all stripes were hugely successful, and two of them (the Labour Party and the Order and Justice Party led by ex-president Paksas) are now junior members of the coalition government.

10. Dreifelds, J., "Latvia", in *Nations in Transit 2012: Democratization from Central Europe to Eurasia*, Freedom House, New York, 2013, pp. 321-323.

The integration of ethnic minorities is not an issue that has faded away after EU membership. Estonia was reminded of this with the "Bronze Soldier" crisis in 2007 when Russian youths rioted in opposition to the government's relocation of the Soviet war memorial from central Tallinn. In Latvia in 2011, a signature collection campaign succeeded in forcing the question of Russian becoming the second official state language being put to a national referendum (where it was defeated by a three-quarters majority). In Lithuania, the issue of the rights of the Polish minority, specifically the question of schooling in the mother tongue, occasioned a war of words between the Polish and Lithuanian governments in 2010. The bilateral dispute has recently toned down somewhat after the inclusion of the Polish minority party in the new Lithuanian coalition government from November 2012.

Paradoxically, the success of integration is usually measured by the pace of naturalisation of minorities, but after joining the Schengen regime there is little incentive for stateless Russians in Estonia or Latvia to apply for citizenship. As permanent residents they can travel and work in the EU almost as freely as citizens and at the same time they can maintain their family and business ties with Russia since Russia does not require a visa and allows them to own property. Though in normative terms they appear underprivileged, in practical terms they can enjoy the best of both worlds.

2.2. EU Membership: the Community Method

During the Convention on the Future of Europe and the drafting of the EU Constitutional Treaty, the Baltic states, especially Estonia, were assiduously courted by the United Kingdom to support its attempts to block deeper integration, particularly in the areas of social and tax policies as well as the security and defence policy. Having open, liberal economies with low flat income tax rates, which they credited for helping them to successfully overcome the negative legacy of the centralised Soviet command economy, they were alarmed at the prospect of greater harmonisation in this field. As fresh members of NATO, they were wary of any EU structures in the field of security and defence that might duplicate or even undermine the Transatlantic relationship. Furthermore, as recently restored states, they valued the sovereignty which

they had struggled so hard to achieve. Thus the Baltic states were initially inclined to favour the intergovernmental model over the community method.

Nevertheless, during the accession process they had learned that the European Commission is the best friend of the small new members, i.e., it is the institution that can ensure that small member states get a fair deal and are not ridden over by the interests of large member states; consequentially, the Baltic states have never supported proposals that would lessen the Commission's power. While Estonia and Latvia were cautious, Lithuania demonstrated its zeal by being the first member state to ratify the Constitutional Treaty in 2004[11].

A watershed for the Baltic states in their understanding of the dynamics of the EU was the signing of the Nord Stream agreement for the construction of an underwater gas pipeline in the Baltic Sea between German Chancellor Gerhard Schröder and Russian President Vladimir Putin in 2005 which blatantly contravened their interests. This shocked the Balts into calling for the need for Europe to speak with one voice to Russia, to strengthen the Common Foreign and Security Policy, and to create a common energy policy. By corollary, it brought the Balts to the understanding of the need for the community method in general.

When it came to the Lisbon Treaty, all three Baltic states displayed greater enthusiasm for deeper integration than previously, and ratification of the Treaty did not occasion any real debate. One of the constant fears of the Baltic states was that of a two-tier Europe, where they would not be included among the core countries. An important step in no longer perceiving themselves as being "second-class" Europeans was the enlargement of the Schengen regime to include the Baltic states in December 2007.

In striving to be among the core countries, Lithuania attempted to join the single currency in 2007 already, however, its bid was rejected as its inflation rate was deemed to be very narrowly (0.1%) above the Maastricht criteria. In retrospect, this is not surprising since the economies of the "Baltic Tigers" were overheating *(as discussed in Part 2)*.

11. Kasekamp, A. & Veebel, V., "Overcoming doubts: The Baltic states and the European Security and Defence Policy", in Kasekamp, A. (Ed.), *The Estonian Foreign Policy Yearbook 2007*, Tallinn, Estonian Foreign Policy Institute, 2007, pp. 11-12.

For Estonia, joining the Euro Area was a way to exit the financial crisis. It provided a positive motivating goal for the budget cuts and averted the risk of forced devaluation of the Estonian currency. On 5 June 2013 the European Commission and the Eurogroup concluded that Latvia also meets the Maastricht criteria and thus is ready to join the Euro Area on 1 January 2014. The Lithuanian government aims to follow in 2015. At present, the majority of the Latvian population is not in favour of membership since they fear price hikes and the prospect of having to contribute to the bailout of wealthier Euro Area members.

Membership in the Euro Area confronted Estonia with a new unexpected responsibility – to show solidarity by lending money to EMU members who had flouted the rules that Estonia has strictly adhered to. In Estonia the European Stability Mechanism (ESM) triggered the first serious public debate about the EU since accession. The initiator was the Legal Chancellor who complained to the Supreme Court that the ESM's procedures violated the Estonian Constitution. The Supreme Court decided narrowly in favour of the government, clearing the way for ratification of the ESM by the Estonian parliament on 30 August 2012. In order to mollify the opposition, the Government broadened the role of the Parliament in future ESM-related decision-making.

2.3. Baltic Policies and Preferences on the EU Level

Within the EU, Estonia, Latvia and Lithuania championed initiatives to strengthen cyber security, energy security, the Eastern Partnership, the liberalisation of the energy market, transparency, innovation, the Single Market (especially free movement of services), and were staunch proponents of enlargement. Cooperation between Baltic states and the Nordic countries as a regional bloc within the EU was also further developed. A new hope for regional convergence was the EU's pioneering Baltic Sea Strategy adopted in 2009 (though without any budget line of its own). Within the EU, Nordic-Baltic coordination continues to be very fruitful and multifaceted[12].

12. See Henningsen, B., Etzold, T., and Pohl, A.-L. (Eds.), *Political State of the Region Report 2013: Trends and Directions in the Baltic Sea Region*, Baltic Development Forum, Copenhagen, 2013.

The Baltic states have niches or pet projects which they have tried to upload onto the EU agenda. Lithuania, in particular, has been concerned about energy security. The country has been the pioneer for the EU Third Package in energy when in comes to unbundling. This has resulted in a hostile response from Gazprom, the monopolistic supplier of gas to the Baltic states. Indeed the aim of the Baltic states is to end their dependence on Russia by using EU funds to build infrastructure connections with the heart of Europe. Consequently the highly ambitious Rail Baltic project which would connect Tallinn with Warsaw, is a top priority for Estonia. In addition to that Estonia has promoted the importance of cyber security and everything digital. The flagship project of Estonia's 2011-2015 EU policy is the creation of an EU digital single market. It will also be a priority of the Lithuanian EU Presidency. Estonia is the home of Skype and e-government, and was the first country to use national online voting in parliamentary elections.

From the outset, the Balts were enthusiastic supporters of the European Neighbourhood Policy and quickly found their niche[13]. With the advent of Eastern Partnership in 2009 it received greater impetus. In this area Belarus has been an issue of special importance to Lithuania. President Grybauskaite went against the EU mainstream in 2009 and sought to engage Minsk. This policy blew up in her face when the Lukashenko regime used brute force against the opposition presidential candidates in December 2010. Nevertheless she was more successful in dealing with Ukrainian President Viktor Yanukovich, insisting on visiting jailed opposition leader Yulia Tymoshenko in hospital.

An aspect to take into account is that joining the EU meant that the Baltic states became donors, no longer recepients of external assistance. The Baltic states have actively sought to transfer their knowledge and experience of reform and European integration to the Eastern European countries that two decades earlier had been with them together at the same starting point with the break-up of the Soviet Union, but who have not enjoyed the same progress[14]. The main target countries for Estonian, Latvian, and Lithuanian development cooperation are Georgia, Moldova and Ukraine, and in addition, Afghanistan,

13. Galbreath, D. J., Lasas, A. and Lamoreaux, J.W., *Continuity and Change in the Baltic Sea Region. Comparing Foreign Policies*, Rodopi, Amsterdam and New York, 2008, p. 127.
14. Andrespok, E., Kasekamp, A., "Development Cooperation of the Baltic states: A Comparison of the Trajectories of Three New Donor Countries," *Perspectives on European Politics and Society*, 13(1), 2012, pp. 117-130.

where all three countries had soldiers on the ground. Here it is evident that values and geopolitical interests intersect. Particularly in the case of the former Soviet Socialist Republics, as the Baltic states are uniquely placed to be the most knowledgeable and effective donor countries.

The Baltic states were relatively pleased by the EU multiannual budget for 2014-2020 agreed upon at the European Council in February 2013. During the budget negotiations public attention was focused on two issues: the first issue was the inequality endured by Baltic farmers vis-à-vis farmers in old member states and the second issue was the Commission's proposal for a Connecting Europe Facility for cross-border infrastructure. There was hope that funding would be found from the facility for Rail Baltic and a Baltic regional Liquefied Natural Gas terminal.

It is worth mentioning that the only time a Baltic state has used its veto in the EU was in 2008 when Lithuania blocked the negotiating mandate for a new EU Partnership and Cooperation Agreement with Russia[15]. Though the stated Lithuanian concern about Russian duplicity in resolving the "frozen conflict" in Abhkazia later proved to have been justified, at that time Lithuania was roundly criticised for its stubborness and even Estonia and Latvia sided with the EU mainstream.

All three Baltic states have been able to attract new EU agencies into their capitals. Lithuania became the first in 2007 by hosting the European Institute for Gender Equality. Latvia hosts the Body of European Regulators of Electronic Communications and finally in 2012 the headquarters of the EU Agency for Large-Scale IT systems became operational in Tallinn.

15. Vilpišauskas, R., "Lithuanian foreign policy since EU accession: Torn between history and interdependence" in Baun, M. & Marek, D. (Eds.), *The New Member States and the European Union: Foreign Policy and Europeanization*, Routledge, London & New York, 2013, p. 139.

3. Future Outlook

3.1. General Trends for the Future

After having imposed drastic austerity measures, the Baltic states have become the fastest growing economies in the EU. Estonia is the newest member of the Euro Area and Latvia is set to be the next one in 2014, to be followed by Lithuania in 2015. This is a sign that the Baltic states continue to aspire to be in the "core" of Europe. In fact Estonia, has become the most integrated country in Northern Europe, in terms of membership in international organisations: EU, NATO, OECD and the Euro Area.

On the downside, an increasing worry is the declining and ageing population. The Baltic states have highly restrictive immigration policies which are a reaction to the Soviet legacy. Unemployment, which would otherwise be substantially higher, has been partially alleviated by mass immigration. The trend started already in the boom years of the mid-2000s when the UK and Ireland, the only EU countries not to put restrictions on new member states, where the most popular destinations. Hundreds of thousands have left Lithuania and Latvia, but the outflow from Estonia has been smaller, only tens of thousands left, and primarily in direction of neighbouring Finland. This emigration often simply takes the form of commuting[16].

3.2. The Lithuanian EU Presidency

Starting on 1 July 2013, Lithuania has become the first of the Baltic states to hold the rotating presidency of the EU. Its performance will be closely watched for lessons learnt by Latvia and Estonia, whose turns to hold the presidency come in 2015 and 2018, respectively. The catchwords of the Lithuania presidency are "credible, growing and open Europe"[17]. Under "credibility", the aim is to work towards financial stability and banking union. "Growth" will be

16. Purs, A., *Baltic Facades: Estonia, Latvia and Lithuania since 1945*, Reaktion, London, 2012, p. 179.
17. Lithuanian Presidency of the Council of the European Union, "Presidency priorities", 17 April 2013.

driven by further deepening and integrating the Single Market. Finally, "open" refers to the EU's global role, particularly towards its neighbourhood. Probably the most anticipated event will be the Eastern Partnership Summit to be held in Vilnius in November 2013. The hope of all three Baltic states is that the Eastern Partnership countries will be brought closer to the EU; the big prize the Lithuanian presidency aims for is the signing of an Association Agreement with Ukraine and/or Moldova.

The EU presidency might prove to be a tremendous challenge for Lithuania's government which has been in office only since November 2012 and most of whose members have little governmental experience and knowledge of the English language. Fortunately, foreign minister Linas Linkevicius, has a prominent role managing the EU presidency, is highly experienced and competent. Furthermore, it is expected that president Dalia Grybauskaite, a former EU commissioner for budget planning and 2013 laureate of the Charlemagne Prize, will play a central part in the EU presidency. Fortuitously in this case, as noted above, the president of Lithuania is endowed with greater powers than heads of states in average parliamentary democracies, though not as extensive as in France. Notably, unlike Estonia and Latvia, it is the president who represents the country at the European Council.

PART 2
ECONOMIC MIRACLE IN THE BALTIC STATES: AN EXEMPLARY WAY TO GROWTH?

by Kristina Maslauskaite and Liva Zorgenfreija

INTRODUCTION

In the recent years, marked by economic and financial turmoil, Estonia, Latvia and Lithuania have been in the international spotlight on more than one occasion. The three Baltic states were hit early and hard experiencing double-digit recessions already in 2009, which in terms of output loss could only be compared to the ones that took place when the Soviet Union collapsed. For a number of reasons, the governments in all three countries quickly and decidedly chose to respond to the crisis by following the route of internal devaluation instead of devaluing their national currencies – a policy option so longed-for by the Southern EMU members today. This strategy has worked remarkably well: today the Baltic tigers start roaring again, though in a more sustainable manner, as the three countries are among the fastest growing in the EU. In addition, Estonia (joined on 1 January 2011) and Latvia (has been invited to join on 1 January 2014) have been rewarded with their much sought-after prize of joining the Euro Area.

As a result, the way the Baltic states dealt with the crisis and the near-miraculous current economic recovery invites the austerity-supporters to proclaim the countries as an example, in particular for the Southern EMU member states caught in protracted recessions. However, even though austerity has played a role in economic recovery in the Baltic states, it is important to recognise that on the one hand, the factors that determined the relatively successful recovery were specific to the region and the countries. On the other hand, the current economic recovery hides a number of social issues that might surface later on and hinder the future development of the economies. The medicine taken by the Baltic states has thus to be prescribed to the other sick men of

Europe with caution – making sure to recognise the differences among the individual symptoms.

The paper starts out by shedding some light on economic developments in the Baltic states after the collapse of the Soviet Union and explaining the factors that contributed to the pre-crisis build-up of macroeconomic imbalances. It then proceeds by presenting the specificities of the great recession and analyses the policy response taken in each of the three countries. The subsequent section looks at the context-specific reasons that played to the advantage of the Baltics as well as the social cost that has emerged as a consequence of the crisis. The last section concludes and provides some policy implications.

1. Developments before the Economic Crisis

1.1. Emergence of the Baltic Tigers

The Baltic economies emerged from communism as examples of quick and efficient transition countries even though the transition period was marked by numerous challenges. First of all, the three states were the only ones of the current Central and Eastern European (CEE) EU member states which had been fully incorporated in the Soviet Union and hence had been deprived of any autonomous institutions needed to run the state. Secondly, all existing economic activity was marked by the Soviet era and trade was geared towards the East. To give an idea, in the years preceding the independence, Estonia had only 34 rather small private companies[1] and 90% of its exports went to the Soviet Union[2]. Finally, the transition was made more difficult by hyperinflation in the rouble-area, with inflation rates peaking at around 1000% in all the three Baltic states in 1992[3]. National wealth was declining below the Soviet-era levels: GDP levels in 1992 fell by more than 20% in Estonia and Lithuania

1. Erixon Fredrick, "Baltic Economic Reforms: A Crisis Review of Baltic Economic Policy", *ECIPE Working Paper*, 2010, p. 9.
2. *Ibid*. p. 10.
3. Stæhr Karsten, "Economic Development in the Baltic States: Success and New Challenges", *Monetary Review 4th quarter 2007*, Denmarks Nationalbank, 2007.

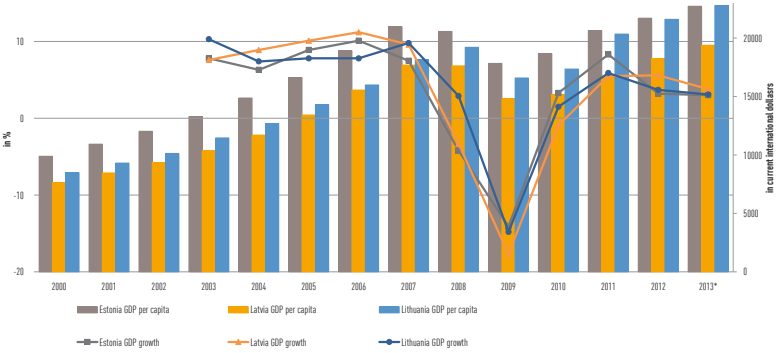
and by more than 30% in Latvia. Therefore, after regaining independence in the beginning of 1990s the three countries lived through an extremely difficult period of reorganisation, reconstruction and economic turmoil.

The Baltic states chose to distance themselves from the Russian influence and direct their policies westwards, largely following the liberal prescriptions of the Washington consensus to become open market economies. So much so that Estonia had to re-regulate its tariffs with the view of entering the WTO and the EU[4]. In addition, after several years of hyperinflation, all three states chose to peg their currencies[5]. The policies in general were geared towards ensuring macroeconomic stability, attracting foreign investment and, finally, entering the prestigious clubs of Western countries, most prominently the EU and the NATO.

Thanks to strong political will and public support the reforms in the fields of institution building, privatisation and trade liberalisation were largely successful as evidenced by the astonishing economic performance. In the mid-2000s, the three Baltic tigers had a golden age. The economies were growing at the spectacular pace of 8-9% per year on average in real terms, and the levels of national real wealth more than doubled in the period of 2000-2008 *(Figure 1)*. The countries possessed "ample room for restructuring"[6] due to an extremely well qualified labour force and low capital endowment, which made them attractive for entrepreneurs. Moreover, the institutional convergence was the fastest one among the post-communist countries as shown by standard governance indicators[7]. Pegged exchange rates and EU membership in 2004 provided the required credibility. As a result, large capital inflows followed, for example, FDI peaked at 20% of GDP in Estonia, 8.5% in Latvia and 6% in Lithuania in the pre-crisis years. Unemployment rates dropped from 14-16% in 2000 to approximately 4% in Estonia and Lithuania and 6% in Latvia in 2007 *(Figure 2)*.

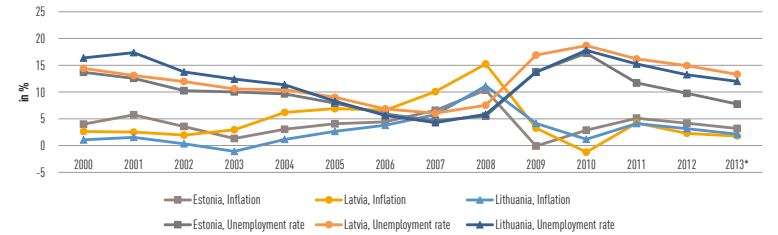
4. Estonia essentially applied near 0% tariffs on its imports until 1995 when it began harmonising its Most Favoured Nation (MFN) tariff rates towards the EU's Common External Tariff (CET). See "Enhancing market openness, intellectual property rights, and compliance through regulatory reform in Estonia", *OECD Report*, 2011, p. 11.
5. The exchange rate arrangements have not been the same in all three countries, but in their essence they have all included a currency peg.
6. Deroose Servaas, Flores Elena, Giudice Gabriele and Turrini Alessandro, "The tale of the Baltics: experiences, challenges ahead and main lessons", *ECFIN Economic Briefs*, Issue10, July 2010.
7. *Ibid.*

FIGURE 1 ► Real GDP per capita, levels (RHS) and growth (RHS)



Source: International Monetary Fund, World Economic Outlook Database, April 2013

FIGURE 2 ► Unemployment and Inflation Rates



Source: International Monetary Fund, World Economic Outlook Database, April 2013

1.2. Build-up of Macroeconomic Imbalances

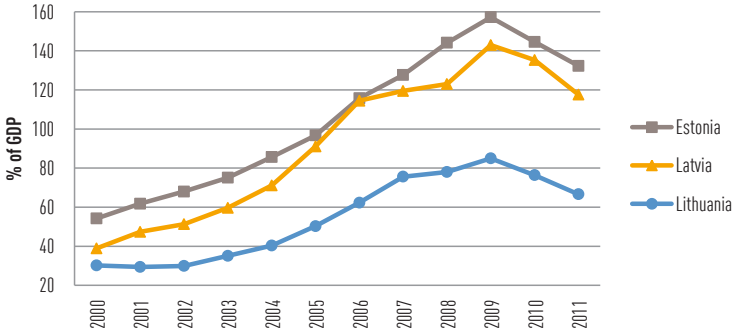
However, the positive developments were accompanied by a significant build-up of macroeconomic imbalances, housing booms and arguably international competitiveness losses in terms of labour costs. In addition, even before the outburst of the crisis, there were growing concerns about overheating in

the Baltics about which the countries have been warned. The IMF[8], the EU[9] and the World Bank[10], all had doubts about the long-term sustainability of the economy. Indeed, Figure 2 illustrates that during the peak year of 2008, the inflation rates in the three states were largely above 10%.

The causes of rising imbalances were several. Firstly, the financial sector was completely liberalised and almost entirely overtaken by the Nordic banks in all three countries, which fuelled capital inflows and credit expansion. In Latvia more than 60% and in Lithuania and Estonia more than 90% of the financial sector became foreign-owned[11]. Competing for market shares within the region and enjoying ample liquidity in the global markets, the Scandinavian banks offered very low interest rates to the Baltic populations. Such conditions, coupled with overly optimistic expectations about the future economic convergence within the EU, fuelled a real explosion of private sector debt. As shown in Figure 3, private sector debt more than tripled in all three states in the period 2000-2008. The great majority of loans were invested in real estate, which subsequently lead to a housing bubble. To quote one example of the magnitude of the boom: the real estate prices in Riga in two years (2005-2007) increased by 385%[12].

8. See for example: IMF, "Republic of Latvia: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia", *IMF Country Report*, No. 06/353, October 2006. The second text reads: "More recently, however, when overheating pressures emerged and credit growth accelerated, fund policy advice had less resonance", p. 7.
9. European Central Bank, "Convergence Report", May 2006 reads: "Over the reference period, Lithuania achieved a 12-month average rate of HICP inflation of 2.7%, which is just above the reference value stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise gradually in the coming months".
10. World Bank, "EU8+2 Regular Economic Report", January 2007 reads: "An excessive growth rate of credit in some countries is contributing to overheating and large external imbalances, especially in the Baltic States".
11. Kattel Rainer, "Financial and Economic Crisis in Eastern Europe", *Journal of Post-Keynesian Economics*, vol. 33, issue 1, 2010, p. 46.
12. Blanchard Olivier, Das Mitali, Faruquee Hamid, "The initial impact of the crisis on emerging market countries", *Brookings Papers on Economic Activity*, 1 January 2010.

FIGURE 3 ► Private Sector Debt



Source: Eurostat

Secondly, as discussed above, the Baltic states quickly became very attractive destinations for foreign investment. However, most of the incoming international investment was directed towards the non-tradable goods sector, namely real estate, retail distribution and the financial sector. Such investment added to the consumption boom, but did not produce the expected productivity gains in the tradable sector. It inflated the profits and wages in the non-tradable sectors, "causing labour and capital to be reallocated from more competitive sectors towards non-tradable ones and playing a key role in inflating internal demand"[13].

Thirdly, wage growth outpaced productivity gains. In the three years preceding the crisis (2006-2008), unit labour costs[14] grew at rates of around 20% in Latvia, 15% in Estonia and 10% in Lithuania[15], suggesting that wage increases were not matched by equally rapid productivity growth. There are several reasons that can explain such a wage boom. Firstly, wages grew because the

13. European Commission, DG ECFIN, "European Economy: EU Balance-of-Payments assistance for Latvia. Foundations of success", *Occasional Paper 120*, November 2012, *see* Di Comite et al., *Chapter 2 – The evolution of the Latvian external sector: imbalances, competitiveness and adjustment*, p. 40.
14. Unit labour costs (ULC) measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs to real output. In broad terms, unit labour costs show how much output an economy receives relative to wages, or labour cost per unit of output.
15. OECD Statistics Database.

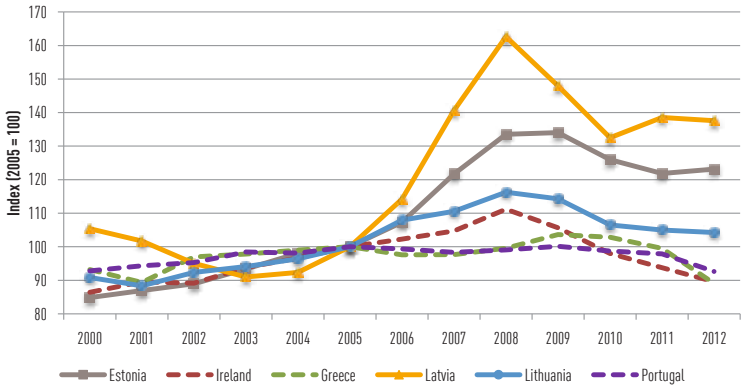
governments of all three Baltic states (especially Latvia and Lithuania) were pursuing expansionary fiscal policies even during the peak boom years[16]. Secondly, after the EU adhesion, wages experienced upward pressure as a result of mass emigration of labour. And finally, the aforementioned capital inflows in the non-tradables sector not only raised the wages in this sector, but also exerted pressure for the wages in the tradables sector to grow faster than productivity.

The surging wages and prices are often said to have resulted in a loss of competitiveness, reflected in the real effective exchange rate (REER) developments. As shown in Figure 4, ULC-adjusted REER[17] experienced significant appreciation in all three Baltic states. However, one has to note that, the REER has a number of flaws as a measure of competitiveness[18], and such a comparison misses the convergence process for catching-up countries. Furthermore, the REERs calculated by Eurostat do not include Russia, which is a key trade partner of the Baltic states.

Indeed, contrary to the usual economic logic, the export shares of the three Baltic states did not decline, up until the crisis even as their REERs appreciated *(Figures 4 and 5)*. This can be explained by the improvements in the non-price factors – the changes in the export structure, consumer tastes, and product quality. If these are taken into account, Latvia's pure price-competitiveness, for example, has been shown to have somewhat worsened over the boom years, although less than suggested by the REER[19]. The non-price competitiveness has been improving since 1999, with the most significant improvement observed during the crisis and post-crisis years.

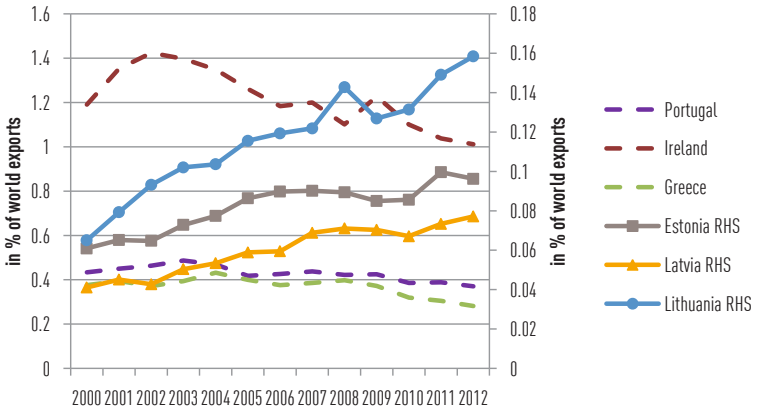
16. Fiscal stimulus has inflationary effect if it is increasing labour demand while the labour supply remains fixed (if the workers that are employed as a result of fiscal stimulus are the ones that had a job anyway).
17. The REER (or Relative price and cost indicators) aim to assess a country's price or cost competitiveness relative to its principal competitors in international markets. Changes in cost and price competitiveness depend not only on exchange rate movements but also on cost and price trends. Calculated against 36 trading partners, excluding Russia. (definition taken from Eurostat) Given the high share Russia has in the exports of the Baltic states, the Baltic states' REERs might not be a good measure of their competitiveness.
18. It is a poor proxy for exporting activities, ignores structural differences of competitors, and, perhaps most importantly, focuses solely on price competitiveness. Source: *Op. cit*. "European Economy: EU Balance-of-Payments assistance for Latvia Foundations of success", *see* Benkovskis, K., "Chapter 3 – Evaluation of non-price competitiveness of exports from Latvia", p. 67.
19. *Op. cit.*

FIGURE 4 ► ULC-adjusted[20] REER



Source: Eurostat

FIGURE 5 ► Export shares in world exports

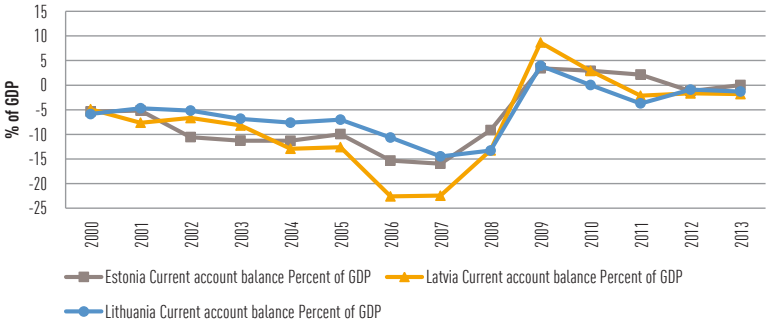


Source: Eurostat

20. Deflated by nominal unit labour costs of the total economy.

These developments, coupled with the fixed exchange rate policy, resulted in large current account deficits that mostly occurred due to increased import demand. Consequently, the three countries accumulated large current account deficits from almost 15% in Lithuania to more than 20% in Latvia *(Figure 6)*.

FIGURE 6 ► Current Account Balance



Source: International Monetary Fund, World Economic Outlook Database, April 2013

2. Difficult Years and Difficult Policies

2.1. The Crash

The recession did not exactly come as a total surprise because macroeconomic imbalances had to be corrected even in the absence of the global financial crisis; however, the magnitude of it did. No one predicted the output losses in one year to be as high as the observed 18%, 15% and 14% in 2009 for Latvia, Lithuania and Estonia respectively[21]. The cumulative output losses were even more dramatic – 21% for Latvia (2007-2010) and 18% for Estonia (2007-2009)[22]. To emphasise the size of the loss, a comparison with the hardest-hit Euro Area periphery economy is useful: the IMF projects that it is only this year (2013) that the Greek output will have contracted by 23% as compared to the peak reached in 2007[23].

As previously explained, there were a number of warnings pertaining to the imbalances accumulated during the boom years, which largely went unheard by the governments, especially the Latvian and Lithuanian ones. The recession in Latvia and Estonia started in the first half of 2008, whilst Lithuania only saw a slowdown in activity at the time *(Figure 1)*. Despite the general lack of a timely and sufficient response to the overheating, almost up until the Lehman Brothers' bankruptcy some still hoped to achieve a "soft landing"[24].

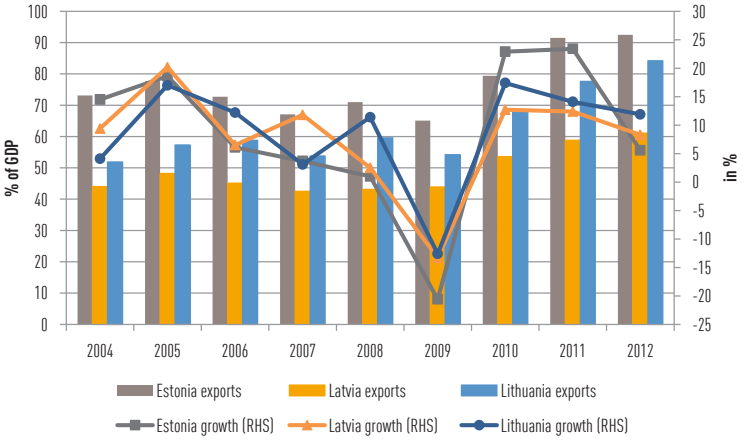
The driving force of the remarkable GDP growth had been domestic demand that was fuelled by credit growth, which in turn occurred due to the large capital inflows. In 2007 the governments adopted certain measures to reign in the credit growth and combat inflation, but it could be described as "too little, too late"[25]. In light of the growing awareness of credit risk in the region, banks reassessed their exposure to the Baltic states and tightened lending standards. Consequently the credit supply decelerated which lead to a slowdown

21. GDP constant prices, own calculations, *see* IMF, "World Economic Outlook Database", April 2013
22. Own calculations, *see* IMF, "World Economic Outlook Database", April 2013.
23. *Ibid.*
24. *See* Grajewski M., "Lithuania set for soft landing, euro in 2010-11 – PM", Reuters, November 2007; Swedbank, *The Baltic Outlook: Over Troubled Water*, January 2008; Swedbank, "The Baltic Outlook: Watch out for the Rocks", July 2008.
25. Peach, G. "Latvia finally tends to runaway economy, but measures may be 'too little too late'", *The Baltic Times*, 14 March 2007.

in the housing market, affecting house prices and decreasing liquidity to the detriment of the value of household equity. The mortgage loan to value ratios increased leading to deteriorating credit quality which in turn raised the credit risks in the Baltic countries, validating the pessimistic conjectures that initiated the downward spiral in the first place.

On the demand side, the irrationally buoyant expectations about the ever-increasing incomes that prevailed during the boom years abated. The imports started falling significantly in 2008 in Latvia and Estonia, and in 2009 in Lithuania, which helped in adjusting the current account balance. The external situation, however, was still relatively favourable until autumn 2008 and the export growth continued *(Figure 7)*. This relatively mild recessionary phase lasted until the September 2008 global financial crash, which removed any glimmer of hope that a full-blown recession can be avoided.

FIGURE 7 ► Exports[26] (LHS) and Export Growth (RHS)[27]



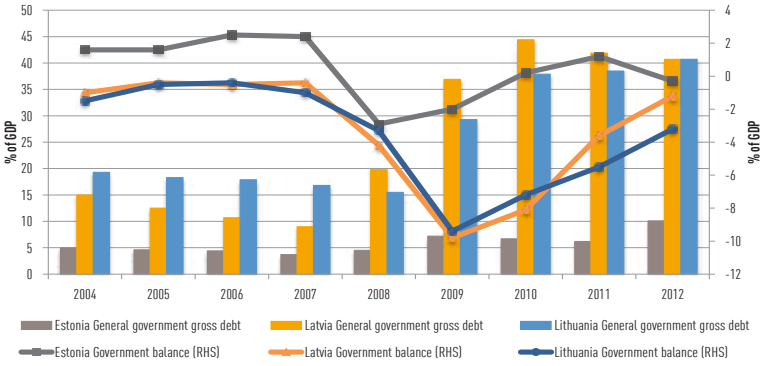
Source: Eurostat, own calculation

26. In current prices.
27. In volumes.

The period from autumn 2008 onwards saw a sharp reversal in capital flows due to the intensification of the aforementioned downward spiral as well as the global liquidity crisis. Elevated risk aversion prevailed globally, and the most vulnerable economies, including the Baltics, were hit hard. Additionally, the exports no longer provided a positive contribution to the economies, since the foreign demand of trade partners fell considerably. In 2009 the huge current account deficits turned to surpluses (Lithuania 3.9%, Latvia 8.7%, Estonia 3.4% of GDP in 2009, *Figure 6*)[28]. All these factors led to a contraction of domestic demand.

Since the public expenditures were in line with the optimistic projections for 2008, whilst the revenue growth slowed considerably; the general government balances deteriorated[29]. The trait was less pronounced in Estonia which maintained surpluses before the crisis *(Box 1)*, a little more so in Lithuania, with the worst development seen in Latvia *(Figure 8)*.

FIGURE 8 ► Government Gross Debt (Maastricht Debt[30], LHS) and Deficit (as considered under the EDP[31], RHS)[32]



Source: Eurostat

28. IMF, "World Economic Outlook Database", April 2013
29. Due to credit rating downgrades it had become very expensive for the Baltic states to borrow in the international markets; the balance of payments financing gap increased, especially so in Latvia, where in addition to the aforementioned effects, the government had to recapitalise the largest domestic bank.
30. Consolidated general government gross debt of the whole general government sector at nominal value, outstanding at the end of the year.
31. The difference between government revenue and expenditure relevant for the Excessive Deficit Procedure.
32. Eurostat database.

BOX 1 ► Fiscal stability and rainy day funds[33]

Rainy day funds allow countries to set aside excess revenue, earned during times of economic expansion, for use in times of unexpected revenue shortfall or budget deficit. The Estonians were the only ones among the Baltic states to appreciate the significance of such an approach to fiscal policy and to accumulate some fiscal buffers during the peak boom years. They started out by targeting a balanced medium-term position. However, in 2006, seeing the pace of economic growth (overheating), the government decided to switch to targeting a nominal surplus which they succeeded at, even outperforming the targets. Nevertheless the rule did not entirely prevent fiscal loosening during the years of high growth, since mid-year supplementary budgets increasing expenditure targets were adopted every year.

Even though the general government balanced budget rule in Estonia was not legally formalised and non-compliance with it did not automatically trigger any punitive action, the rule was observed up until the crisis. That is why already in 2008, after seeing that the actual revenues were likely to underperform, the Estonian government and Parliament adopted a supplementary restrictive budget that initiated a series of consolidation measures in 2009[34]. As a result of the comparatively prudent approach, Estonians could rely on the accumulated reserve when the crisis hit. Therefore, an important lesson for the Baltic states as well as for other countries can be learnt from the Estonian experience: in order to ensure fiscal stability, the country has to work towards the goal at the times of both unfavourable and favourable economic environment.

While Lithuania had set some rules on central government net borrowing and balanced budget rules for local governments, these did not prevent the implementation of procyclical fiscal policy in the boom years. There were no binding fiscal rules for the central government in Latvia at all.

2.2. Austerity as an Exit Strategy

There were two ways of dealing with the crisis – either through external (currency) or internal devaluation. The supporters of the former approach included such prominent names in academic world as Krugman[35], Roubini[36] and Rogoff[37] who argued that, in the Latvian case, the cuts required in public spending would be unsustainable and that eventual devaluation was unavoidable.

33. Based on: European Commission, DG ECFIN, "Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review", *Occasional Papers 91*, February 2012.
34. European Commission, DG ECFIN, "European Economic Forecast – autumn 2009", *European Economy 10*, 2009, p. 86.
35. Krugman Paul, "Latvia is the New Argentina", *New York Times Blog*, 23 December 2008.
36. Roubini, N., "Latvia's Currency Crisis is a Rerun of Argentina's", *The Financial Times*, 10 June 2009.
37. Magnusson, N. "Rogoff Says Latvia Should Devalue Its Currency, Direkt Reports", *Bloomberg*, 29 June 2009.

However, the Baltic central banks, governments and the EU rejected devaluation as a policy option[38]. Devaluation in one of the Baltic countries could have caused contagion in the other two and would have been a threat to the stability of the whole region. In addition, domestically, the high share of euro-denominated loans (in 2008, more than 80% of loans in Latvia and Estonia and more than 60% in Lithuania were foreign currency-denominated[39]) meant that the solvency of households and corporates would come under serious pressure, resulting in a sharp deterioration in the asset quality of banks. The global downturn cast a doubt on the potential magnitude of a devaluation-fuelled rebound in exports, while the competitiveness gains associated with devaluation would not have lasted long since exports had a high import content. Due to the weight of imports in the economy, the consumer price inflation would have sky-rocketed. Devaluation would have also meant that the goal of joining the Euro Area, viewed by most as the main crisis exit strategy, had to be forgotten. Finally, it was of great importance that the public and the governments understood that there were structural problems in the economy that needed to be addressed in any case in order to regain market confidence and put the economies on a more sustainable path.

As a result of the above considerations, the Baltic states opted for internal devaluation that consisted of both expenditure cuts and revenue increases. In addition, there were several types of external help provided, amongst these were: medium-term financial assistance to Latvia[40]; adherence to the "Vienna initiative"[41]; EU's frontloading of structural and cohesion funds[42]; the central bank currency swap agreements between Denmark and Sweden on one side and Latvia or Estonia on the other[43]; the expansion of EBRD activities; and policy advice from such institutions as the European Commission (EC), the IMF and the World Bank.

38. European Commission, DG ECFIN, "European Economy: EU Balance-of-Payments assistance for Latvia Foundations of success", *Occasional Paper 120*, November 2012.
39. European Commission, DG ECFIN, "Cross-country study: Economic policy challenges in the Baltics. Rebalancing in an uncertain environment", *Occasional Papers 58*, February 2010, p. 47.
40. Under the EU medium-term financial assistance facility for non-euro-area EU countries. The EU Balance-of-Payments assistance programme amounted to EUR 3.1bn. There were also loans provided by the IMF, the World Bank, regional neighbours and the EBRD (a total of EUR 7.5bn of which Latvia used only EUR 4.5bn).
41. The European Bank Coordination "Vienna" Initiative, created in January 2009, was a coordinated effort by the public and private sector to secure financial sector stability in the CEE countries with substantial foreign bank ownership.
42. Although the allocation of structural and cohesion funds to support the EU's poorer regions and infrastructure improvements is not related to the crisis, frontloading of disbursement was decided in response to the crisis.
43. Darvas, Z. "The EU's Role in Supporting Crisis-hit Countries in Central and Eastern Europe", *Bruegel Policy contribution*, Issue 2009/17, December 2009, p. 5.

The three countries differed in terms of the severity of the crisis, but followed a similar process when dealing with it. Primarily due to the need to bail out the largest domestic bank (Parex Bank), the Latvian fiscal situation was the worst among the three. In November 2008 the Latvian authorities applied for a balance of payments support from the IMF, the EU and regional neighbours. The country took drastic measures in a short period of time – the cumulative fiscal adjustment from 2008 to 2011 was estimated to be at 17% of GDP (6.8% on the revenue side, 10.2% on the expenditure side)[44]. In comparison, it is only this year that the Greek cumulative fiscal correction is expected to surpass the Latvian one. As a part of structural reforms, state institutions saw important changes: half of the state agencies were closed, support functions were centralised, and the average size of a ministry was reduced by one third[45]. Hospitals, especially the small ones, schools, and vocational education institutions were closed. The financial sector saw a division and a restructuring of the bailed-out bank. Even though the consolidation measures *(Table 1)* brought changes to taxes, the National Reform Programme states that the tax burden against the GDP did not increase[46]. To avoid similar crises in the future, a Fiscal Discipline Law that provides for a balanced budget in the economic cycle came into force in March 2013.

The realised measures have been effective in stabilising the Latvian budgetary situation; the budget deficit in 2012 was only 1.2% of GDP *(Figure 8)*. Latvia returned to the international capital markets very successfully in June 2011, issuing USD-denominated bonds[47]. The balance-of-payments assistance programme was concluded in January 2012. Not only did Latvia use just EUR 4.5bn out of the EUR 7.5bn loan, but also it repaid the part owed to the IMF early – at the end of 2012. The GDP growth, led by exports, resumed in 2011 (5.5%), and in 2012 (5.6%) it was the fastest growing country in the EU. Perhaps the most important development is the country's recent bid to join the Euro Area. Latvia fulfils the Maastricht criteria, and on the 9th of July 2013 the Council invited the country to join the EMU.

44. European Commission, "Convergence Programme of the Republic of Latvia 2012-2015", Riga, April 2012, p. 27.
45. Working group for the development of the National reform programme of Latvia, "National Reform Programme of Latvia for the Implementation of the "Europe 2020" strategy", Riga, April 2011, p. 9
46. *Ibid.*
47. *Op. cit.*, European Commission, *Occasional Paper 120*, p. 10.

Lithuania was hit later, had no systemically important domestic banks to save, adopted significant austerity measures and saw rebound quicker than Latvia; the year-on-year growth turned positive in the second quarter of 2010, chiefly due to exports. The Excessive Deficit Procedure (EDP) that was started in July 2009, together with the tough existing financing conditions at the time, provided the necessary push for a serious response to the crisis. In 2009, consolidation measures amounted to around 8% of the GDP[48] and were focused mainly on the expenditure side, involving public sector wage cuts, as well as cuts in social benefits *(Table 1)*. Lithuania initiated radical health care and education reforms, but all in all the institutional changes were less drastic than those seen in Latvia. Furthermore, alongside the consolidation measures, Lithuanians introduced comparatively more stimulus measures than the other two Baltic states. For instance, the personal income tax was reduced by 9 percentage points to 15% and exemptions were added to excise duties[49]. The measures granted the needed credibility and put the economy on a more sustainable path. The export-driven GDP growth reached 5.9% in 2011 – in the EU, second only to Estonia's 8.3%. According to the recent opinion of the EC on Lithuania's National Reform Programme, the 2012 level of general government deficit (3.2%) can be considered sufficient for abrogation of the decision on the existence of excessive deficit[50]. The Lithuanian authorities have also declared their willingness to introduce the euro in 2015[51].

Estonia, having been the most prudent one during the boom years *(Box 1)*, embarked on fiscal consolidation early in 2008 because it aimed to fulfil the Maastricht criteria in the near future, which was out of reach for both Latvia and Lithuania. Similarly to the other two countries, public sector wages were slashed and benefits were cut, but unlike the neighbours, Estonia changed little on the institutional level[52]. The country also introduced several one-off measures aimed at improving the budget balance in order to qualify for the introduction of euro. In addition to the consolidation measures, the Estonian government attempted to further liberalise the economy. The country's approach was successful and the developments in main trade partners were

48. European Commission, "Assessment of the Action Taken by Lithuania and Romania", Communication to the Council, 2010, p. 5.
49. Bagi, A. and Mezo, J., "Crisis management in the Baltic States" *Munich Personal RePEc Archive*, No. 40366, August 2012, p. 435.
50. European Commission, "Recommendation for a Council Recommendation on Lithuania's 2013 national reform programme", Brussels, 29 May 2013, p. 3.
51. Lithuanian Finance Ministry's affirmation to adopt the euro in 2015.
52. Kattel, R. and Raudla, R., "The Baltic Republics and the Crisis of 2008–2011", *Europe-Asia Studies*, 65 (3), p. 439, 2013.

favourable. Estonia resumed growth in the second quarter of 2010, primarily due to increasing exports, and by 2011 it had already joined the Euro Area. In 2011 it was the only EMU country with a budget surplus.

TABLE 1 ► Budgetary Adjustment in the Baltic States

	Consolidation	Expenditure	Revenue
LITHUANIA	Examples of measures	• Cuts of public sector operating expenses by 10% in 2009.[53] The cuts were progressive, from 8-36%, and highest earners took larger hits. • Sickness benefits curtailed; old-age pensions cut[54]; the part of the social insurance contributions to the compulsory private funded pension pillar were reduced from 5.5% to 2%.	• VAT increase from 18-21% (2009); corporate income tax rate 15-20% (2009)[55]; increase in excise duties. • Broadening of the base for VAT, by reducing the number of goods with favorable rates, and increasing the favorable rates. • Introduction of a real-estate tax.
	as % of GDP	2009: 5.8%, 2010: 3.7%	2009: 1.6%
LATVIA	Examples of measures	• Cuts of public sector operating expenses by 18% in 2009 and continued later. Central government officials saw cuts of 30% between 2009-2011, while public wages were cut by 25%. • Sickness benefits that exceeded a threshold were cut by 50%; old-age pensions cut[56]; the part of the social insurance contributions to the compulsory private funded pension pillar were reduced from 6%-2%. Increase in retirement age to 65 (2012).	• Increase in the rate of personal income tax 23-26% (2010)[57]; employee social contribution rate 9-11% (2011); VAT increase from 18-21% (2009) and then to 22% (2011); increase the excise duties on alcohol, tobacco and energy; increase in vehicle taxes. • Broadening of the base for personal income tax and VAT. • Introduction of a progressive real-estate tax in 2009 that was doubled in 2011.
	as % of GDP	2008: 0.5%, 2009: 6.7%, 2010: 1.9%, 2011: 0.7%, 2012: 0.4%[58]	2008: 0%, 2009: 2.8%, 2010: 2.1%, 2011: 1.6%, 2012: 0.3%

53. Masso, J., Krillo, K., *Labour Markets in the Baltic States During the Crisis 2008-2009: The Effect on Different Labour Market Groups (2011)*, University of Tartu, Faculty of Economics and Business Administration, 2009.
54. Progressive – larger pensions facing larger cuts. The cuts were contested by judicial review and were found to be unconstitutional.
55. Reversed in 2010.
56. The cuts were contested by judicial review and were found to be unconstitutional. The government had to cancel the cut and compensate the pensioners.
57. Reduced again to 25% in 2011.
58. European Commission, *Convergence Programme of the Republic of Latvia 2012-2015*, Riga, April 2012, p. 27.

ESTONIA	Examples of measures	• Cuts to public sector operating expenses by 8% in 2009. Some groups, like teachers, were subjected to a lower pay cut than others. • Sickness benefits for the first days of leave were cut; pensions were not indexed by the planned 14%, but rather by 5%; state-financed contributions to the second pillar were stopped (July 2009 – December 2011). Retirement age to be raised from 2017.	• Planned income tax rate reduction was postponed; Unemployment insurance contributions increased from 0.9-4.2% of gross wages; VAT increase from 18-20%; • Broadening of the base for VAT, by reducing the number of goods with favorable rates, and increasing the favorable rates. • No new taxes introduced • One-off measures: taking dividends from SOEs (2009); selling shares of Estonian Telecom (2009); sold "Kyoto Units".
	as % of GDP	2009: 6.2%, 2010: 1.6%[59]	2009: 2.7%, 2010: 1.3%

59. OECD, "Restoring Public Finances", *Journal on Budgeting*, vol. 11, no. 2, 2011, p. 101.

3. Why has Austerity Worked for the Baltics and at What Price?

3.1. Specific Economic and Political Context

There were several contextual factors that helped the countries deal with the crisis and that, in a way, set them apart from the hard-hit Southern Euro Area member states.

3.1.1. Low Levels of Debt

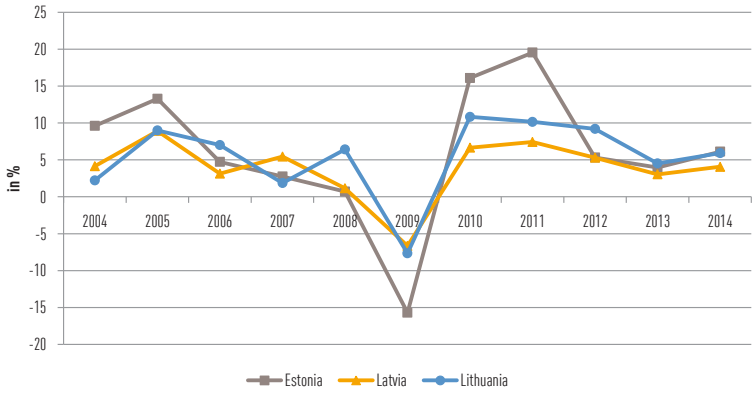
The Baltic states did not go through a sovereign-debt crisis. The countries started out with low and stable debt-to-GDP ratios that did increase sharply during the crisis due to falling GDPs and increasing budget deficits, in Latvia's case, particularly due to the support given to the banking sector. The government debt has since stabilised thanks to effective consolidation measures and revived growth. The low level of government debt in the three Baltic states *(Figure 8)* was of paramount importance for the successful recovery from the crisis. For example, when Latvia entered the balance-of-payments assistance programme, its debt was negligible compared to that of Greece (9% of GDP for Latvia vs. 107% for Greece in 2007[60]). Public debt in the three countries was therefore used to absorb the shock of the collapse in economic activity. The 2012 debt ratios of around 40% of GDP for Lithuania and Latvia and 10% for Estonia[61] are considerably higher than before the crisis, but are still well below those seen in Europe. The fiscal consolidation was needed to offset the gap in the budget, rather than to bring down excessive public debt-to-GDP ratios as it is in most countries that are under pressure from markets to act today. The comparatively low level of debt increases the credibility in the eyes of the markets and implies a brighter outlook for the future, since there is less fiscal retrenchment required going forward as compared to the highly-indebted countries.

60. Source: Eurostat.
61. The debt increased sharply (by 3.9pp) in 2012. The main reasons for the government debt increasing were an increase in loans issued by the European Financial Stability Fund (EFSF) and the use of the credit from the European Investment Bank to co-finance structural funds. Source: Ministry of Finance of Estonia, *Stability Programme 2013*, 2013, p. 39.

3.1.2. Export-Led Recovery

Common to all three Baltic states was their export-led recovery. The Baltic economies are very open and the exports as a percentage of GDP are as high as 60% for Latvia, above 80% for Lithuania and above 90% for Estonia *(Figure 7)*. For Greece and Portugal in 2012, for example, the exports constituted only around 25% and 37% of the GDP respectively[62]. Therefore it is not surprising that the main driver for the revival of the GDP in the post crisis period in the Baltics was exports *(Figure 9)*.

FIGURE 9 ► Contribution of Exports to GDP Growth



Source: Eurostat, own calculations

The reasons for exceptional export growth were generally twofold. Firstly, it is important to recognise that the countries' main export partners *(Table 2)* managed to survive the crisis comparatively well (Poland) or recover quickly (Scandinavian countries, Russia, and all three Baltic states, who are among each other's main trading partners). This is reflected in the sharp rebound of the foreign demand[63] at the beginning of 2010 *(Figure 10)*[64]. The import

62. Source: Eurostat.
63. Foreign demand is the import demand of a country.
64. The weighted change in foreign demand of the five largest trading partners. Rather than sticking to the weights observed at an arbitrary point in time, a time series of trade weights was determined in order to capture the potential changes in the importance of each of the trading partners.

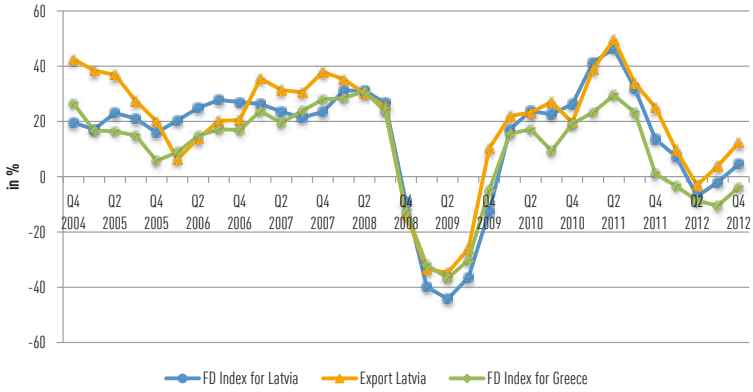
developments in the main trading partners of the Southern Euro Area periphery countries were different and the foreign demand growth they were facing was not as steep as that experienced by the three Baltic states. This leads to a conclusion that the external environment was relatively beneficial and, what is more, the countries, by the virtue of being much more open than the Southern Euro Area states, were well disposed to profit from that.

TABLE 2 ► The Largest Export Partners in 2012

ESTONIA		LATVIA		LITHUANIA	
Country	Average GDP growth 2010-2012	Country	Average GDP growth 2010-2012	Country	Average GDP growth 2010-2012
SWEDEN	3.7	RUSSIA	4.1	RUSSIA	4.1
FINLAND	2.0	LITHUANIA	3.7	LATVIA	3.4
RUSSIA	4.1	ESTONIA	4.9	ESTONIA	4.9
LATVIA	3.4	GERMANY	2.7	GERMANY	2.7
LITHUANIA	3.7	POLAND	3.4	UNITED KINGDOM	1.0

Source: Eurostat, ComExt , IMF World Economic Outlook

FIGURE 10 ► Foreign Demand Growth and Export Growth for Latvia[65] and Foreign Demand Growth for Greece



Source: Datastream, IMF DOTS, own elaboration

Secondly, the developments in the external competitiveness are of key importance for the export performance. The boom years in the Baltics had seen wages grow significantly faster than productivity, impacting competitiveness. In the aftermath of the crisis the countries experienced gains in competitiveness. The REER fell sharply, whilst the export market shares increased *(Figures 4 and 5)*. The comparison with the hardest-hit Southern EMU periphery countries shows that, according to the REERs, they too saw increasing competitiveness in the post-crisis years, whilst their export market shares have been deteriorating since the early 2000s. The continuing decline in export shares of the Southern Euro Area countries might suggest that these have not managed to undertake the reforms necessary to sufficiently boost their competitiveness.

To some extent, the significant improvement in the Baltic states' competitiveness was achieved through internal devaluation. Even though none of the countries experienced significant deflation *(Figure 2)*, there was a sizeable reduction in real wages coupled with important labour productivity gains. In Lithuania,

65. The foreign demand growth indices for Estonia and Lithuania are very similar to that of Latvia due to the similarities in their main exports partners.

and to a smaller extent in Estonia, private sector nominal wages decreased by more than public sector ones, while in Latvia public sector employees experienced the sharpest declines[66].

The improvement in relative cost and price indicators might have also been aided by sectoral re-orientation of the economy from construction and real estate back to manufacturing. Before the crisis the reverse shift took place, as the economy was shifting towards the non-tradables. These changes might have an impact on the economy-wide ULCs, but are generally not taken into account when calculating those. The ULCs are calculated simply by dividing the aggregate labour costs by GDP, without adjusting for the structural changes. Using this approach, the aggregate ULC index might show deterioration even though the individual indices at the sector level do not[67]. Similarly, now after the crisis, the observed ULC improvement and the resulting ULC-adjusted REER depreciation could be simply reflecting the structural shift thereby overestimating the impact of the austerity measures.

3.1.3. Flexible Labour Markets

Another important factor for successful internal devaluation in the Baltic states was their labour market flexibility. Indeed, labour markets are more flexible in the Baltic states than they are in the Southern Europe on several dimensions. For example, strictness of employment protection in Estonia is lower than in Portugal and Greece[68]. In addition, workers representation is extremely weak in all three Baltic states as trade union density and collective bargaining coverage are (among) the lowest in the EU[69]. Finally, the generosity of unemployment benefits is also below the EU average in all three Baltic states whereas they are higher than EU average in Portugal and Ireland[70]. Against such background, employee bargaining power in the Baltic states remains extremely limited enabling employers to adjust their production decisions quickly and often unilaterally.

66. Kattel, R. and Raudla, R., "The Baltic Republics and the Crisis of 2008–2011", *Europe-Asia Studies*, 65 (3), p. 444, 2013; Darvas, Z. "A Tale of three countries: Recovery after banking crises", *Bruegel Policy contribution*, Issue 2011/19, December 2011, p. 6.
67. European Commission, DG ECFIN, "European Economy: EU Balance-of-Payments assistance for Latvia Foundations of success", *Occasional Paper 120*, November 2012, p. 45.
68. As measured by OECD "Strictness of Employment Protection" indicator.
69. Quantitative estimations available at http://fr.worker-participation.eu/content/download/4283/58937/file/EPI_2_0_data.xls
70. Stovicek, Clara and Turrini, Alessandro, "Benchmarking Unemployment Benefit Systems", *European Economic Papers Nr. 545*, European Commission, May 2012, p. 19.

3.1.4. The Societal Ethos

A key factor that made the chosen policies work is related to the existent ethos of the Baltic societies. The overall economic adjustment process in the Baltic states could be (and often is) regarded as an example of swift and efficient political action. In both Estonia and Latvia, austerity governments have been re-elected and seem to have solved J. C. Juncker's conundrum of how to adopt politically unpopular reforms and get re-elected afterwards[71]. Whilst the austerity government in Lithuania lost in recent polls, it entered into history as the first government after independence to have served its full term.

The absence of common action aimed at denouncing austerity policies in response to the social consequences of the economic recession does not mean that the societies did not suffer *(see the following section (3.2) on Social cost of adjustment)*. One could claim that no significant protests were observed because, even though the recent crisis has brought about an economic "collapse that is comparable to that at the beginning of the 1990s, right after independence"[72] in terms of proportional GDP loss, the real GDP levels have remained as high as in 2006 (or shortly before the break-out of the crisis, *Figure 1*).

However, there were other more important reasons that made the fiscal adjustment story a success. First of all, because the time span has been relatively short and the generation shift has not yet taken place, the national memory of real economic hardship of the 1990s was undoubtedly instrumental in facilitating the swallowing of the bitter pill of austerity in the context of a deep recession. Secondly, due to heavy historical heritage, civil societies in the Baltic states are still rather immature and common action in general is extremely rare when compared to the "older" democracies. As a consequence, rather than engaging in political action, significant parts of Baltic societies "voted with their feet" by choosing the path of emigration. Thirdly, there was a deep-running national consensus on both the political and the societal level on the

71. "We all know what to do, but we don't know how to get re-elected once we have done it." Jean-Claude Juncker, Prime Minister of Luxembourg and President of the Eurogroup, *see* "The Quest for Prosperity", *The Economist*, 15 March 2007.
72. Hoen Herman, "Crisis in Eastern Europe: The Downside of a Market Economy Revealed?", *European Review*, Cambridge University Press, Vol. 19(1), 15 April 2011, p. 38.

need for austerity and economic rebalancing, which made the governments' job in explaining the drastic approach easier.

3.2. Social Cost of Adjustment

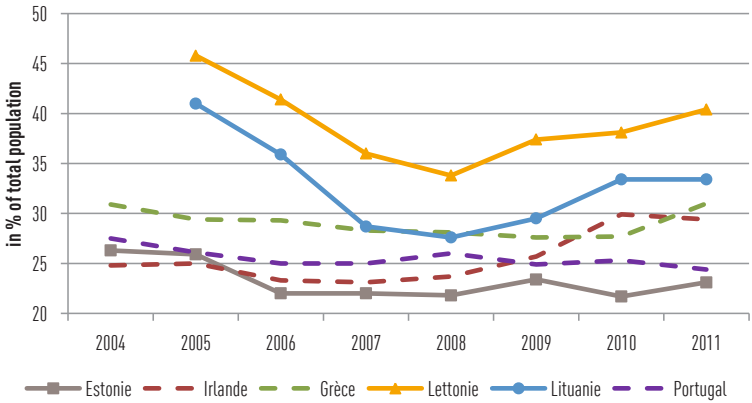
The fact that austerity measures have not been accompanied with any significant public action geared against them might lead towards a simplified conclusion that these policies have not been extremely painful in social terms. However, in certain dimensions the social situation has deteriorated much more in Latvia, Lithuania and Estonia than it has in Portugal or even Greece, which is usually seen as the most striking case. Not only are these social consequences dramatic in their own right as relatively poor (parts of) populations became poorer, but they could also have significant negative repercussions on the future growth prospects of the three Baltic states.

As emphasised in the latest Commission's assessments of all three National Reform Programmes[73], the most acute social problems, namely poverty and social exclusion, have been getting more serious. Figure 11 illustrates that more than a third of the population in Latvia and Lithuania are at risk of poverty and social exclusion[74]. The trends are also similar for severe material deprivation[75], which has increased significantly in the last several years. The levels of these two indicators today are lower than in 2005 (when almost a half of population in Latvia were at risk of poverty and social exclusion), yet they remain among the highest in the EU. Of the "programme" countries, only Greece is approaching comparable levels, which nonetheless remain below those of

73. European Commission, Staff Working Document, "Assessment of the 2013 national reform programme and stability programme for Estonia" *Accompanying the document* "Recommendation for a Council Recommendation on Estonia's 2012 national reform programme and delivering a Council Opinion on Estonia's updated stability programme for 2012-2016", Brussels, COM(2013) 364 final, 29 May 2013. Same for Latvia and Lithuania.
74. At risk of poverty or social exclusion (AROPE) indicator is defined as the share of the population in at least one of the following three conditions: 1) at risk of poverty, meaning below the poverty threshold, 2) in a situation of severe material deprivation, 3) living in a household with very low work intensity.
75. Material deprivation refers to a state of economic strain and durable, defined as the enforced inability (rather than the choice not to do so) to pay unexpected expenses, afford a one-week annual holiday away from home, a meal involving meat, chicken or fish every second day, the adequate heating of a dwelling, durable goods like a washing machine, colour television, telephone or car, being confronted with payment arrears (mortgage or rent, utility bills, hire purchase instalments or other loan payments). The material deprivation rate is an indicator in EU-SILC that expresses the inability to afford some items considered by most people to be desirable or even necessary to lead an adequate life. The indicator distinguishes between individuals who cannot afford a certain good or service, and those who do not have this good or service for another reason, e.g. because they do not want or do not need it.

Latvia and Lithuania. The situation in Estonia is somewhat better. However, the Commission notes that "the targets set for reduction of poverty and social exclusion will pose a serious challenge" as "the poverty risk of children in jobless households is starting to increase, while the number of children needing social assistance has more than doubled over the last five years".[76] Worryingly, these social indicators continued to deteriorate in all three Baltic states in 2011, even though economies were recovering already.

FIGURE 11 ► People at Risk of Poverty or Social Exclusion



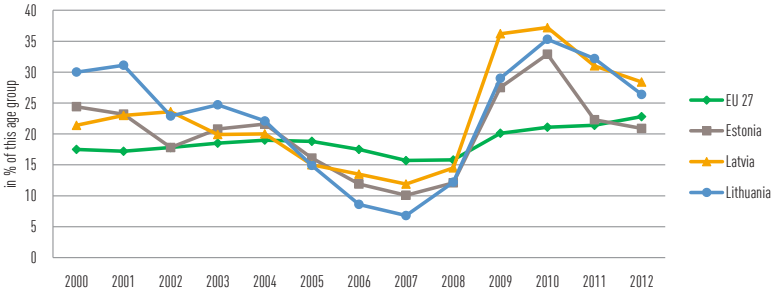
Source: Eurostat

Currently, worse-than-expected developments on the labour market are undoubtedly one of the most important reasons of increasing poverty. Overall unemployment rates in all three Baltic states are still higher than the bellow-natural pre-crisis levels and will remain so in 2013 (around 8% in Estonia and above 10% in both Latvia and Lithuania, *Figure 2*). The figures are more alarming for more vulnerable social groups, in particular the young and the long-term unemployed. In the period 2010-1012, long term unemployment has reached decade's highs and remains well above the EU average[77]. In addition, in 2012,

76. European Commission, *op.cit.*, p.13.
77. Eurostat Database.

more than 25% of young people were unemployed in Latvia and Lithuania, whilst Estonia has managed to achieve below EU average levels *(Figure 12)*.

FIGURE 12 ► Youth Unemployment Rate (25 years old and younger)



Source: Eurostat

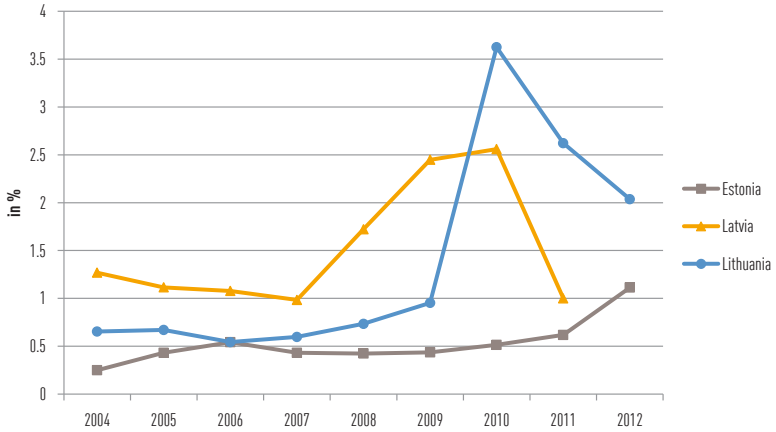
These figures might not seem as dramatic as in Spain and in Greece, where youth unemployment is above 50%, yet it is obvious that they are very much deflated by another mass phenomenon in the three Baltic states, namely labour force emigration. Generally speaking, in less than a decade of EU membership (2004-2013), Latvia and Lithuania have lost 13-14%[78] of their total population whereas the size of the Estonian population remained more or less stable. In order to get a sense of magnitude, if Spain and Italy would have lost the same proportion of their population as Latvia and Lithuania in the past 5 years, it would represent a total of 11 million people[79].

Even though populations of the Baltic states are naturally ageing, net emigration accounted for more than three fourths of the total population loss in the last decade[80]. Figure 13 illustrates that the extent of declared year-on-year emigration since the three countries joined the EU has been impressive. Official emigration numbers peaked in the year 2010 in Lithuania (more than 3.5% of

78. Eurostat Database.
79. Wolf Martin, "Why the Baltic states are no model", *Financial Times*, 30 April 2013.
80. Hazans Mihails, "The changing face of Latvian emigration... and the changing face of Latvia", AmCham Outlook on demographics, University of Latvia, Institute for the study of labour(Iza Bonn), 1 March 2012.

its working age population)[81] and in Latvia (2.5%), the year when unemployment rate also reached its heights in both countries. More worryingly still, actual emigration numbers are even higher than these estimations. For example, OECD study quotes that "undeclared emigration accounted, on average, for more than a half of total outflows in the period 2001-10".[82]

FIGURE 13 ► Official Emigration as % of Working Age Population (15-65)



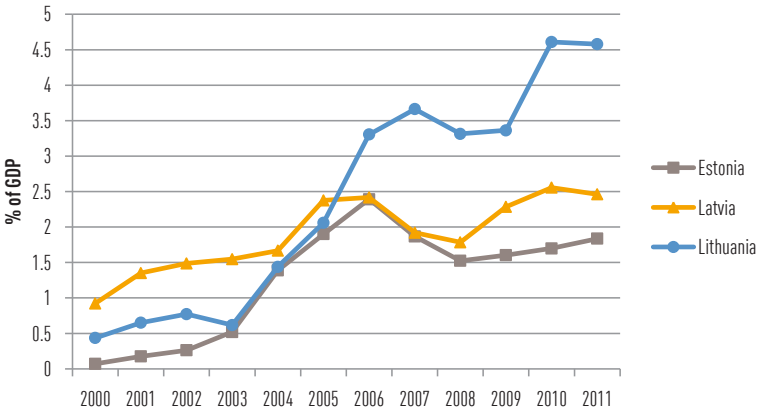
Source: own elaboration, national statistics departments for emigration flows and Eurostat for working age (15-65) population, for Latvia data available until 2011 only

In some respects emigration has positive effects. Indeed, as suggested by the Optimal Currency Area theory, labour mobility is instrumental in cushioning asymmetric economic shocks and benefit the whole monetary union as workers from a badly hit country go to work in other better-off member states. In this way, Latvia and Lithuania are spared from paying unemployment benefits with obvious positive effects for public finances whereas better-off countries such as Finland or Germany get a much needed labour inflow. In addition, in the case of the Baltic states, remittances represent a non-negligible part

81. The peak in Lithuania was also influenced by a change in national laws whereby declaring departure became compulsory; otherwise, the emigrant would have to continue paying national social insurance contributions.
82. OECD, "Country notes: recent changes in migration movements and policies: Lithuania", *International migration outlook 2012*, 2012.

of national wealth *(Figure 14)*. For example, in Lithuania, more than 4.5% of national GDP came as transfers from Baltic workers living abroad in 2010 and 2011. These transfers stimulate national demand and potentially serve as a "safety net" against poverty for a number of households.

FIGURE 14 ► Remittances



Source: World Bank

Despite all these benefits, massive emigration represents several serious challenges for such small nation states both in the short and in the long term. In the shorter term, gains in public finances accruing from savings on unemployment payments might be largely offset by missing budgetary revenues as potential tax payers are paying their taxes abroad. But the main problem is that emigration concerns not only the unemployed, but also people in employment who are looking for a higher pay abroad. As a consequence, a significant proportion of young, flexible and highly skilled segments of labour force might be lost as the "brain drain" materialises. For example, in Lithuania more than 50% (more than 80% in Latvia[83]) of emigrants are between 20 and 35 years old and 75%

83. *Op. cit.*, Hazans Michails.

of emigrants have post-secondary education[84]. This aggravates existing skilled labour shortages and makes labour matching much more difficult[85].

In the longer term, and in the absence of compensatory (re)immigration, emigration might result in a demographic gap whereby a significant part of working-age population goes missing in the national demographic pyramid. As a result, population ageing accelerates with all its negative consequences; threats for public finance sustainability, especially in what regards pension and healthcare systems, lack of economic dynamism, and labour shortages, among others. All these threats are even more credible as the surveys suggest that out of current emigrants only 8% plan to return to their homelands within 6 months and just about 20% within next 5 years[86].

84. "Migracija Lietuvoje: Faktai ir Skaiciai".
85. As discussed in the three assessments of the NRP, EC, *Op. cit.*
86. *Op. cit.*, Hazans Michails.

4. Conclusions and Lessons for the Future

From the collapse of the Soviet Union up until the global financial crisis the Baltic states were largely considered a success story. However, their rapid development and fast GDP growth took place concurrently with a build-up of massive economic imbalances. The most problematic development in the pre-crisis period was the excesses of internal demand and consequently, the soaring imports. These occurred due to the capital inflows that made credit amply available and the investment that went largely into the non-tradable sectors fuelling asset price bubbles. The wages grew faster than productivity, impacting competitiveness; however, the extent of the pre-crisis competitiveness losses is usually exaggerated. At the end of the boom years, the worsening outlook caused a slow-down in the lending activities, which were entirely stopped after the Lehman Brothers bankruptcy.

In the second half of 2008 the three countries experienced a sharp reversal of capital flows, and the general government balances swiftly deteriorated. Despite the comparatively low levels of government debt, it became very expensive to borrow on international markets. Furthermore, Latvians, unlike the other two neighbouring governments, had to save a systemically important domestic bank. There were two ways out of the crisis: external (currency) or internal devaluation, out of which the second policy option was chosen. Therefore, the countries' response to the crisis was to front-load harsh austerity measures. The Baltic states saw drastic cuts in public spending; wage deflation; institutional changes; and a drop in domestic demand that translated into a huge fall in imports helping to correct the current account imbalances.

However, before the austerity supporters can attribute the Baltic recovery to a strict adherence to austerity, and prescribe the approach to all the crisis-hit countries, it has to be pointed out that the unique economic and societal model of the small open economies has worked to their advantage when dealing with the crisis. The government debt issue, so pressing in the rest of Europe, is not a key concern in the Baltics, due to their low debt levels. Exports, the main driver of the revival of GDP, rose quickly partly because of competitiveness increases

and partly because of the favourable developments in the main export partners. Whilst the rising competitiveness was austerity-facilitated, the post-crisis structural shift back from the construction and real estate sectors to manufacturing could have played a role. Flexible labour markets, weakness of trade unions and the comparatively low social demands – the opposite of what is seen in Southern Europe – fostered successful implementation of the austerity policies.

Perhaps most importantly, another reason for the success of the austerity policies in dealing with the crisis was the ethos of the Baltic population. The people are not prone to voicing their concerns through public action in the form of demonstrations, protests or strikes. The civil society in general is weak. Furthermore, the memories of the post-Soviet economic collapse are still alive, therefore, the recent crisis did not come as great a shock to the Baltics as to the Southern European states, who prior to the crisis had enjoyed a much longer period of prosperity and economic growth. Finally, the public understood that reforms were needed and that the previous growth streak was not sustainable.

Contrary to what the lack of protests might suggest, the populations are paying a high price for the austerity policies. The most acute social problems, namely poverty and social exclusion, have been getting more serious. Unemployment figures are down from the crisis readings, but are still relatively high. The extremely high emigration, especially in Latvia and Lithuania, flatters the official statistics in terms of national unemployment and even poverty levels. However, the emigration trend has a number of negative consequences, including "brain-drain" and the creation of a demographic gap that will threaten the sustainability of the future public finances.

In conclusion, the Baltic states' near-miraculous recovery from the crisis was a result of many factors, not least of them being the strict adherence to austerity policies. However, one has to be careful not to overestimate the importance of austerity measures in reviving economic growth, or underestimate their impact on the wellbeing of the three societies. Currently the social situation is slowly improving, but some trends are a threat to sustainable development of the three Baltic states. The extent to which other crisis-hit countries can learn from the experience of the Baltics is limited due to the specificities of the three. Therefore, perhaps the most valuable lesson is to be learnt by the tiny Baltic countries themselves for their own future policies.

PART 3
ENERGY POLICY: THE ACHILLES HEEL OF THE BALTIC STATES

by Dr. Agnia Grigas

INTRODUCTION

Nearly a decade following EU accession, the energy sector remains the most vulnerable national arena for Estonia, Latvia and Lithuania – an "Achilles heel" of the three Baltic states. The vulnerability stems from the fact that the energy sectors of the three states remain inextricably linked to and fully depended on Russia while they are virtually isolated from the rest of the EU, making them "energy islands". This predicament is not only of concern to statesmen and strategists as energy effects almost every aspect of the Baltic states – the economy, industry and the wellbeing of citizens. The rapid inflation of the mid 2000s leading to the economic overheating and eventual economic crisis in 2008 was in part due to the rapidly accelerating costs of Russian gas and oil. Industry which accounts for a significant portion of total gas consumed (50%[1] of total gas consumed in Lithuania, 21%[2] in Estonia, 14%[3] in Latvia) was also hard-hit. Gas prices are particularly sensitive for households who depend on gas for heating in the winter months, making up 10%[4] of total gas used in Estonia in 2011, 9%[5] in Latvia, and 5%[6] in Lithuania, which represents 10 to 15% of their post-tax income[7].

1. Calculated by the author according to the 2011 data of Statistics Lithuania. Statistics Lithuania, "M8020304: Fuel in natural units by fuel, year", 11 May 2013.
2. Calculated by the author according to the 2011 data of Statistics Estonia. Statistics Estonia, "FE061: Consumption of fuels by Year, Branch of economy and Type of fuel", 11 May 2013.
3. 2011 Central Statistical Bureau of Latvia, "Consumption of energy resources in Latvia in 2011", 9 May 2012.
4. Calculated by the author according to the data of Statistics Estonia. *Op. cit.*, "FE061: Consumption of fuels by Year, Branch of economy and Type of fuel", 11 May 2013.
5. *Op. cit.*, "Consumption of energy resources in Latvia in 2011", 9 May 2012.
6. Calculated by the author according to the data of Lithuanian National Control Commission for Prices and Energy. Valstybinė kainų ir energetikos kontrolės komisija, "2011 metų energetikos sektoriaus plėtros apžvalga", p. 7.
7. Grigas Agnia, *The Politics of Energy and Memory between the Baltic States and Russia*, Farnham, Surrey: Ashgate Publishing, 2013, p. 83.

In face of the pressures of the existing energy predicament, the priorities of the Baltic countries have generally coincided with the objectives of EU energy policy. Diversification and security of energy sources, increasing the competitiveness of domestic energy markets and a focus on renewables are all within the interests of the three countries. In fact at times, the three Baltic states have been drivers of EU's energy policy and at times passive recipients. Lithuania and to some extent Estonia have been less compromising towards Russia and more willing to take the lead in liberalisation and security of supply policies, while Latvia has preferred a slower and more cautious approach. In terms of sustainability and renewables, Latvia has set the most ambitious targets. It is of no surprise that when Lithuania takes the helm of the EU presidency in July 2013, energy will figure among the main objectives. Vilnius will seek to promote energy security through consolidation of energy infrastructure and strengthening of the position of EU's common external energy policy. Vilnius will also support the EU's Strategy for the Baltic Sea Region (EUSBSR) which is engaged in a number of energy flagship projects, particularly improving access to, and the efficiency and security of energy markets for eight EU member states that border the Baltic Sea[8].

The following paper seeks to provide an overview of the contemporary Baltic energy realities and policies and to assess the successes and challenges that the three states face as they try meet the EU energy policy objectives. First a brief summary of the Baltic gas, oil and electricity sectors will be provided. The second section will focus on the political implications of the isolation and energy dependence on domestic politics, bilateral relations with Russia, and EU-Russia relationship. Lastly, the progress and effectiveness of EU's energy policy of liberalisation, integration and diversification for the Baltic energy markets and region will be assessed. The conclusion will offer insights to where the EU's energy policy has provided real value added for the Baltic states and where EU energy policy must be strengthened to be most effective in the Baltic region and for the EU overall.

8. European Commission, "Action Plan for the European Union Strategy for the Baltic Sea Region", February 2013.

1. Baltic Energy Sector

1.1. Gas Sector

Just as a few other EU states such as Bulgaria, Romania, Slovakia, and Finland, the Baltic states likewise rely solely on Russia for gas imports[9]. The Baltics are more vulnerable in terms of gas than most other EU states not only because of their import dependence on a single and potentially hostile source, but also due to their gas transport and delivery infrastructure. Baltic gas infrastructure was built in the Soviet era and depends on Gazprom-owned pipelines that deliver Russian gas. Only Finland and Bulgaria have comparable conditions. The Baltic states are still not connected to the gas pipelines of other EU states and have no means of accessing non-Russian gas or liquefied natural gas (LNG). Furthermore, Russian interests dominate the Baltic gas sector since Gazprom became an investor in the national gas companies of all three states: Eesti Gaas (37%), Latvijas Gāze (34%), and Lietuvos Dujos (37%) *(Table 1)*.

9. Eurostat, "Energy dependence", 2012; International Energy Agency, "Country reports", 2012.

TABLE 1 ► Gazprom's Penetration of Baltic National Gas Companies

COUNTRY AND FIRM	OWNERSHIP OF FIRM BY RUSSIAN COMPANIES (rounded to nearest %)	OWNERSHIP OF FIRM (rounded to the nearest %)	MAIN ACTIVITY OF FIRM
Estonia **Eesti Gaas**	47% (Gazprom + Itera)	37% Gazprom 34% E.ON Ruhrgas 18% Fortum Oil and Gas 10% Itera Latvija 2% Private investors	Import, transmission (including ownership of pipelines), and sales of natural gas
Latvia **Latvijas Gāze**	50% (Gazprom + Itera)	47% E.ON Ruhrgas 34% Gazprom 16% Itera Latvija 3% Private investors	Import, transmission, storage and sales of natural gas
Lithuania **Lietuvos Dujos**	37% (Gazprom)	39% E.ON Ruhrgas 37% Gazprom 18% Lithuanian state 6% Private investors	Import, transmission, distribution, and sales of natural gas

Source: Eesti Gaas, Latvijas Gāze, and Lietuvos Dujos websites as of May 2013.

Despite this general gas vulnerability, Latvia and Lithuania each benefit from unique circumstances that to-date have mitigated their gas sectors' weakness. Latvia's comparative advantage and guarantee of gas supply is Inčukalns, the only significant gas storage facility in the region[10]. Besides Latvia it also serves Lithuania, Estonia, and northwest Russia in the winter period[11] and could ensure supply in case Russia interrupts provision of gas as it did to Ukraine (March 2005; March 2008; December 2008) and to Belarus (February 2004; January 2010). However, some analysts are cautious of Inčukalns' mitigating effect since Gazprom is its partial owner via its shares in Latvijas Gāze.

In Lithuania, the gas transit from Russia to its Kaliningrad territory via Lithuania serves as a sort of guarantee of gas supply for Vilnius since any interruption to Lithuania would directly affect Kaliningrad. Vilnius has used Kaliningrad's reliance on Lithuania for gas, oil, and electricity transit and

10. The present capacity (4.4 billion cubic meters of which 2.3 billion cubic meters is active) exceeds Latvia's annual consumption of gas, which in 2011 was 1.6 billion cubic meters. *Op. cit.*, "Consumption of energy resources in Latvia in 2011", 11 May 2013.
11. Sprūds Andris, "Latvia's Energy Strategy: Between Structural Entrapments and Policy Choices", *in* Rostoks Toms, eds., *Energy: Pulling the Baltic Sea Region Together or Apart?*, Latvian Institute of International Affairs, Riga, 2009, p. 228.

supply as a bargaining tool with Moscow in the 1990s and again in the more recent years. However, since the 2000s Moscow sought to make gas supply independent from transit by completing gas storage facilities in Kaliningrad (by 2010 and by 2015) and planning to link Kaliningrad with the Nord Stream gas pipeline which delivers Russian gas via the Baltic Sea directly to Germany, thereby bypassing the Baltic states.[12]

MAP 1 ► Energy and Gas Pipeline Infrastructure in the Baltic Region

Source: Grigas Agnia, "The Gas Relationship between the Baltic States and Russia – politics and commercial realities", Oxford Institute for Energy Studies, October 2012, p. 7.

12. *Op. cit.*, *The Politics of Energy and Memory between the Baltic States and Russia*, p. 81.

Shale gas also holds promise for the Baltic countries. Most recent estimates suggest that Lithuania may possess the greatest reserves – 10 billion cubic meters – yet this could supply Lithuania only for 3 years since the country imports 3 billion cubic meters of gas annually from Russia[13]. However, test drilling will be completed only by 2020 and further investment and exploration will depend on those results and environmental regulation decisions[14]. In Latvia, the United States Geological Survey in 2012 re-assessed Soviet-era research on shale gas in Latvia[15]. The results were not optimistic, but the Latvian Prime Ministry of Economics hopes to continue the examination[16]. Meanwhile, Estonia has yet to confirm any reserves.

Overall it is too early to assume that shale gas will change the Baltic energy balance as it did in the United States. For instance, neighbouring Poland's test drills of 2011 did not justify the optimistic projections[17]. Furthermore, EC regulation on drilling procedures expected in late 2013 may create limits to shale gas exploration. Absent regulations, it is likely the Baltic states will be more aggressive considering in shale gas exploration than many European countries led by Austria, France, Netherlands, Luxembourg, Romania, Bulgaria and Czech Republic who have expressed caution regarding shale gas development.

1.2. Oil Sector

The Baltic states import nearly 100% of their oil from Russia. Despite their ability to import non-Russian sources of oil, historically Baltic oil terminals (Estonia's Muuga Port, Paldiski South harbour and Paljassaare Harbour; Latvia's Ventspils and Liepāja; Lithuania's Būtingė) primarily import Russian oil and export it westwards on the Baltic Sea. Since 2000, all three states have experienced Russian oil sanctions. Latvia's port facility Ventspils Nafta and Lithuania's oil refinery Mažeikių Nafta were both cut-off from Russian oil supply since 2003 and 2006 respectively[18]. Both halts in supply occurred following the refusal of Riga and Vilnius to sell the shares of Venspils Nafta and Mažeikių

13. www.DELFI.lt, "Amerikiečių skaičiavimai laidoja Lietuvos skalūnų viltis", 12 June 2013.
14. *Ibid.*
15. news2biz LATVIA, "Low perspectives for shale gas in Latvia", 18 October 2012.
16. www.DELFI.lt, "Latvija su pavydu žiūri į Lietuvos skalūnų dujas", 15 April 2013.
17. KPMG Global Energy Institute, "Central and Eastern European Shale Gas Outlook", 2012, p. 34.
18. For more information on the closure see *op. cit.*, *The Politics of Energy and Memory between the Baltic States and Russia*, pp. 49-67.

Nafta to Russian investors. Estonia similarly experienced a halt and then a reduction in its supplies of oil products in 2007, following a political standoff between Tallinn and Moscow over a Soviet bronze solder war memorial[19].

While all three states have invoked help from the EU to assist in returning oil deliveries, even the sale of Ventspils Nafta and Mažeikių Nafta to a Russian investor is unlikely to resume the deliveries and the Baltic states will likely be completely eliminated from the transit of Russian oil. Since 2000s Russia has been notably and purposefully re-orientating its energy export flows (to western clients) away from old routes via the Eastern European states to new direct routes to Western Europe through Russian territory and ports and eliminating transit states such as the Baltics. Russia has been updating its energy export infrastructure through completion of Baltic Pipeline System (BPS) in 2001, the Primorsk two oil terminals in 2006 and 2008. Going forward Moscow aims to expand BPS to completely bypass Belarus and the Baltic states and to nearly double the capacity of Russia's north-western ports of Ust-Luga, Primorsk, Vysotsk, Kaliningrad, and Murmansk by 2015.

1.3. Electricity Sector

The domestic electricity market of the Baltic states is unique, each relying on different domestic resources or lack thereof for electricity production. Estonia relies on its resources of oil shale, which is used to generate 90% of the country's electricity[20]. Despite EU environmental regulations Estonia will open the world's biggest shale oil plant Enefit280 in mid 2013 and double Eesti Energia's oil output to 10,000 barrels a day[21]. For electricity Latvia depends on three hydroelectric power plants on the Daugava river: Keguma HES, Plavinu HES and Rigas HES, which in 2011 supplied 48% domestically produced electricity[22]. Lithuania closed its last nuclear reactor, which accounted for 77% of domestic electricity production, due to EU regulation in 2009 and went from

19. For more information on the Soviet bronze solder war memorial see *ibid*., pp. 67-72.
20. *Op. cit.*, "A study on the EU oil shale industry – viewed in the light of the Estonian experience", May 2007, p. 14.
21. Bloomberg.com, "Eesti Energia Shale Oil Plant Delayed to Next Year, CEO Says", 28 November 2012.
22. Calculated by the author according to the data of Central Statistical Bureau of Latvia. *Op. cit.*, "Consumption of energy resources in Latvia in 2011", 9 May 2012.

being an electricity exporter to depending on imports from Russia, Estonia, Latvia and Belarus.[23]

For nearly a decade Lithuania has been planning to build a new regional nuclear power plant in Visaginas with the help of Poland, Estonia, and Latvia. A bureaucratic stalemate, disagreement among political parties, Russia's meddling, lack of interest among commercial investors and scepticism in Warsaw, Tallinn, and Riga have been the main culprits for delay. Furthermore, the 2012 national referendum in Lithuanian showed that only 34% participants were in favour of nuclear power plant construction while 63% were against. The new government led by the Social Democrats and Prime Minister Algirdas Butkevičius is sceptical regarding a new nuclear power plant calling it "unwise" and too expensive[24]. The final decision will be voted by Lithuanian Parliament but regardless of the decision the Visaginas NPP will face a long delay[25].

Estonia is also considering nuclear power to diversify energy sources by either building a domestic nuclear power plant or participating in Lithuanian Visaginas[26]. Neighbouring Kalingrad and Belarus have also discussed projects for competing nuclear plans. Sceptics say that these projects would produce a regional electricity surplus and serve to confuse and put off potential investors in Lithuania's Visaginas[27].

23. U.S. Energy Information Administration, "Lithuania", 11 May 2013.
24. www.DELFI.lt, "A. Butkevičius: Visagino AE statybos būtų neišmintingas sprendimas", 23 April 2013.
25. www.DELFI.lt, "A.Kubilius: judame į Kaliningrado glėbį", 24 April 2013.
26. European Commission, Joint Research Centre, Institute for Energy and Transport, "Estonia", 11 May 2013.
27. Grigas Agnia, "Legacies, Coercion and Soft Power: Russian Influence in the Baltic states", Chatham House, August 2012, p. 8.

2. Political Implications of Baltic Energy Dependency on Russia

The acute Baltic dependence on Russia has had an influence on domestic political processes, particularly by entrenching energy interest groups. With corruption and lack of transparency in the financing of political parties still a risk factor, the influence of energy-related business interests has been more significant. The most powerful interests groups in the Baltics, particularly in Latvia and Lithuania, are in the business of energy imports from Russia and in energy transit. These include national gas companies such as Eesti Gaas, Latvijas Gāze, and Lietuvos Dujos as well as Russian gas distribution company Itera that has daughter companies operating in Latvia and Estonia, as well as local gas distributors such as Lithuania's Dujotekana, Stella Vitae and Vikonda whose ownership structure has been linked to Gazprom. While there is limited verifiable documentation of the influence of business groups, unofficial testimony from Baltic decision-makers and media accounts shed light on such activities[28]. The resulting domestic conditions often make it difficult for the three Baltic states to carry out coherent energy policy or foreign policy towards Russia.

To counter Moscow's and energy-interest groups' influence in domestic politics, the Baltic states have tried to leverage their EU membership. As a result, tensions have escalated both in Baltic-Russia and EU-Russia context. In 2008 Lithuania tried to veto EU's negotiations to renew the Partnership and Cooperation Agreement (PCA) with Russia primarily over the oil halt to Mažeikių Nafta. Most recently the main flashpoint has been in the gas sector. In the 2010s the Baltic states, particularly Lithuania, voiced concerns that Russia discriminates them in terms of gas pricing, imposing politically rather than commercially derived prices. Following a complaint by Lithuania, in September 2012 the European Commission's Directorate General for Competition launched a formal antitrust investigation against Gazprom's practices in Central and Eastern Europe, which include imposing unfair oil-based pricing, hindering the free flow of gas from one country to another and preventing diversification

28. *Ibid.*, p. 3.

of supply of gas[29]. However, if the Commission fails to alter Gazprom's pricing model from oil-linked to hub-based prices, the Baltic states will be further disadvantaged as Europe moves towards hub-based prices because the Baltics are not connected to European gas markets and are not close to any hubs that would allow them access to gas at competitive market prices[30].

In the future the European Commission (EC) involvement in Baltic negotiations of gas supply contracts with Russia could be another source of tensions. While the EC has had a history of pressuring energy companies to adhere to EU competition norms, involvement in bilateral relations between a EU member state and external energy supplier was unprecedented until 2010 when EC got involved in Poland's negotiations with Russia over gas transit and supply as well as Bulgaria's negotiations with Russia over South Stream pipeline project[31]. Following this example, in 2013 Lithuania officially asked for EC involvement when renegotiating its gas supply with Gazprom as its long-term contract is due to end in 2015[32]. Estonia is also due to renew its gas supply contract from Gazprom in 2015 and various lobbies and media reports have called for EU involvement in the negotiations though no official arrangements have been made[33]. Meanwhile though the EC promised to support Latvia in their gas supply negotiations[34], Latvia so far has not elected to involve the EU in the process. Unofficial reports indicate that Gazprom has been offering Riga a 20% discount on gas (Estonia and Latvia allegedly already pay 10-15% less than Lithuania) in exchange for a delay implementation of EU's Third Energy Package[35]. EU's involvement in the Baltic re-negotiation of gas supply contracts with Gazprom is crucial not only for the Baltic negotiation position but also to EC's efforts in liberalising EU's gas market and ensuring that the resulting contracts conform with EU laws and regulation[36]. To better leverage EC support, greater cooperation between the Baltic countries, Finland and the EC regarding Gazprom will be necessary[37].

29. European Commission press release, "Antitrust: Commission opens proceedings against Gazprom", 4 September 2012.
30. Grigas Agnia, "Can EU face Russia down over energy policy?", oDRussia, 18 March 2013.
31. Łoskot-Strachota Agata, "The EU internal market – a stake or a tool in European-Russian gas relations", 24 June 2011.
32. Grigolytė Rūta, www.lrt.lt, "Ar Lietuva pasiruošusi nusikratyti „Gazprom "gniaužtu?", 30 April 2013.
33. The Baltic course, "Estonian home owners: EU should buy gas from Gazprom jointly", 29 March 2012.
34. BNN, "European Commission promises to support Latvia in negotiations with Gazprom", 6 September 2010.
35. eurotopics.com, "Gazprom wraps Latvia around its finger", 24 April 2013.
36. *Op. cit.*, "The EU internal market – a stake or a tool in European-Russian gas relations", 24 June 2011.
37. BNN, "Baltics, Finland and EC to coordinate their position in talks with Gazprom", 7 March 2013.

3. EU Energy Policy and the Baltic States

3.1. Liberalisation of EU Internal Market by 2014

EU's energy policy's is centred on creating an internal market through energy sector liberalisation and integration of European energy networks. Liberalisation of the energy market seeks to give consumers a choice between different gas and electricity companies as well as making the market entry accessible for all suppliers. For the Baltic states a truly competitive and integrated internal EU market can help achieve diversification and thus security of supply[38]. In order to liberalise the energy market, three legislative packages were adopted from 1996 to 2009. The Third Energy Package effective since March 2011 seeks to prevent energy monopolies by separating energy production from transmission activities ("ownership unbundling") for electricity and gas companies.

Baltic unbundling and liberalisation has achieved greater success in the electricity sector rather than the gas sector. In Estonia and Lithuania the electricity market has been liberalised for all customers, including households since 2013[39]. In Estonia the electricity transmission system operator (TSO) Elering AS is 100% owned by the state and separated from all other electricity production and sale undertakings since 2010, while the independence of the transmission network has been enforced since 2012[40]. Yet, while Estonian households can now choose from seven electricity providers, the majority of consumers remain customers of the market incumbent Eesti Energia. Paradoxically, market liberalisation is expected to result in electricity price increases due to the lack of real competition on the open electricity market and Estonia's limited integration with the EU market[41]. In Lithuania the situation is similar – while electricity transmission and distribution activities are separate since 2010, households continue to pay higher price for Russia-sourced electricity

38. Summaries of EU legislation, "Internal energy market", 11 May 2013.
39. news2biz, "Latvia to delay electricity market liberalisation", 26 March 2013.
40. Estonian Competition Authority, Estonian Electricity and Gas Market. Report 2011, Tallinn, 2012, p. 8.
41. The Baltic Times, "Electricity market opens to consumers", 9 January 2013.

since most users remain clients of the national electricity provider LESTO and Lithuania lacks electricity links to Scandinavia and Poland[42].

Though Latvia has fully unbundled its electricity TSO, in contrast to Estonia and Lithuania, Latvia has been slower with its market liberalisation reforms and is likely to delay it further. Smaller enterprises and households still remain on the regulated electricity market and thus are customers of Latvenergo[43]. Thus, while *de jure* liberalisation of the electricity market has proceeded with some success, *de facto* the Baltic households will not benefit from liberalisation until the three states remain outside the EU electricity markets due to lacking infrastructure.

The liberalisation and unbundling of the Baltic gas sector has been more problematic because it requires separating Gazprom's ownership of operations supplying gas to consumers from ownership of the gas transmission and distribution pipelines. Lithuania has been the most aggressive in pursuing unbundling among the three Baltic states, trailed by Estonia with Latvia lagging behind. Of the three EC unbundling options – ownership unbundling (OU), independent system operator (ISO) and independent transmission system operator (ITO) – Lithuania selected the most stringent Commission-preferred option of OU. With OU both the management and the assets of gas networks are sold by the vertically integrated companies, to other companies which have no interests in gas production or supply. A 2010 Lithuanian law proposed that the transmission business of Lietuvos Dujos (37% owned by Gazprom) would be separated from the distribution business by July 2013 and distribution activities will be transferred to a newly-established subsidiary by October 2014[44]. In response, in March 2012 Gazprom took Lithuania to international arbitration at the UN, according to UNCITRAL rules, over Vilnius' plans to break up Lietuvos Dujos, and disagreements over heat tariffs in Kaunas where Gazprom owns a thermal power plant. While a partial agreement that unbundling will proceed was reached between Lithuania and Gazprom in May 2012, Gazprom reserved its arbitration rights.

42. Kolisova Vitalija, "Be jungčių elektros rinka – kreiva", *Atgimimas*, 14 January 2013.
43. Balticexport.com, "The energy sector is adapting slowly", 11 May 2013.
44. en.15min.lt, "Lithuanian Gas submits unbundling terms for regulatory approval", 1 February 2013.

In contrast to Lithuania, both Estonia and Latvia initially sought an exemption from the new EU gas directive until 2014, which was available to them as EU members whose energy infrastructure is not connected to the rest of the EU. Initially both opted for the ITO option, which allows energy companies to retain ownership of their transmission networks but makes the transmission subsidiaries legally independent stock companies operating under their own brand name, different management and strict regulatory oversight. This was the least stringent and the most favourable option for Gazprom. By 2012 Estonia's policies changed course towards "unbundling" OU rather than the ITO model. The Estonian government passed legislation in June 2012 directing the national gas company Eesti Gaas (Gazprom owns 37%, E.ON Ruhrgas 34%) to sell its pipeline unit by 2015[45]. Meanwhile, in February 2013 the Latvian Parliament agreed to postpone gas market liberalisation and continue taking advantage of its exemption option from unbundling[46]. In a further move that suggest the lobbying powers of Russian gas interests, in March 2013[47], Latvian MPs sought to ensure that Latvijas Gāze and its shareholder Gazprom would be the only suppliers of natural gas in the country[48]. While the final policies will be determined in the months to come, tensions will run high between various government groups, established gas interests and constrains of EU obligations[49].

In summary, the liberalisation and unbundling efforts in Baltic electricity and gas sectors have not resulted in a competitive energy market due to the lack of alternative suppliers and lack of links to European energy networks. The Baltic example illustrates the discrepancy between the EU liberalisation process and the real integration of energy markets within the EU.

45. European Commission, "Single market for gas & electricity. Estonia", 11 May 2013.
46. The Baltic Times, "Saeima committee reverses progress on gas market liberalization", 6 March 2013.
47. BNN, "Latvijas Gāze attempts to lobby Gazporm's interest in the parliament", 11 March 2013.
48. BNN, "Economy Minister: certain players wish to stop gas market liberalization", 25 March 2013.
49. BNN, "Specific Saeima officials call to delay the progress of the gas liberalization bill", 4 April 2013.

3.2. Integration of EU Internal Market by 2015

The Baltic case demonstrates that integrating energy infrastructure by connecting pipelines and establishing electricity links between EU member states is necessary for the functioning of the single EU energy market. EU's integration policies are driven by EC's 2011 conclusions that "No EU member state should remain isolated from the European gas and electricity networks after 2015 or see its energy security jeopardised by lack of the appropriate connections"[50]. The main mechanism to achieve this in the Baltic states has been EC's Baltic Energy Market Interconnection Plan (BEMIP), which plans for several interconnection projects in the gas and electricity sector[51].

There are two strategic Baltic gas interconnection projects: GIPL[52], a gas pipeline with 2.3 Bcm per annum connecting Poland to Lithuania and Balticconnector, an offshore pipeline between Finland and Estonia. GIPL is included in the European Network of Transmission System Operators (ENTSO-G) Ten-year Development Plan for 2011–2020, as well as the BEMIP Regional Transmission System Operators Gas Regional Investment Plan for 2012–2021. The estimated costs of the pipeline are around EUR 500 million with the EU likely to be the primary funder and Lithuania's Lietuvos Dujos and Polish GAZ-SYSTEM to contribute funds[53]. Though Warsaw has been lukewarm on the project due to projected gas over-supply in 2017-2020 in Poland[54], the recent appointment of Polish-Lithuanian and member of Lithuania's Electoral Action of Poles party, Jaroslavas Neverovičius, as Lithuania's Minister of Energy is hoped to be a facilitating factor. Still the success of the project will very much depend on EU's support and financing if it is to be completed by the 2017 deadline. The Balticconnector seeks to connect Baltic and Finnish gas grids to enable two-way gas flows between Finland and Estonia and provide more gas supply capacity and flexibility for the whole region[55]. The pipeline's capacity will reach 2.4 bcm/year, cost €96 million and is scheduled to be implemented in 2015[56].

50. European Council, "Conclusions on Energy", 4 February 2011, p. 2.
51. European Commission, "Baltic Energy Market Interconnection Plan. 4th progress report, June 2011-May 2012", June 2012.
52. Hockertz Joachim, Wittmann Rafał, "Gas Interconnection Poland-Lithuania (GIPL): Backbone of Regional Market Development", BEMIP Regional Conference, 14 September 2012, Vilnius.
53. Staselis Rytas, "Vamzdis „pirk arba mokėk", 8 March 2013.
54. *Ibid*.
55. Gasum, "Balticconnector - interconnecting gas markets around northern Baltic Sea", 11 May 2013.
56. Gasum, Balticconector Executive Summary, February 2011.

BEMIP-supported electricity links include Nordbalt (Sweden-Lithuania-Latvia), Estlink2 (Estonia-Finland), LitPol Link (Lithuania-Poland) and an Estonian-Latvian 3rd interconnection[57]. Implementation of these projects has gained new momentum with the promise of EU funds. The electricity connection projects as well as the gas connection projects have been submitted to be considered as EU Projects of Common Interest (PCI) in energy infrastructure[58]. The PCI list will be confirmed in end of 2013 and could qualify for funding from the "New Package", which designated €5.1 billion from the EU's 2014-2020 budget to upgrade Europe's energy infrastructure[59].

After years of delay due to Latvia's and Lithuania's disagreement over whose territory will receive the cable from Sweden, Nordbalt interconnection is scheduled for launching into operation in December 2015[60]. Meanwhile, EstLink2, the second[61] undersea cable between Estonia and Finland, is scheduled for early 2014[62]. LitPol Link planned for 2015[63] would for the first time allow Lithuania and other Baltic states to join the Western European Electricity System via Poland[64]. The project had experienced years of delay primarily because of lack of Polish interest and difficulty finding agreement with the various Polish land owners of the territory where LitPol Link will pass through. However, in 2012 when the EU designated €214 million and EBRD with Lithuanian government agencies offered an additional €2 million and €4 million respectively, progress started to accelerate[65]. Following the interconnection of Lithuanian and Polish transmission grids, a new back-to-back converter station and strengthening of Polish and Lithuanian internal high voltage transmission grids is planned.

In the meantime, the electricity systems of the Baltic states continue to operate on the grid of Belarus, Russia, Estonia, Latvia and Lithuania (BRELL) which

57. The third interconnection is planned to increase of the available EE-LV interconnection transfer capacity, and to be introduced in 2018-2020 (now in preparatory phase).
58. European Commission, "List of projects submitted to be considered as potential Projects of Common Interest in energy infrastructure – Electricity", 11 May 2013.
59. European Council, "Conclusions (Multiannual financial framework)", 7/8 February 2013, p. 9.
60. Litgrid, "NordBalt", 11 May 2013.
61. In December 2006, Estonia completed Estlink, an electricity cable that links Estonia and Finland, which is at the moment the only working power linkage to outside the region in the Baltic states.
62. Fingrid, "EstLink2", 11 May 2013.
63. Ministry of Energy of the Republic of Lithuania, "LitPol Link (Lithuania - Poland electricity link)", 11 May 2013.
64. LitPol Link, "About LITPOL Link", 11 May 2013.
65. Global Transmission Report, "LitPol Link, Lithuania – Poland", 1 September 2012; BNS, "Litgrid – iki 15 mln. litų ES paramos transformatorių pastočių rekonstrukcijai", 27 June 2012; Lankininkaitė Rūta, LRT Televizijos Naujienų tarnyba, "Elektros jungtis juda į priekį", 15 March 2013.

is controlled by Moscow. While operation of the electricity systems has been secure, consistent and not subject to Moscow's political pressure to date, the market and management of the system is not consistent with EU requirements and impairs the full implementation of the Third Energy Package[66]. Operation on BRELL has made it difficult for the Baltic states to manage congestion and develop intra-day market for electricity, while the cross-border loop flows from and to the Russian Federation, for which the Baltic states are used as transit countries, require significant reductions of capacity on the market or taking high network security risks. An ongoing feasibility study financed by TEN-E on the integration of the Baltic states to the EU Internal Electricity Market is planned to be completed in the second half of 2013. Since 2012 the EC has been negotiating an agreement with Russia and Belarus to facilitate the implementation of the EU internal market rules in the Baltic states power systems[67].

3.3. Diversification of Sources and Resources

Liberalisation and integration of the Baltic energy markets will also require diversification of sources away from Russian gas and diversification of resources towards renewables. LNG, as an alternative to natural gas piped by Gazprom, has been in Baltic discussions for several decades. After the EC expressed its support, in 2011 the idea of building a land-based LNG terminal gained traction in all three Baltic states. Currently there are plans for a regional land-based terminal to meet the needs of the Baltic states and Finland. According to EU studies, the terminal should not have larger capacity than 4 Bcm/year and would serve to diversify the Baltic supply mix to 60% of Russian gas, 20% LNG, 20% gas imported from European network[68]. The overall investment for the LNG terminal and the proposed pipeline interconnector projects would be about €1.3 billion[69]. In November 2012 the EC released study suggesting to build it on the shore of the Gulf of Finland[70], but its location is still undecided with Estonia and Finland both in competition and the EC

66. *Op. cit.*, "Baltic Energy Market Interconnection Plan. 4th progress report, June 2011-May 2012", June 2012, p. 12.
67. *Ibid.*
68. Booz & Co, *Analysis of costs and benefits of regional Liquefied Natural Gas solution in the East-Baltic area, including proposal for location and technical options under the Baltic ENERGY Market Interconnection Plan*, 20 November 2012, p. 5.
69. Botzki Annemarie, "Oettinger highlights need for Baltic LNG terminal", 29 November 2012.
70. *Op. cit.*, "Analysis of costs and benefits of regional Liquefied Natural Gas solution in the East-Baltic area, including proposal for location and technical options under the Baltic ENERGY Market Interconnection Plan", 20 November 2012.

to make a decision this year[71]. To attract EU funds the project has been proposed as a Project of Common Interest (PCI) candidate by likely participant, Finnish gas company, Gasum[72]. However, without an agreement, the terminal can not be included in the EU's list of PCIs, which will be announced in Vilnius in November 2013.

Lithuania has its own plans to build a floating LNG terminal using regasification ship technology in Klaipėda which would be quicker, easier and less costly to set up than a land-based terminal. The Euro200 million project will be carried out by the government-controlled oil terminal operator Klaipėdos Nafta. A 20% stake may be offered to outside investors, with Norwegian Hoegh to be the LNG vessel provider and American Cheniere Energy, a possible LNG provider. In 2012, the Lithuanian parliament approved the plans for the floating LNG terminal, which is scheduled to be completed by the end of 2014. While the new government elected in October 2012 initially expressed doubt on the project, prime minister Butkevičius' support for the project has reduced some of the uncertainty[73].

Both the floating terminal in Lithuania and the land-based terminal in the Gulf of Finland would significantly alter the region's gas security by providing the possibility of alternative sources of gas from the LNG market, strengthening the Baltic bargaining position vis-à-vis Gazprom and reducing the likelihood that Russia would use a gas cut off as a political weapon. Lithuanian preliminary estimates suggest that a floating LNG terminal in Klaipėda working at full capacity would be able to fully meet Lithuania's gas needs and reduce gas prices for end-consumers by 30%. However, with the fluctuation of LNG prices and the fact that LNG would have to be shipped from distant sources (for instance, in the Middle East, north or sub-Saharan Africa and North America), it is highly uncertain if an LNG terminal would actually reduce the price of gas to Baltic consumers. The main benefit would be improving gas security.

In terms of renewable energy, the Baltic states are also under obligation to meet Europe 2020 strategy and raise their share of renewable energy sources

71. The Baltic Course, "Estonia and Finland didn't reach an agreement on LNG terminal", 28 March 2013.
72. *Op. cit.*, "Oettinger highlights need for Baltic LNG terminal", 29 November 2012.
73. lrytas.lt, "Premjeras tiki, kad dujų terminalas bus pastatytas laiku", 15 March 2013.

(RES) consumption to at least 20% by 2020 and according to the "Green Paper" to 30% by 20130[74]. In fact, each of the states has raised more ambitious targets with Estonia seeking 25% in renewables, Latvia 40%, and Lithuania 23% by 2020 *(Table 2)*[75]. In the latest 2011 annual reports, the share of RES in gross final energy consumption in Estonia was 25,9%, Latvia 33,1% and Lithuania 20,3%[76]. The Baltic performance has been exemplary with Latvia having the second highest RES percentage after Sweden in the EU[77] and Estonia being the first member state to exceed its Europe 2020 target in 2011[78].

Estonia's high levels of RES is linked to electricity production from biomass which is used in co-burning with oil shale, but is criticised for high levels of carbon dioxide emissions. Estonia's greatest potential in renewables lies with biomass, wind power which rose 23% due to three new wind parks[79], and small-scale hydro-power *(Table 3)*[80]. Latvia has historically benefited from hydro power as its most significant RES but also has potential in biomass while solar energy is still only generated by pilot projects[81]. Lithuania's greatest RES potential to-date appears to be biofuel, biodegrading industrial and communal waste, solar energy and possibly wind energy[82]. However, the higher prices of RES have received a backlash from the Lithuanian government, which plans to re-assess government subsidies and seek more EU funds for financing renewables[83].

74. European Commission, "National Renewable Energy Action Plans Estonia, Latvia, Lithuania", 11 May 2013; European Commission, "Green Paper. A 2030 framework for climate and energy policies", 27 March 2013, p. 3.
75. Statistics Estonia, "Share of renewable energy in gross final energy consumption", 11 May 2013.
76. Eurostat, "Europe 2020 Indicators", 11 May 2013.
77. The Baltic Times, "Latvia registers EU's second highest share of renewable energy in 2011", 29 April 2013.
78. The Baltic Times, "Estonia fulfilled the aim of consumption of green energy", 29 April 2013.
79. Bloomberg.com, "Estonian Renewable Energy Rose to 14.9% of Consumption in 2012", 28 January 2013.
80. Elering, "Renewable Energy", 11 May 2013.
81. Ministry of Economics of the Republic of Latvia, "Renewable Energy", 11 May 2013.
82. Lithuanian Confederation of Renewable Resources, "What is current situation in Lithuania?", 11 May 2013.
83. www.DELFI.lt, "J.Neverovičius: ketiname mažinti atsinaujinančios energetikos subsidijas", 14 February 2013.

TABLE 2 ► Share of Renewable Energy Sources in the Baltics in 2011

SHARE OF RENEWABLE ENERGY SOURCES (%)	ESTONIA		LATVIA		LITHUANIA	
	2020 TARGET	2011	2020 TARGET	2011	2020 TARGET	2011
in final energy consumption	25%	25.9%	40%	33.1%	23%	20.3%
in heating and cooling	17.6%	46%	53.4%	44.7%	39%	33.8%
in electricity	4.8%	12.3%	59.8%	44.7%	21%	9%
in transport	2.7%	0.2%	10%	4.8%	10%	3.7%

Source: European Commission, "National Renewable Energy Action Plans Estonia, Latvia, Lithuania", 11 May 2013; Eurostat, "Energy SHARES 2011", 11 May 2013.

TABLE 3 ► Primary Production of Renewable Energy in the Baltics (1000 Tonne of Oil Equivalent) in 2011

	SOLAR ENERGY	BIOMASS AND WASTE	GEOTHERMAL ENERGY	HYDROPOWER ENERGY	WIND ENERGY	BIOFUELS
Estonia	0	942	0	3	32	0
Latvia	0	1,817	0	248	6	54
Lithuania	0	1,077	3	41	41	82

Source: Eurostat, "Energy statistics", 11 May 2013.

3.4. Regional Cooperation in the Baltic States

Creation of a single EU energy market, integration of the Baltic energy sectors, and the aforementioned diversification projects naturally depend on regional cooperation. There are a number of existing frameworks for energy cooperation. The Council of the Baltic Sea States (CBSS)'s intergovernmental Baltic Sea Energy Co-operation (BASREC), initiated by the EC and the Baltic Sea countries, supports the creation of competitive, efficient and well-functioning energy markets and pursuing energy efficiency and renewable energy measures[84]. The Permanent Partnership Council (PPC) is another framework for

84. Baltic Sea Region Energy Cooperation, "Baltic Sea Region Energy Cooperation", 11 May 2013.

cooperation and is the main working body governing the Russia-EU relationship, which since 2012 focuses on four themes of energy markets and strategies, electricity, energy efficiency and innovation, and nuclear issues. The Baltic Electricity regional initiative comprised of the three Baltic national regulators is working in elaborating a "European Energy Work Plan 2011-2014" both for electricity and gas at the request of the EC[85]. The Baltic electricity transmission system operators (TSO) in 2012 signed a Memorandum of Understanding to cooperating on common research and development projects related to transmission grid planning, operation and market modelling[86]. The Baltic TSOs also cooperate and form a regional group in the framework of European Network of Transmission System Operators for Electricity[87].

To-date the success of Baltic cooperation has been limited as the three states often compete with one another for the EU funding and locations of energy integration and diversification projects. Likewise, as interconnection projects such as LitPol Link have demonstrated, cooperation with neighbouring states is fruitless if there is no promise of EU funding and support. However, without cooperation, progress of Baltic integration into EU energy markets or diversification of energy supplies is unlikely. As small economies, small energy markets, and rather weak bureaucracies, none of the three Baltic states is capable of implementing large energy infrastructure or production projects on their own.

85. ACER, "Baltic Region Electricity Regional Initiative Work Plan 2011-2014", November 2011.
86. Elering, "Baltic electricity TSO-s agreed on R&D cooperation", 12 November 2012.
87. ENTSOE, "Regional Group Baltic", 11 May 2013.

4. Conclusion

While EU energy policy has not yet translated into a liberalised and integrated energy market for the Baltic states, it has had a notable impact on the Baltic energy sector. The next five years is likely to see greater liberalisation of Baltic energy markets, gas and electricity interconnection with neighbouring EU states, and even diversification of energy sources. The real added value of EU energy policy has been moving Baltic energy projects from wish-lists and memorandums to a workable agenda. This has had two effects. First, Baltic governments had to put action to their proclamations on energy security. Second, the EU agenda has made it more difficult for Baltic governments to backpedal in the face of pressure from political parties and energy interest groups that benefit from the current dependence on Russia. This has been most evident in the gas market unbundling and gas source diversification efforts. EU 2020 and 2030 plans also helped make renewable resources a priority – an area that had long failed to garner sufficient domestic support in the face of entrenched energy interest groups. Lastly, the Baltic inability to fund and implement energy interconnection and diversification projects during the past decade of EU membership highlights that without ambitious economic instruments for financing common energy projects, progress in EU's common internal energy market and renewables objectives will be slow and difficult. Certainly to date the Baltic states have been both unable and unwilling to finance the necessary energy projects and thus, EU planification, financing, R&D and institutional support will prove crucial.

The case of the Baltic states also draws attention to a number issues highlighted by *Notre Europe – Jacques Delors Institute* regarding EU's energy policy. The Baltic ability to implement energy reforms is greatly tied to EU's external actors such as Russia and Gazprom. Furthermore, the implementation of the Third Energy Package and other objectives has translated into a flashpoint in relations between the Baltic states and Russia. Without EU support in their relations with Moscow, the Baltic states will have difficulty adopting the EU energy agenda. Yet the EU currently has limited capacity for external action beyond EU borders to project its interests and guarantee its objectives at the international level. While the EC has flexed its muscles with its investigation of Gazprom's monopolistic practices, as *Notre Europe – Jacques*

Delors Institute highlights, most EU initiatives regarding external gas policy remain statements and resolutions without binding commitments[88]. Likewise, while the EC may start playing a greater role in helping member states negotiate with their international energy suppliers in the future, the current vulnerability of the Baltic states in their relationship with Gazprom persists. As the *Notre Europe – Jacques Delors Institute* proposes, the only effective solution would be a mandate to the EC to negotiate with external suppliers and transit countries on behalf of the EU or the creation of EU-level fossil fuels purchasing groups. In the absence of such mechanisms the Baltic states continue to be played against one another in their gas pricing contracts while Baltic decision makers are coerced to renege on their EU-stipulated energy reforms and diversification projects. While the Baltic states have not suffered Gazprom's gas cut off since the early 1990s, the lack of adequate EU strategic and crisis-management energy reserves and access to these reserves as outlined by *Notre Europe*[89] enable Russia to subject the three states to continuous political pressure. The Baltic "Achilles heel" still remains vulnerable.

88. Andoura Sami, d'Oultremont Clémentine, "The Role of Gas in the External Dimension of the EU Energy Transition", *Policy Paper No. 79, Notre Europe – Jacques Delors Institute*, March 2013.
89. Andoura Sami, Hancher Leigh and Van der Woude Marc, "Towards a European Energy Community: A Policy Proposal", Foreword by Jacques Delors, *Studies & Research No. 70, Notre Europe*, March 2010.

ANNEX: BASIC FACTS ABOUT THE BALTIC STATES

Name of the Country	ESTONIA	LATVIA	LITHUANIA
Population	1,286,479 inh.	2,017,526 inh.	2,971,905 inh.
Surface	43,698 km^2	64,589 km^2	65,303 km^2
GDP per capita	€9,400 68% of EU average in PPS	€6,800 62% of EU average in PPS	€8,100 70% of EU average in PPS
State language (and language branch)	Estonian (Finno-Ugric)	Latvian (Baltic)	Lithuanian (Baltic)
Neighbouring countries (by land)	Latvia Russia	Belarus Estonia Lithuania Russia	Belarus Latvia Poland Russia
Flag			

PPS: Purchasing Power Standard

Source: all data comes from Eurostat

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THE BALTIC STATES IN THE EU: YESTERDAY, TODAY AND TOMORROW

2013 is a significant year for the Baltic states in their relations with European integration. On 1 July 2013, Lithuania became the first of the Baltic states to hold the rotating presidency of the EU Council of ministers. Its performance is closely watched by Latvia and Estonia, whose turns to hold the presidency come in 2015 and 2018, respectively. In addition, this year Latvia has been invited to join the Euro Area thus becoming the second Baltic state after Estonia to share the common currency. This Study aims to show that these developments are extremely important for the young and small Baltic states, which continue to aspire to secure their place in the European "core".

Having emerged from the crisis as good students of internal devaluation, the Baltic states have a window of opportunity to voice their main concerns and priorities regarding the future of European integration. Lithuanian presidency puts an emphasis on more economic growth and credibility within the E(M)U as well as increased energy security, the challenges that have been daunting the Baltic states in the past years and decades.

In order to better understand the origins and the significance of these priorities, this Study is divided into three distinct parts dealing with historical and political context of the three Baltic states (Part 1), the causes and consequences of the recent economic crisis (Part 2) and specific issues related to the energy policy in the region (Part 3).

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