
**THE ECONOMIC PRESENCE OF RUSSIA AND
BELARUS IN THE BALTIC STATES:
RISKS AND OPPORTUNITIES**

Editor Andris Sprūds

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INTRODUCTION

Andris Sprūds

Economic trends and interests have always been closely linked with political choices. The countries of East Central Europe have not been an exception, especially within the context of the global financial downturn. The global economic recession has hit the EU's new members and new neighbors hard. Countries in the region have faced considerable economic, financial, social, and political challenges. The economies of the three Baltic countries, Russia, and Belarus, all of which previously enjoyed substantial growth, revealed their structural imbalances and their exposure to fluctuations in external financial and commodity markets. As a result, the economic recession eventually contributed to raising awareness and determination in those countries (to varying degrees) to stabilize, strengthen and modernize national economies, attract investment and search for favorable outside markets and partners. Economic interests moved visibly upward on the list of priorities for Latvia, Lithuania, Estonia, Russia, and Belarus.

Economic challenges have also had an impact on domestic and foreign policy choices. They had implications for the nature of bilateral relationships among the countries of East Central Europe. Many in Latvia and the other Baltic countries have seen more active economic engagement with their eastern neighbors, such as Russia and Belarus, as an imperative direction for external economic activity. As a result, the economic interests and engagement have been incrementally and more closely intertwined with the political dynamic and political strategies. At the same time, relations with Russia and Belarus have been far from effortless and uncomplicated, and undoubtedly a political and security component will also remain formative in the future. Hence, the economic crisis may open some windows of political and economic opportunities, but may also reinforce misperceptions and eventually create new risks.

The major objective of this publication is to examine how the transforming economic rationale in policies of the Baltic countries has influenced both economic and political relations with other countries in the neighborhood, namely Russia and Belarus. Some important and valuable research contributions to economy related issues surrounding Baltic relations with Russia have been made by a number of previous research endeavors.¹ However, this research

¹ See, for instance, Nils Muiznieks (ed.), *Latvian-Russian Relations: Domestic and International Dimensions* (Rīga: Latvia University, 2006); Zaneta Ozolina (ed.), *Latvian and EU Relations with Russia: the Differing Agendas. In Latvia-Russia-X* ►

project intends to expand and elaborate on a number of additional research issues and perspectives. First, an emphasis on Latvia notwithstanding, a comparative perspective of three Baltic countries is provided. The Baltic countries are strategic partners but may be economic rivals, especially within the neighborhood. Second and similarly, patterns and issues with the two eastern economic partners – Russia and Belarus – are compared. Russia has continuously been treated as a policy and research priority while the Belarusian direction has been rather underdeveloped. This research project intends to fix this problem and integrate a Belarusian aspect into a wider regional and bilateral assessment. The effort becomes even more acute in the context of an ongoing EU debate over economic and political relations with the “last European dictatorship”. Third, the authors make efforts to balance both economic and political challenges and interests. Hence, the articles lend considerable weight to the political economy. It is intended to look beyond the official data and economic trends, and to identify and analyze crosscutting themes: the existing formal legal frameworks and consulting bodies, regional cooperation, investments and particular business groups, as well as the business and political culture and mutual perceptions.

The book is structured into nine chapters. Each chapter is intended to contribute to the overall objective of understanding the trends, character, formal and informal frameworks, and implications of Latvia’s economic interaction with Russia and Belarus. The Estonian and Lithuanian chapters follow suit in a more condensed way, while providing the specific and general trends of their interaction with their eastern neighbors. The Estonian and Lithuanian perspectives allow assessing and discerning both commonalities and divergences among the three Baltic countries. This provides an important comparative perspective for all three Baltic countries. Although the general structure is streamlined and the major aspects are set, the authors remain free to contribute their own idiosyncratic emphases, assessments, and recommendations. This diversity of approaches has essentially been perceived as an important element in reflecting the plurality of opinions in the policy and research community and the multifaceted nature of interaction between the three Baltic countries, on the one side, and Russia and Belarus, on the other.

The successful fruition of the current research project was enabled by a number of joint efforts. Above all, an international body of researchers have contributed to achieving the objectives of the research project. The involvement of authors

from partner countries has been considered an imperative precondition for ensuring a diversity of views and recommendations with a genuinely comparative perspective. It was also a deliberate intention to bring in authors from a younger generation of the research community in order to integrate a somewhat fresher breath into the rather hefty and politically sensitive subject of relations among neighbors in East Central Europe. The Latvian Institute of International Affairs and the Centre for East European Policy Studies cooperated closely to address the research challenges and take full advantage of the opportunities of the joint research project. The Soros Foundation in Latvia was instrumental in supporting the current research endeavor and in bringing it to a fruitful result. Last but not least, this publication would be irrelevant without a reader attentive to the subject and interested in understanding the constraints and opportunities for productive and balanced political and economic engagement among neighbors in the strategically important region of East Central Europe.

(Riga: Strategic Analysis Commission, 2008); Andris Spruds and Toms Rostoks (eds.), *Energy: Pulling the Baltic Sea Region Together or Apart?* (Riga: Zinatne, 2009); Nils Muiznieks, *Latvian-Russian Relations: Dynamics since Latvia's Accession to the EU and NATO* (Riga: University of Latvia Press, 2011).

THE ECONOMIC DIMENSION OF BILATERAL RELATIONSHIPS BETWEEN LATVIA, RUSSIA AND BELARUS – PAST AND PRESENT

Andrejs Jakobsons

This chapter explores aspects of the economic cooperation between Latvia and its eastern neighbors (Russia and Belarus) within the context of Latvia's external economic policy. The paper primarily focuses on trade and investment flows between countries. At the outset it is important to examine the historical background of the development of the economic relationship between these countries, and to attempt to link this to today's situation. Then, a more detailed discussion of the key economic trends will be provided as a review of the development of trade and investment flows between the countries under consideration.

In the early 1990s, trade links between the countries under consideration were still dominated by the cooperation principles established under the central planning system of the Soviet Union. Although the collapse of industrial output and related trade links during the breakdown of the Soviet Union is well documented, over the following years Latvia was able to maintain some transit trade links due to its strategic location and its integral role in the logistics of natural resources (rail transportation services, the use of pipelines, etc.). Subsequently, trade and investment relationships were tested by a few other notable events, including the banking crisis in Latvia in the mid 1990s, the Russian financial crisis in 1998, Latvia's entry into the World Trade Organization (WTO) in 1999 and the European Union in 2004, and the dramatic increase in oil and natural gas prices just prior to the world financial crisis which began in 2008. The most recent developments have been related to Russia's prospective entry into the WTO, which is a significant step toward a stable trade relationship with other WTO countries. In other words, there is a full set of both economic and non-economic events that have influenced the bilateral trade relationships between Latvia, Russia and Belarus. This chapter will also attempt to explore the investment flows between Latvia and Russia in order to identify patterns and trends. As investment flows tend to be associated with not only a search for the highest possible profits, but also with a bid for influence, it will explore whether evidence of this exists in the case of the Latvia-Russia relationship and what steps Latvia has attempted to take in order to protect certain specific enterprises and industries from excessive influence by foreign capital. The aspect of influence must also be viewed in the

context of the privatization process, which in the 1990s provided a framework for attracting foreign capital.

It has to be noted at the very beginning that the focus of this chapter will be on the Latvia-Russia relationship, while the case of Belarus will be referred to when appropriate. The rationale of this approach is driven by the difference in trade volumes that Latvia has with these two countries, whereby Russia certainly plays a leading role in terms of the absolute volume. Also, the flow of investment to Latvia from Belarus has been negligible, as described later in this chapter. The political dynamics of the Western countries' relationship with Belarus would also make it extremely hard to draw specific conclusions in terms of purely economic indicators.

1. Historical context and related studies

Throughout more than two decades of Latvian independence there has been speculation about the political aspects of the economic relationship between Latvia and Russia. From the economic point of view, the exploration of trade and investment dynamics in a political context is a very complicated task as the political aspects are extremely difficult to quantify. Therefore, the focus of this analysis will be on exploring the statistical data and trends therein, and will attempt to draw parallels with political events. A much deeper approach, and probably the most appropriate way to assess the possible existence of political distortions, would be to carry out an econometric analysis that attempts to identify possible political distortions. Unfortunately, recent research efforts on this topic are very scarce. The most notable example of such an analytical effort in Latvia is related to a paper by Vyacheslav Dombrovsky and Alf Vanags, who explore the economic relationship between Latvia and Russia in their chapter titled "Latvian-Russian Economic Relations"². They utilize to the so-called "gravity model" approach to explore political aspects in the trade relationship between the two countries. Researchers find no evidence of political distortions between the trade patterns. The essence of this model lies in the analogy between the concept of gravity in physics, on the one hand, and the strength of the trade flows between countries based on the distance between them and their income levels, on the other. The closer the countries are geographically, the higher trade turnover one would expect. Similarly, the higher the income levels in the two countries, the more trade takes place between them. On the basis of this logic one may develop an econometric

² See: *Latvian-Russian Relations: Domestic and International Dimensions*. 2006. Editor Nils Muižnieks (Chapter 10: *Latvian-Russian Economic Relations* by Vyacheslav Dombrovsky and Alf Vanags).

model looking for certain distortions in this pattern. One obvious source of such distortions is politics, which may reduce the trade flows between the countries under consideration. Extreme examples of such distortions might include calls for boycotting goods imported from a specific country, and region- or country-specific tariff discrimination. More often, however, these distortions may stem from less favorable attitudes toward investors from specific countries or regions (e.g., less support from investment agencies, language and cultural barriers, etc.).

The list is by no means complete here, but this provides a first glance at some of the underlying issues. The mentioned study found no statistically significant evidence of distortion in trade between Latvia and Russia, which suggests that despite the sometimes heated international relations, trade links have remained based on more pragmatic grounds. The usual way of thinking about the spillover of certain economic distortions in one country to others is based on examining the level of trade integration between the countries, as well as other links (e.g., the financial sector and investment flows). An interesting study³ on this issue was carried out in 1998 by the World Bank just before the Russian financial crisis took place. The study focused on the links between the financial sectors, and more specifically on the exposure of Latvian banks to the public debt of CIS area countries. The outcome of the Russian financial crisis and its impact on the Latvian economy is well-known – it took place through two main channels: the financial channel (an almost immediate negative impact on the holdings of Russian public debt by some Latvian banks) and the trade channel (a dramatic slowdown of trade flows between Latvia and Russia, resulting in serious financial difficulties for some sectors of the Latvian economy). While the former link was contained relatively soon (and fortunately the negative impact on the Latvian banking system was relatively small), the latter led to the permanent loss of Russia as one of the most important export destinations for Latvian enterprises (especially in the food industry). Again, from an historical perspective this was one of the key turning points of the reorientation of Latvia's exporting industries toward the well-established Western European markets. Hence, the initial reorientation was achieved primarily due to the collapse of trading links with CIS countries, especially Russia.

Trade and investment relations between Latvia and Russia have quite often been discussed in the media within a political and geopolitical context. This aspect provides additional interest in exploring the topic in more detail, but such an exploration may go beyond the focus of this chapter. Regarding the references to relevant studies that have explored this topic, it has to be pointed out at the very outset that a full exploration of this subject cannot be performed solely on

³ See: *Latvia – Macroeconomic and Financial Sector Vulnerability Review*, World Bank, 1998.

the basis of economic arguments and statistics, mainly because political aspects can sometimes play an important role. In general, cross-border investment flows links have been explored to a much lesser extent. Partly this is due to the relatively small volume of foreign direct investment that flows in this direction. Companies from Russia and Belarus have expressed relatively little interest in privatization in Latvia (with just a couple of notable exceptions, including “Latvijas Gāze”, a natural gas company in Latvia). More recently, a revival of investment flows can be observed through the period of Latvia’s entry into the EU. We will explore these trends in more detail in one of the following sections.

2. Trade dynamics

2.1. *Commodity trade*

The economic relationship between Latvia and Russia has seen highs and lows since the early 1990s. A rapid expansion of the trade volume up until mid 1998 was abruptly cut off due to the Russian financial crisis, which was for Latvia as the most significant external shock since regaining independence in the early 1990s. This example may still play a significant role in trying to understand the risks associated with being excessively exposed to trade partners from a single country. On the other hand, one certainly cannot ignore the fact that Russia has huge potential as a destination for Latvian commodity and service exports, especially in the context of an era of high commodity prices, which have already provided a boost for the Russian economy. Although existing studies have not found evidence of “missing trade” between Latvia and Russia, the growth of income in both countries could lead to a logical expansion of the trade relationship as well (despite the risks, it is obvious that Latvia-Russia trade can also be positively influenced by both a more rapid growth of income than in Western Europe as well as Russia’s prospective entry into the WTO, which will remove some of the uncertainties in trade).

Past experience shows that trade patterns are often influenced by events that originate in other sectors of the economy. For example, the Russian financial crisis may also have worked as a catalyst for the increased orientation of Latvian exporters toward Western Europe. Although the re-orientation toward the lucrative Western European markets had been on the agenda since regaining independence, practical steps in the early 1990s were quite slow due to a lack of skills and experience with exporting to partners in developed countries. The FSU countries, meanwhile, provided an easier alternative, at least from the perspective

of established trade (and sometimes personal) links. While the reorientation of the commodity trade toward Western European markets seemed almost natural due to the considerations mentioned above, service exports (particularly in transportation) were destined to remain heavily oriented toward the FSU area. The rationale again ranges from purely geographical advantages and existing personal contacts between enterprises to more objective reasons, such as the connectivity of the railway and electricity supply systems (due to the common economic area established during Soviet rule).

We will now turn to examining the data in more detail. A quick historical review of the merchandise trade between Latvia and its eastern neighbors (namely Russia and Belarus) underlines the patterns already discussed. The historical patterns of external trade with Russia and Belarus over the past 20 years represent mostly the realities of economic development and seem to receive little influence from political events in the countries. Indeed, the commodity trade between these countries usually exhibited growth during the “good times” and vice-versa. The first upward trend in trade volume between Latvia and Russia can be observed in the mid 1990s; however, data on the share of exports indicates that during this period overall export volumes were growing even faster, leading to a decline in the share of Latvian exports to Russia (from nearly 30% in 1993 to about 20% of total exports in 1997, the year before the Russian financial crisis in the summer of 1998). A detailed examination of trade data suggests that the increasing export volumes during this period were mostly from products of agricultural origin (most notably, products from Latvian food-processing enterprises, which have been well-known in the FSU since the Soviet times). The exports of the Latvian food-processing industry to Russia more than doubled between 1993 and 1997, when the peak was reached.

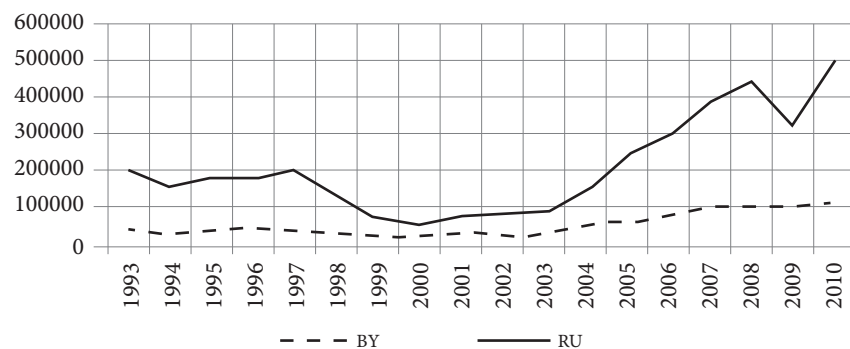
On the import side, trade volumes increased less dramatically in 1993-1997; however, the Russia’s share of Latvia’s imports experienced a rapid decline due to opening the domestic market to Western European countries as bilateral trade relationships gained strength in that direction. By 1997 Russian imports had dropped to just 15% of total imports to Latvia. Imports of energy-related mineral products still played a significant role in the structure of imports, accounting for more than a half of the total value between 1993 and 1997, but the contribution of other sectors stagnated or declined.

When the Russian crisis struck in 1998, the Latvian economy was affected through several channels. External trade was hit by a sharp decline in income in the CIS countries, mostly affecting Latvian agricultural producers and the food industry (for example, Latvian food industry exports to Russia dropped from around 50 million LVL in 1996-97 to just around 10 million LVL in 1999-

2000 – a drop of roughly 80%). The other spillover came through the financial sector, as some Latvian banks turned out to be exposed to Russian sovereign debt. Fortunately, the impact on the financial sector was contained in a relatively timely manner and only one major bank needed assistance in restructuring. The events of 1998-1999, however, served as a warning for those industries that based their growth on a strategy of expansion in one direction – namely, toward the CIS area. Unfortunately, expansion in this region turned out to be fragile and several enterprises faced immediate financial difficulties in this context. If we consider the bright side of the story, the message that Latvian exporters received during this period was that the extra effort of finding a way into Western European commodity markets might be worth it (from the point of view of diversification). Although the above-mentioned considerations mostly apply to the Latvian food industry, the lessons learned were probably noted throughout the Latvian economy, which consequently reoriented exports toward the West in the following years.

The following graphs indicate the trends in Latvia's commodity exports to Russia and Belarus. We first examine the trends in absolute volume. A more complete picture can be obtained by also looking at the next graph, which indicates the share of exports to these countries, thus providing a better understanding of the importance of these countries as destinations for commodity exports. Moreover, as Latvia's total export volume has grown considerably during this period of time, this is really the only way to evaluate whether the importance of Russia and Belarus as export destinations has increased or declined.

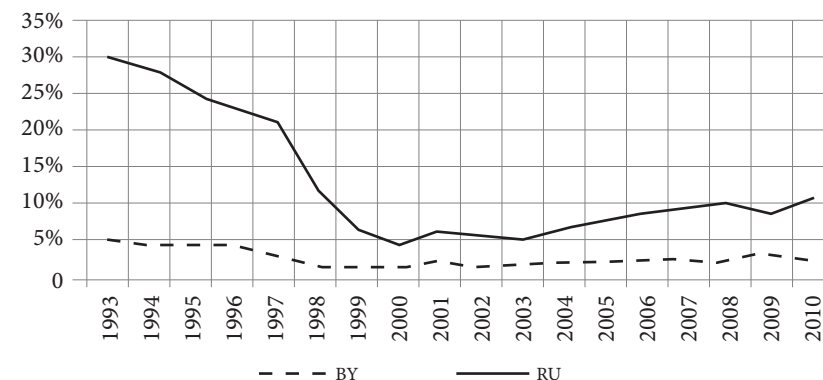
Chart 1. Commodity exports from Latvia to Russia and Belarus (in thousands of LVL)



Source: Central Statistical Bureau of Latvia⁴, author's calculations.

⁴ See data of Central Statistical Bureau of Latvia, available at <http://data.csb.gov.lv>.

Chart 2. Annual shares of Russia and Belarus in Latvia's commodity exports (per cent)



Source: Central Statistical Bureau of Latvia, author's calculations.

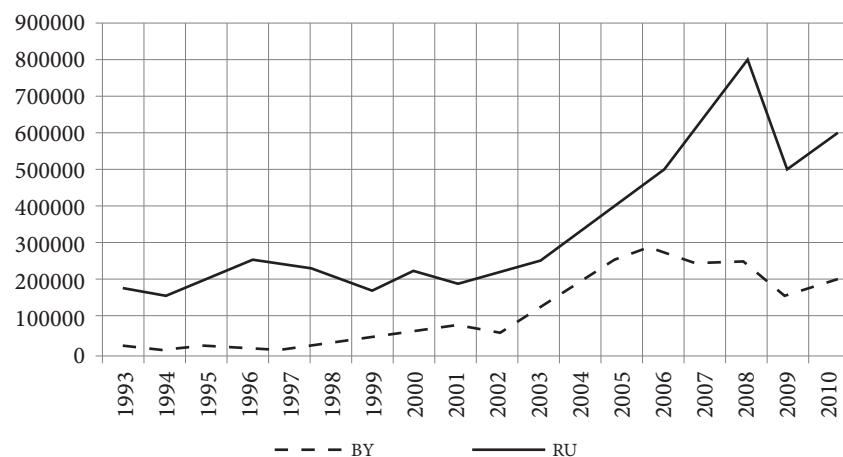
The above graphs indicate that the export volume to Russia declined dramatically following the Russian financial crisis (down to just 25% of the peak reached in 1997). A recovery took place only after Latvia's entry into the EU in 2004 – since then, the nominal value of exports to Russia has increased more than four times over (peaking out in 2008). More recently, the global recession has again influenced trade patterns, though this has nothing to do with the bilateral relationship. In viewing the trend from a relative perspective (i.e., the share of Latvian exports going to Russia) we can see that the importance of Russia as an export destination has never come close to the levels that were reached in the mid 1990s. Even the rapid growth of exports in absolute terms mentioned above only brought the share of exports to Russia to 10% (in 2008-09), while the statistics from before the Russian financial crisis were between 20% and 30%. Therefore, we have to conclude that the strong recent growth of exports in absolute terms may still be far from exhausted.

The pattern of exports to Belarus seems to be more balanced. It also has to be noted that despite being one of the closest neighbors of Latvia, the share of exports to Belarus has never exceeded 5% of total export volume. As in the case of Russia, we can see that the share of trade between Latvia and Belarus declined in the late 1990s. Table 1, listing top 15 destinations of Latvian exports, also highlights the fact that despite Belarus being a larger country in terms of territory and population when compared with Estonia and Lithuania, trade volumes have remained negligible, reaching just 100 million LVL in 2010 (which constitutes just about 15% of the exports volume going to Estonia). The explanation for such an unbalance obviously extends beyond the gravity theory, as one should also keep in

mind that Belarus is separated from the EU market by the border of the customs union, which makes the other nearby trading partners much simpler to reach.

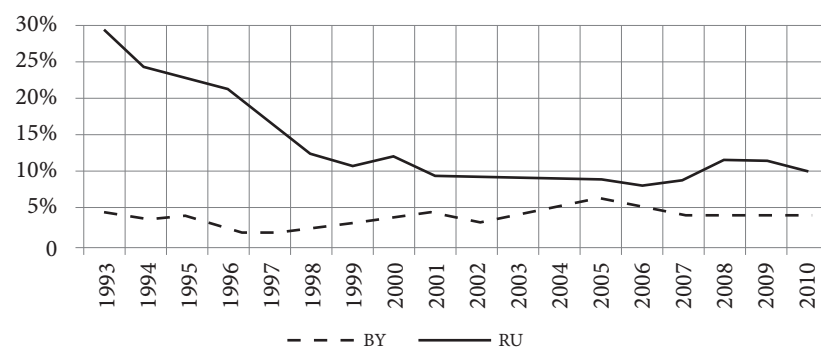
The situation is slightly different regarding imports because Russia has remained the key supplier of energy-related commodities to Latvia. On the one hand, this has certainly stabilized the import volumes. On the other, such a situation provides grounds for arguments about an excessive dependency on Russia's commodity exports. Some key statistics are presented in the following graphs.

Chart 3. Commodity imports to Latvia from Russia and Belarus (thousands LVL)



Source: Central Statistical Bureau of Latvia, author's calculations.

Chart 4. Annual shares of Russia and Belarus in Latvia's commodity imports (percent)



Source: Central Statistical Bureau of Latvia, author's calculations.

According to the trends described above, we can conclude that Latvia has been a fairly good and predictable (although certainly small) partner for Russia's energy-related exports. The overall trends are surprisingly similar to those on the export side. This seems to suggest that the trade relationship on both the export and import sides has been more dominated by fundamental events taking place in the countries (the Russian financial crisis certainly stands out as the major event here), rather than by short-term shifts in comparative advantage (e.g., changes in the relative prices of tradable goods, leading to changes in the structure of trade due to the increased competitiveness of one country's exports).

In terms of absolute volume, we do not observe in this case a decrease in trade volume in the mid 1990s. This can be explained by the relatively stable demand for the Russian mineral exports, which remained almost unchanged despite volatility on the financial side during this period. In terms of relative statistics, Russia's share of Latvian imports has remained close to 10% over the past 10 years.

Trade patterns with Belarus seem to show some more interesting trends in this case. Specifically, we can clearly see an increase in the volume (and for some years in the country's share as well) after 2003. This can most probably be linked to the industrial policy of the country. However, due to recent developments surrounding the devaluation of the Belarusian currency and the related uncertainties associated with it, future developments are much less clear. Despite these events, Latvia certainly remains one of the countries for which imports from Belarus exceed exports by far.

In summarizing the review of the trade trends presented in this chapter, the key conclusion is that most historical patterns of external trade with Russia and Belarus over the past 20 years represent the realities of economic development in the involved countries, rather than specific political considerations. The development of the trade relationships have to be viewed from the perspective of significant international events, the influence of which has been significant (Latvia's entry into the EU and the subsequent higher trade volume serves as an example).

Finally, we will provide a brief insight into the overall significance of trade with Russia and Belarus for the economy of Latvia. On the export side, a first impression about the importance of this trade can be obtained by looking at the overall export volumes by country provided in the following table.

Table 1. Top 15 destinations of commodity exports from Latvia in 2010 (millions of LVL)

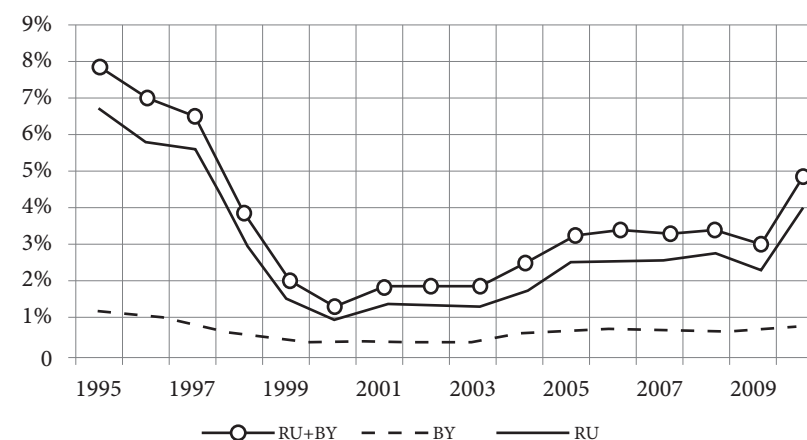
Country	Volume of exports
Lithuania	762
Estonia	633
Russia	497
Germany	410
Sweden	296
Poland	232
Denmark	182
UK	165
Finland	148
Norway	131
Netherlands	106
Belarus	100
Italy	92
Algeria	91
France	76

Source: Central Statistical Bureau of Latvia

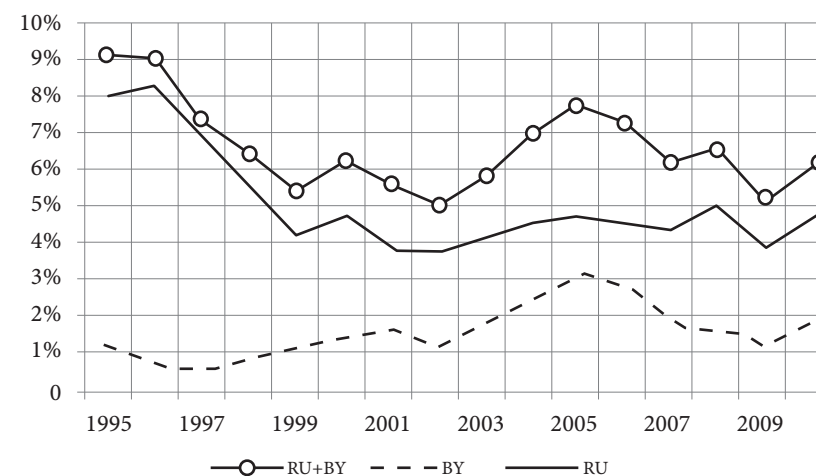
Russia plays a relatively significant role (as the 3rd largest export destination), while Belarus is only 12th on the list. Although the difference in volume between Russia and Belarus can be clearly explained by country size, it is also useful to look at this table from a relative perspective. It clearly suggests that the trade links between countries inside the EU are much stronger. Perhaps the situation may gradually change after Russia approves its membership in the WTO – the data above suggest that there is potential for higher trade volumes.

If we express these trade statistics as a percentage of GDP, the data shows that the relative significance of Latvian exports to Russia and Belarus dropped dramatically during the late 1990s (from 6-7% of GDP in the mid 1990s to just 1.3% of GDP in 2000). Over the last decade a recovery has been observable, with the export to GDP ratio climbing back to just above 3%. It is probably not surprising that imports have shown much less volatility, with the share of imports in GDP fluctuating between 5% and 8% throughout most of the period under consideration. The shares occupied by Russia and Belarus are provided separately in the following graphs. On the export side, we observe much less trade with Belarus, which has rarely exceeded 1% of GDP. Russia's share,

meanwhile, is more sizable and increased quite rapidly in 2010 (during the early recovery from the crisis).

Chart 5. Latvian exports to Russia and Belarus (% of GDP)

Source: Central Statistical Bureau of Latvia, author's calculations.

Chart 6. Latvian imports from Russia and Belarus (% of GDP)

Source: Central Statistical Bureau of Latvia, author's calculations.

These graphs could help indicate the direct effect on the economy of Latvia of any trade-related shocks. It certainly shows that on the export side links are quite weak, accounting for just above 4% of GDP in 2010. On the import side, the question is more about the possibility of substituting energy imports from Russia with alternative supplies. It also has to be pointed out that the increase of imports from Belarus after Latvia joined the EU suggests a potential for cooperation in external trade. Despite a fall in exports to Latvia in recent years, Belarus still maintains a highly positive trade balance with Latvia. The import of goods from Belarus into Latvia was quite significant in the first few years following Latvia's entry into the EU, but then declined over the next few years.

2.2. Key characteristics of the service trade

The other part of the story of trade relations between Latvia and its closest neighbors – Russia and Belarus – lies in the service trade. The key components of the service trade in Latvia are transportation and tourism. Transportation services account for roughly half of the total service exports of Latvia. The rest is split between tourism, financial and IT-related service exports. Although not all transportation services are directly related to transit trade via Latvia, the composition of the industry emphasizes the importance of this activity for the Latvian economy. Moreover, most of these services are conducted along an East-West direction, which is entails both Russia and Belarus.

The concept “transit trade” in the context of this chapter refers to activities related to the flow of third country goods through Latvia with a final destination elsewhere. The key way that the Latvian economy may benefit from this flow of goods is through providing transportation services and other activities – for example, services provided by the seaports. Although one may argue about the precise scale of this activity, the competitive advantage provided by Latvia's geographic location has certainly worked in the country's favor, as is evidenced by the continuously positive service balance within the the balance of payments of Latvia (although the relative importance of these activities has declined since the early and mid 1990's). In addition, it is important to mention that in this case the physical volume of goods transiting through Latvia plays a secondary role, and the net impact on the Latvian economy is best characterized by the value-added in this sector.

Latvia's geographic location ensures that it has an advantage in providing transportation services for the transit trade flows from Russia and Belarus through

Latvian ports. At the same time, recent service trade exports are no longer related to oil pipeline transportation services, as this channel of transit trade has not been operational for more than 10 years. A summary of service trade links is provided in the following tables. Unlike in the commodity trade, Latvia is a net exporter of services to both Russia and Belarus, suggesting that the country has a competitive advantage in this area.

Table 2. Service trade with Russia (mln LVL)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Imports	4.1	0.6	0.0	0.8	2.1	4.6	2.9	7.5	7.5	7.4
Balance	0.0	0.9	3.5	2.2	0.2	1.0	3.0	6.0	2.2	9.6

Source: Bank of Latvia⁵.

Table 3. Service trade with Belarus (mln LVL)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Exports	51.1	53.4	93.5	93.1	92.3	95.7	115.9	91.5	99.7	147.0
Imports	44.1	50.6	60.0	60.8	72.1	84.6	92.9	97.5	67.5	77.4
Balance	7.0	2.9	33.5	32.2	20.2	11.0	23.0	-6.0	32.2	69.6

Source: Bank of Latvia.

Despite the positive balance for the service trade (from the Latvian point of view), it has to pointed out that the volumes are certainly lower than for commodities. Nevertheless, we can conclude that Latvia does hold some “market power” in this area of trade, and this ensures that even during periods of economic downturn service exports to Russia and Belarus have provided a stabilizing cushion to the economy of Latvia.

2.3. Overall significance of trade and comparative advantage

To summarize the relative importance of trade (both commodity and service), the corresponding volumes are combined in the following table, which expresses them as a percent of Latvia's GDP in order to evaluate the significance of the links between countries. The data is analyzed for the last 10 years.

⁵ See Bank of Latvia, available at <http://www.bank.lv/publikacijas/latvijas-maksajumu-bilance/5199>.

Table 4. The relative importance of commodity and service trade from Latvia to Russia and Belarus (as a percent of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Service Exports	1.4	1.3	1.9	1.8	1.3	1.1	1.0	0.9	1.1	2.2
Commodity Exports	1.9	1.8	1.8	2.5	3.2	3.3	3.3	3.4	3.1	4.7
Total Exports	3.3	3.1	3.7	4.2	4.5	4.4	4.2	4.2	4.2	6.9
Service Imports	1.0	1.0	1.1	1.0	1.0	0.9	0.7	0.7	0.7	0.8
Commodity Imports	5.6	5.0	5.8	6.9	7.7	7.2	6.2	6.5	5.1	6.2
Total Imports	6.6	6.0	6.9	7.9	8.7	8.1	6.9	7.3	5.8	7.0
Total Balance	-3.3	-2.9	-3.2	-3.6	-4.2	-3.7	-2.7	-3.0	-1.6	-0.1

Source: Bank of Latvia, Central Statistical Bureau of Latvia, author's calculations.

The overall summary of the statistics provided above suggests that the significance of Russia and Belarus as an export market has remained relatively stable throughout the period in question. Apart from a sharp increase in export volume in 2010 (related to the general recovery of exports and the low GDP base during that year), the rest of the period has shown just a slight increase in total export volume after Latvia's entry into the EU in 2004. The table also provides us with an estimate of the direct impact of trade-related activities with Russia and Belarus – on average, this accounted for around 4% of GDP during the period, with a sharp increase in 2010. On the import side, the patterns are less explicit due to fluctuations of commodity prices and other factors. In this case, total import volumes have remained in the range of 6-9% of GDP.

When looking at the trade patterns between two countries, an economist very soon starts to wonder about the comparative advantages of each of the involved countries. This is certainly one of the primary questions of interest for trade economists, and usually it helps in providing some closer insights into the strengths and weaknesses of the economies of the involved countries. A quick indicator that provides us with a rough insight into this issue is the export/import ratio at the industry level. Based on publicly available data, the following table provides these ratios for some of the key sectors in the commodity trade between Latvia and Russia. Although this approach does not break down trade flows into specific commodities, it does provide a first look at the relative strengths of the country's exports. Only those industries accounting for at least 5% of the total

trade turnover between Latvia and Russia from 1993-2009 are considered (as we can see from the following statistics, six industries meet this criterion). The table below summarizes the findings and attempts to rank the industries by their relative importance in trade between the two countries.

Table 5. Export/import ratios in selected industries for trade flows between Latvia and Russia (1 – balanced trade; >1 – Latvian exports exceed imports; <1 – Russian exports exceed imports)

	1993	1995	2000	2005	2009	TOTAL (1993-2009)	Share of the sector in external trade
TOTAL	1.1	0.8	0.2	0.6	0.6	0.6	100.0%
Mineral Products (V)	0.1	0.04	0.01	0.03	0.02	0.03	33.7%
Base Metals And Articles Of Base Metal (XV)	0.7	0.4	0.1	0.2	0.2	0.2	12.5%
Machinery And Mechanical Appliances (XVI)	2.2	1.8	1.3	3.0	4.4	2.7	9.9%
Prepared Foodstuffs (IV)	13.9	21.5	3.6	2.8	3.8	4.5	9.9%
Products Of The Chemical Or Allied Industries (VI)	1.1	1.0	0.5	1.2	2.7	1.1	8.6%
Wood And Articles Of Wood (IX)	2.7	1.6	0.1	0.04	1.4	0.1	5.0%

Source: Central Statistical Bureau of Latvia, author's calculations.

The overall picture suggests that the export/import ratio declined sharply between 1993 and 2000, most significantly during the aftermath of the Russian crisis, when the nominal exchange rate of the Russian ruble depreciated sharply. Since then, however, exports have grown in relative terms, and while Latvia still imported roughly 30% more commodities from Russia than it exported in 2010, the situation has improved since 2005.

At the sectoral level there are several interesting trends to discuss. As mentioned above, we focus here on six key sectors of trade between Latvia and Russia. By far the biggest share of trade is generated by mineral products (33.7% of the trade volume between 1993 and 2009), followed by base metals and articles of base metals (12.5%). In terms of export/import ratios, the picture here is very simple – these are the sectors in which imports from Russia have been inevitable and the direction of trade is determined simply by the lack of domestic natural resources in Latvia. The decrease of the ratio for base metals when compared to 1993 simply points to the increased activity of Latvian enterprises, which depend on imported raw materials.

The following two sectors – machinery and prepared foodstuffs – present a more interesting story, as in this case there is no clear predetermined advantage for any of the countries involved in terms of the availability of natural resources. As the table above suggests, both of these sectors have been dominated by Latvian exporters. Despite a reorientation toward Western European markets in 1999-2000, these industries in Latvia still maintained advantages over their Russian counterparts – export/import ratios have remained significantly above one, even in 2000 (i.e., the year that trade patterns settled down given post-crisis realities in Russia). Latvia's advantages seem to have strengthened again in the food industry over the past five years – the ratio has gradually climbed from 2.5 in 2006 to 4.5 in 2009, mostly due to favorable conditions in the world's commodity markets and increases in the purchasing power of Russian consumers. To be fair, one has to note that each of these sectors accounts for just 10% of the overall trade volume between Latvia and Russia.

Finally, the chemical and lumber industries complete our overview of export/import activities between Latvia and Russia. From the macroeconomic perspective, both of these present interesting scenarios of development in the past few years. In the chemical industry, trade advantages seem to have changed direction several times between 1993 and 2009. In the early to mid 1990s trade flows were close to balanced. The situation changed dramatically in 1998, suggesting that the movement of the real exchange rate due to the Russian crisis strongly favored Russian chemical exports. After Latvia joined the EU the situation changed once again, most probably due to the Latvia's entry into the European customs union (eliminating bilateral tariffs with Russia). In the lumber industry the swings have been even more extreme, with Russia being a clear net exporter to Latvia between 1998 and 2008, suggesting that Latvian processing enterprises have been taking advantage of the vast forest resources available in Russia. In summarizing the discussion above we can conclude that while the situation is fairly straightforward in the industries related to natural resources (e.g., mineral products and metals), the situation has been far more complicated in several other industries. A Latvian advantage can be observed in the food industry, while more complicated dynamics are observed in the chemical and lumber industries. The discussion above has been based solely on economic aspects. We do remember, however, some examples of times that political aspects have come into play (for example, Governor Luzhkov's call to boycott Latvian sprats in 1998). When looking at the export/import ratios, however, it does not seem that these factors have played a major role in the development of the trade relationship between Latvia and Russia. At the macro level, factors related to changes in income levels, as well as certain other notable events (such as Latvia's entry into the EU), seem to have played a much more significant role.

3. Investment links between Latvia and Russia

In this section investment inflows into Latvia are examined from an international perspective. The following table provides an overview of the top investors in Latvia in terms of cumulative investment as of 2010. As the investment flows from Belarus have been extremely small over the period under consideration (accounting for just 0.1% of the total inflow, ranking Belarus in 35th place), the focus of this section is solely on investment links between Latvia and Russia.

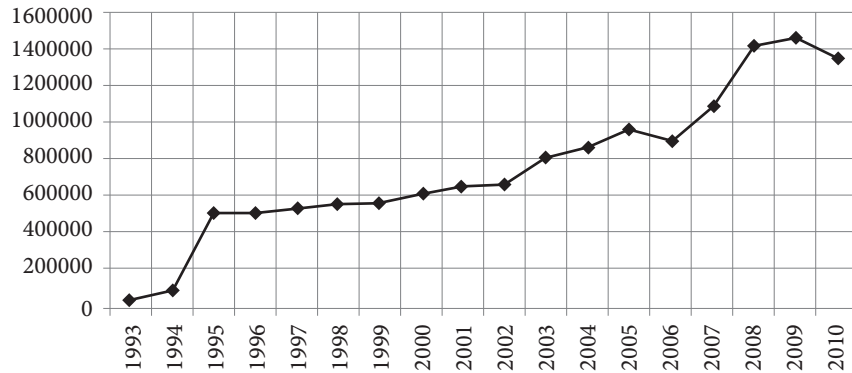
Table 6. Top 15 countries by cumulative direct investment in Latvia in 2010
(as the percent share of total direct investment received)

Country	Share of direct investment in Latvia
Estonia	20,9%
Sweden	9,0%
Denmark	6,9%
Netherlands	6,0%
Cyprus	6,0%
Norway	5,9%
Lithuania	4,6%
Finland	4,4%
Russia	3,5%
USA	3,3%
Austria	2,8%
Luxembourg	2,8%
Switzerland	2,3%
Germany	2,1%
Malta	1,8%

Source: Central Statistical Bureau of Latvia, author's calculations.

Before attempting to examine the specifics of the investments, let's take a look at a relatively simple set of graphs characterizing the overall investment trends since 1993, and then turn to a more detailed examination of the underlying factors. The following tables provide an overview of the official statistics on foreign direct investment flows from Russia.

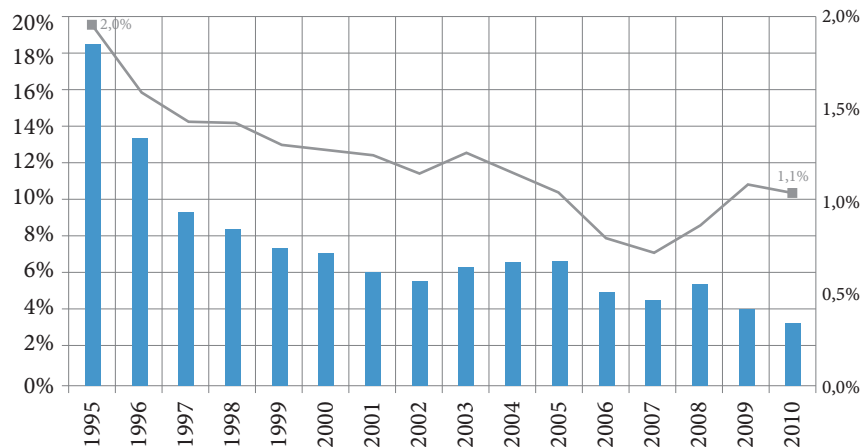
Chart 7. Cumulative Russian foreign direct investment in Latvia (thousands of LVL)



Source: Central Statistical Bureau of Latvia, author's calculations.

As the graph above suggests, investment in Latvia has experienced a fairly even upward trend, with the exception of the mid 1990s and the years after 2006, which roughly correspond to Latvia's economic boom and the increase of global commodity prices. In order to get an idea of Russia's relative standing compared to other countries, we should also consider the share of Russian foreign direct investment during the same period (see the following table).

Chart 8. Share of cumulative Russian foreign direct investment in Latvia (percent, left-hand scale) and its relative significance (as a percent of GDP, right-hand scale)



Source: Central Statistical Bureau of Latvia, author's calculations.

When compared to its Eastern European counterparts, Latvia has been fairly successful in attracting foreign investment. The first wave of investment inflows was associated with the privatization process in the 1990s, while another significant pickup took place after its entry into the EU. When comparing investment inflows from Russia the trends look fairly similar, though investment inflows seem to have slowed down during the last few years (2009–2010) as the global economy also slowed down during this period.

It has to be admitted that the investment inflows from Russia into Latvia might not be straightforward to track. The authorities can certainly provide a breakdown of investment flows by country – however, due to various considerations, including taxation and political issues, the actual amounts may be difficult to discover. The graphs above represent the “official” story that is based on the available official statistics from Latvian authorities on cumulative investment (namely, Russia's share of it). The investment share from Russia reached its peak in 1995 (but was still less than 20% of the total), and in general has gradually declined afterward, staying in the single digits since 1997. A slight acceleration can be observed only around the time that Latvia joined the European Union. However, the latest official data suggests that the share in 2010 has even dropped below 4% of cumulative direct foreign investment in Latvia. In absolute numbers the trends suggest two periods of a relative “boom” in investment flows – the mid 1990s (related to the privatization process in Latvia, with the natural gas company “Latvijas Gāze” being the prime example) and the years shortly after Latvia's entry into the EU, when presumably export-oriented Russian enterprises started viewing Latvia as a potentially interesting partner for accessing EU markets. During the rest of the period in question, the official statistics provide very little in terms of interesting trends and deviations.

The other aspect highlighted by the above graph is the relative significance of Russian investments, as represented by the right-hand scale. The numbers tell us that in the past 10 years the cumulative investment from Russia has fluctuated around 1% of GDP, which is certainly an insignificant share compared to the total investment volume. Again, we emphasize that this is the story told by the official statistics, which are unable to directly capture any investment made via third countries.

The reality may or may not be different from the official statistics, as it is extremely hard to track. In particular, the question remains of whether investment flows from Russia can be easily identified in the official statistics. Again, an illustrative numerical example of this is the fact that by the end of 2010 the cumulative investment into the Latvian economy from Cyprus exceeded

investment from Russia by more than 70%⁶. There is certainly more at work here than the seemingly logical approach of gravity models or other scientifically recognized explanations of investment flows that could provide a detailed explanation here. The picture is more complicated due to significant differences in taxation, even between member states of the EU. Although in the past any hard evidence of the actual beneficiaries of certain investments is very hard if not impossible to obtain, the trends suggest that third countries may be widely used to access the final destination of investments. The already mentioned case of “Latvijas Gāze” may again serve as an example here, as minority shareholder “Itera Latvija” is in fact owned by a Cypriot (66% of shares) and a Danish company (34% of shares), which complicates the process of identifying the actual beneficiaries.

Although Latvian authorities have in general pursued a liberalistic approach regarding financial and investment flows, there are some aspects of this that deserve closer attention. In the 1990s the ongoing privatization process was a key tool for attracting foreign investment. Although not entirely a success story, it provided opportunities for foreigners who were interested in starting a business in Latvia, providing the country with a valuable inflow of capital. Even after almost two decades of privatization, there are still a number of fully or partly state owned enterprises whose future has been widely discussed.

The decision to privatize a large state-owned enterprise in a small open economy can lead to all kinds of speculation about the intent of potential investors. In the past there have been occasions when the proposal to privatize a certain enterprise has led to significant political tension. For example, in 2000 the parliament avoided a referendum on the issue of the privatization of “Latvenergo” by deciding not to follow through with plans to privatize it. While this example does not directly tell us about a specific case of foreign interests in Latvia, it certainly shows that privatization has been a very challenging issue for policy makers.

Although the process of privatization (especially regarding large enterprises) has been a long and complicated story, lately there have been several steps from the authorities to bring some clarity to the process, and possibly to try to avoid speculation about foreign powers gaining influence in some vital enterprises in Latvia. Specifically, in 2005 the Cabinet of Ministers of Latvia approved a list of six state-owned enterprises that will not be privatized. The areas covered by these enterprises include transportation and communications services (railways, air traffic control, the Riga airport and postal services), energy (“Latvenergo”), and forestry. This step toward certainly helps in terms of avoiding conspiracy theories

⁶ This observation, however, has to be treated cautiously, as Latvian companies themselves might use Cyprus and other countries for the purposes of tax optimization.

– at least pertaining to the mentioned enterprises. This clarity, however, is likely to last only as long as the current ruling coalition remains in office.

The Ministry of Foreign Affairs of Latvia published in July 2011 a summary of the Latvian-Russian relationship, which among other things included a list of the largest direct investments into Latvia made by Russian companies and residents so far.⁷ This list provides us with a starting point to characterize the flow of investment between the two countries. According to this list, the largest investment was made by “TRANSNEFTEPRODUKT AO” in the amount of 36.55 million LVL (34% SIA “LatRosTrans” shares). This fact clearly indicates that Russian investors appreciate and try to take advantage of Latvia’s strategic location. The next largest investments were in car manufacturing (“Amo Plant”, a daughter company of Russia’s ZIL) at 20.09 million LVL, and in “Latvijas Gāze” at 13.57 million LVL (34% of shares of the company). While the former of these two investments was relatively recent and indicates that Russian companies are increasingly interested in locating their production activities in the EU, the latter was a significant Russian investment made during the privatization process. The next two entries on the list are related to the banking sector: an investment of 10.82 million LVL (99.87% of shares of “Latvijas Biznesa banka”) and an 8.2 million LVL investment in another bank, “Latvijas Tirdzniecības Banka”.

In summarizing the observations of investment links between Latvia and Russia, it can be concluded that the official statistics present a picture where the share of Russian investment in Latvia is relatively small (just about 3.5% of the total cumulative investment received). Except for “Latvijas Gāze”, Russian investors have also played a very small role in the privatization process in Latvia. At the same time, indirect evidence suggests that investment through third countries may play a considerable role in the flow between Russia and Latvia. This dimension, however, is extremely difficult to track in many cases, even though it is present even in notable cases of investment such as the “Latvijas Gāze” case mentioned above.

Conclusions

The discussion of the economic relationship between Latvia and its neighbors, Russia and Belarus, has focused on several aspects – historical trends in trade and investment flows, industry specific trends, and the factors that have influenced economic cooperation between the countries. Past trends suggest that

⁷ See Latvijas un Krievijas attiecības, available at <http://www.mfa.gov.lv/lv/Arpolitika/divpusejas-attiecibas/Krievija/>.

economic relations between the two countries can be characterized by several distinct periods:

- an initial weakening of trade links established during the Soviet rule,
- some recovery in activity from the mid 1990s until the Russian crisis,
- a collapse of Latvian exports to Russia and Belarus after the 1998 Russian financial crisis and a following period of stagnation,
- a new wave of growth after Latvia's entry into the EU,
- the impact of the global recession during the last few years.

An examination of commodity trade patterns between Latvia and Russia suggests that while Russia has maintained its dominance in industries related to mineral products, Latvia has outperformed its neighbor in other industries (most notably food processing and machinery/mechanical equipment). Changes in trade patterns have mostly taken place on the basis of changes in fundamental economic indicators (e.g., income and real exchange rate changes). The overall volumes of commodity and service trade expressed in relative terms contribute to about 3-5% of GDP on the export side and 6-9% of GDP on the import side (with a notable exception in 2010, when exports increased significantly).

In terms of investment flows, the data points toward a lesser share of Russia's investments in Latvia. An increase in the absolute volume of foreign direct investment from Russia can be observed, especially after Latvia's entry into the EU. The situation, however, is much harder to fully examine in practice as there is evidence of foreign investment entering Latvia via third countries. This approach is not really a recent innovation, due to tax optimization and other issues. Unfortunately, it complicates an analysis for the purposes of this study because the actual beneficiary of a certain investments is extremely difficult to track.

Regarding the discussion of the ways that Latvia has attempted to limit the inflow of foreign investment in several specific areas of the economy, it appears that there have been some specific efforts undertaken. Currently, the approach taken by the Latvian authorities is linked to compiling a list of state-owned enterprises that are not subject to privatization. Apart from this list, the overall approach taken by the Latvian authorities has been quite liberal. It has to be pointed out that in several cases the privatization process has been an extremely long-lasting affair, which in itself seems to be restrictive.

Finally, the sectoral composition of Russian investment in Latvia was considered: both the partial ownership of "Latvijas Gāze" and the more recent investments in the banking sector. Although the volume of direct investment is fairly low (not taking into account possible investment routes via third countries),

it has been oriented toward several specific sectors of the Latvian economy, which probably seem attractive in the context of Latvia's presence in the common EU trade area. So far banking sector investments have been marginal, but given the features of this specific industry in Latvia an economist would certainly welcome a more diversified ownership profile, which hopefully would also lead to increased competition in the sector.

In terms of recommendations for the future of the economic relationship with Russia and Belarus, a key step in this area is Russia's entry into the WTO. This step will eliminate key uncertainties that limit the flow of goods and services between the countries. The issue of uncertainty has been quoted by the Latvian side frequently, and the WTO should reduce if not eliminate this negative aspect. Regarding the flow of investment, Latvia's best approach would probably be to work toward creating a mix of East and West investment in key sectors of the economy, thus ensuring the joint economic interests of the participating countries. It seems that the advantages of Latvia's position are understood both by the EU and by eastern neighbors; however, joint investments have been rather scarce.

The future of the trade relationship with Russia seems rather bright in light of Russia's entry into the WTO. Although we have yet to see any tangible benefits, the WTO certainly provides a forum for equal cooperation in the area of foreign trade. In terms of the development of investment relationships, it seems that the potential is there; however, activity may be subdued due to threats of an economic slowdown in the EU, which may temporarily limit the interest of Russian companies to enter the market. Once the EU resolves the current financial issues in some of its member countries, the potential for increased investment flow from Russia is fairly high.

FOREIGN ECONOMIC POLICY OF THE RUSSIAN FEDERATION: THE CONSTRAINTS AND OPPORTUNITIES OF THE BALTIC DIMENSION

Victoria Panova

The long history of political, economic, social, cultural and ideological interaction in Eurasia reveals the uneasy context of the current geopolitical and geo-economic system. The Russian Federation – which occupies 13% of the world's territory and around one third of Eurasia, possesses a variety of mineral deposits, vast forests and hydro resources, is the 6th largest world economy (by PPP), is one of the 5 countries with a permanent UNSC seat and holds one of the world's largest nuclear arsenals – is a powerhouse on the continent and a force that other countries need to come to terms with.

In the past, Eurasia was divided by the Iron curtain, which ran between two different political and economic systems. Within the Soviet bloc this led to a number of issues that still definitively influence relations between Russia, as a successor of the USSR, and its neighbors. Even two decades later emotions and historic issues hamper full-fledged cooperation and unbiased attitudes toward each other (one can see an example of this in the absence to date of a bilateral intergovernmental commission between Russia and Estonia). Nevertheless, there's great potential and a willingness on the part of both sides to overcome the past and finally start living in the present. This paper will explore Russian attitudes and interests, as well as existing problems of historical perception, in order to enhance the current and future potential for developing a common area of mutually beneficial development.

1. The Russian economy: challenges and prospects

As mentioned above, Russia is one of the world's leading economies, even if it is not among the best performing ones. Its GDP has finally recovered from the crisis and constituted 54,585.6 billion rubles (at current prices) in 2011, or roughly \$1,856.65 billion counted at the April 2011 ruble/dollar exchange. After a deep plunge of 7.9% in 2009, the Russian economy saw growth rates of 4.3% in 2010 and 2011.⁸ During the crisis all indicators worsened considerably, but one can see

⁸ Russian Statistical Bureau. GDP data. <http://www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/account/#> With the Ruble to USD exchange rate equaling 32.19 in December 31, 2011, approximate figure in USD is 1.7 trillion of GDP.

steady, if not rapid, recovery and growth. Russian exports reached \$471.6 billion in 2008, then plunged by over 35% in 2009 before increasing again to \$522 billion in 2011. A similar picture was seen in Russian imports, which reached \$291.8 billion in 2008 and then lost almost 35% the next year – a similar recovery tendency was demonstrated here, as exports have grown to \$323.2 billion.⁹ The main problem that remains with external trade for Russia is the unbalanced structure of its exports, which continue to rely heavily (almost 70%) on hydrocarbons.

As far as international reserves are concerned, after reaching a peak of \$596.6 billion in August 2008, Russia was forced to dip into reserves during the crisis and bring the total volume down to a low of \$383.8 billion in May 2009. Since then reserves have resumed their growth (with additional attention given to the growth of gold reserves, which provide almost solely for the accumulated growth in emerging economies) and as of June 2012 amounted to \$510.4 billion, constituting 85.5% of the pre-crisis figure.¹⁰ The problem is that post-crisis reserves gradually increased to \$545 billion in September 2011, but then the outflow of capital surpassed \$80 billion last year and reserves started depleting again until early 2012, when the Central Bank intervened to sustain the ruble in the context of capital outflow and a weak balance of payments.

Further developments in the Russian economy would be closely linked to two main factors. The first an external one, is the condition of the world economy. The overall economic situation remains uncertain, with the euro-zone crisis continuing. Thus, prospects for a fast recovery, even though pre-crisis macroeconomic indicators are likely to be achieved within next couple years, remain vague, especially given Russia's serious interdependence with European countries. Russian dependence on hydrocarbon exports will keep it more exposed to external shocks, and a speedy recovery would be undermined by the likely reduction of oil prices against the background of weak world economic development. Even though the situation is still under control, a further markdown in oil prices might present considerable danger to the state budget and overall economic situation in Russia.

Second, until the announcement of who would be running in the presidential elections and the formal outcome of those elections, there was an unclear legal

9 Russian Statistical Bureau. External Trade. http://www.gks.ru/bgd/free/b12_00/IssWWW.exe/Stg/dk01/3-2.htm, Central Bank of Russian Federation. External Trade. http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/trade.htm&pid=svs&sid=vt, Ministry of Economic Development of Russia, Social and economic development indicators for 2011-2013. http://www.economy.gov.ru/minec/activity/sections/macro/prognoz/doc20101217_03.

10 Central Bank of Russian Federation. Russian foreign reserves. http://www.cbr.ru/hd_base/mrrf/?C_mes=01&C_year=2007&To_mes=05&To_year=2012&x=31&y=11&mode=

climate for investors and a short term lack of attractiveness for FDI. When reading the reaction of foreign experts on Putin's decision to come back, one can't find a homogeneous approach to the issue. Major hesitations stem from the question of whether stability, which is associated with Putin as a leader, is going to make the country attractive to investors or whether it will result in stagnation, or even a step backward in terms of tightening the rights and freedoms of the population and tighter control of businesses. Nevertheless, it seems legitimate to presume that Putin would be business-friendly, or at least eager to promote Russian big business interests abroad, which was consistently demonstrated during his previous terms in office. All in all, with the current and upcoming legal atmosphere for foreign investments, we might witness further joint ventures with big international businesses while small and medium-size enterprises are likely to come to Russia with reservations.

It is true that of major developing countries Russia has suffered the most from the current world financial and economic crisis, and the dilemma for Russian authorities is still in the area of the modernization of the Russian economy to sustainable levels. Still, if taken in general, Russia will remain attractive as a host country for foreign investment in the mid-term, and more money is likely to flow into the country after next year. Of the BRIC countries, Russia occupied third place in terms of GDP growth in 2011 (after China [9.2%] and India [7.4%]), while the other G8 countries remained behind that figure (Germany at 3%, the USA at 1.7%, Japan with a reduction of 0.9% etc.). With regards to data on industrial production, Russia (4.7%) came third (after Germany [8%] and India [4.9%]).¹¹

Meanwhile, the current situation remains strong concerning Russian capital outflow.¹² Considering the above mentioned euro-zone crisis and the United States' state debt, some experts even compare the situation today to that of 2008. Banks lack liquidity and the trade balance is still positive, but the pattern is changing. Thus, in the near future Russian authorities might face the difficult choice of either closing the trade balance deficit with foreign reserves or drastically devaluing ruble. Considering the prospects of further integration of the three countries of the Customs Union (Belarus, Kazakhstan, Russia) into

11 Pace of economic development: BRIC should be read as CIRB. Vesti, Economics, 21.02.2012. <http://www.vestifinance.ru/articles/7818>.

12 Capital outflow for 2009 amounted to \$56.1 billion, in 2010 to \$34 billion, over \$84.2 billion in 2011, and \$46.5 billion over the first five months of 2012. For more information see Ministry of Economic Development. On the foreign investments. http://www.economy.gov.ru/minec/activity/sections/investmentpolicy/doc20110801_001 Although Russian Finance Minister A.Silouanov believes that further lowering of oil prices will inevitably lead to lower pace of capital outflow. See "Silouanov: pace of capital outflow will go down as a result of oil price reduction", <http://www.newsru.com/finance/08jun2012/silouanov.html>, June 8, 2012.

a provisional Eurasian Union with a single currency, problems with the Russian ruble (while Belarus supports using the Russian ruble as a single currency) might undermine the process. As far as the current situation with the investments is concerned, according to the Russian Statistics Agency (Rosstat) the total volume of foreign investment in Russia as of the end of 2011 amounted to \$347.2 billion (a 15.7% growth from the previous year), with the IFDI stock amounting to \$190.6 billion.¹³ The top 10 countries that invest in Russia are Cyprus, the Netherlands, Luxembourg, Germany, China, the UK, the Virgin Islands, Ireland, Japan, and France¹⁴, while the Baltic states make up only a miniscule part of the overall volume of investments, with less than 0.2% altogether (Latvia with \$263 million of investment into Russia, Lithuania coming next with \$224 million and Estonia last with \$167 million).¹⁵

Russian OFDI mostly goes in similar directions. The Netherlands came in first in 2011 in terms of investment stock (while Switzerland occupied first place in terms of the volume of investments of 2011), followed by Cyprus, the USA, Switzerland, Belarus, the Virgin Islands, Saint Kitts and Nevis, the UK, Luxemburg and Austria.¹⁶ As of early 2011, the Baltic states (even though there is a positive investment tendency) also occupy a minor part (the cumulative figure is slightly over \$2 billion, or 0.54%) in the total volume of \$368.7 billion of Russian OFDI. Of the three countries the biggest investment stock is found in Lithuania, surpassing in volume the total investment figure of Estonia and Latvia combined.¹⁷

2. The impact of Russia's presence in international economic mechanisms

Until recently Russia was outside the WTO, but it still took part in major formal and informal economic and political groupings, and actively participated in international trade, world economic and financial institutions, and global economic interactions. Being part of all the 3 major informal "clubs" – the G8, G20 and BRICS – in economic terms it yields only to the USA, Japan and Germany

13 Rosstat. On international investments in 2011. http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d03/42inv27.htm

14 Net flows of the previous year present a slightly different picture, including Switzerland and Virgin Islands in the top 10 investor-countries.

15 Central Bank of Russian Federation. http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/dir-inv_in_country.htm&pid=svs&sid=ITM_58761

16 Rosstat: Investments in Russia. http://www.gks.ru/bgd/regl/b09_56/Main.htm

17 Central Bank of the Russian Federation. Foreign Investments of the Russian Federation. http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/dir-inv_out_country.htm&pid=svs&sid=ITM_58823

within the G8 and to China and India within BRICS. A number of deficiencies exist in the Russian economy – high dependency on hydrocarbon exports, poor efficiency and weak institutional and legal development – that leave the country less attractive for foreign investment¹⁸ and allow for an outflow of shadow capital.¹⁹ However, Russian economic power will at the same time continue to be an important factor for the sustainable functioning of other economies.

On December 16, 2011, the protocol of Russia's accession to the WTO was finally signed; the final step is its ratification by the Russian Duma, which is due on July 4th 2012, to be followed by presidential approval.²⁰ Even after the conclusion of long negotiations on WTO accession, there is still no universally agreed position on the impact of WTO membership on the Russian economy. The majority of experts agree that this is bound to have positive effect for Russian consumers, although presidential aid Arkady Dvorkovich rushed to state that WTO accession wouldn't bring about lower of prices, and thus this isn't likely to seriously influence import dynamics.²¹

As for the possible influence this could have on Russian-Baltic relations, there doesn't seem to be much of an impact. *Gazprom* continues with the functions it had previously and there will be no anti-state-company measures resulting from the membership, and pipeline transit will remain closed. On the other hand, Russia sees the possibility to turn to the WTO court with complaints against the EU surrounding the third energy package, which undermines *Gazprom's* acquired position in Europe, as well as on energy correctives, whereby EU was using anti-dumping measures judged by "surrogate prices". The issue of timber is also relevant for the another country on the Baltic Sea, namely Finland. With Latvia being among the top five exporters of cement to Russia, the terms of WTO won't stimulate additional export volumes for this country either. The industries that would be most negatively affected by WTO accession, the car industry and royalty payments for Trans-Siberian routes, aren't of primary concern for Russian-

18 Although one should note that Russia remained in 7th and 8th place within the list of top 20 destinations of host countries for FDI, and stayed in 8th place for OFDI during the period of 2009 and 2010, and is projected to occupy an even higher 5th place. See UNCTAD, World Investment Report 2011. Chapter 1, pp. 4, 9, 19. <http://www.unctad-docs.org/files/UNCTAD-WIR2011-Chapter-I-en.pdf>

19 According to the Ministry of Economic Development, 2011 will see \$30-40 billion of capital fleeing, while it was previously hoped to come to a neutral balance.

20 Unless the ratification process is not completed by July 23, 2012, in which case Russia will have to restart the process of negotiations for the WTO accession.

21 While according to Moody's analysts Russian premium retailers trading with imported products are likely to "be among the few who'd win from WTO accession". (see A.Kreknina. Traders of imported goods will win from WTO accession. *Vedomosti*, 16.03.2012, #47 (3061), http://www.vedomosti.ru/companies/news/1538797/vto_dobavit_pribyli)

Baltic economic ties. One exception is probably the market for used cars, which are now primarily transported via the Baltic states (since Belarus has become a less attractive transit point within the Customs Union). With Russia inside the WTO, the routes of transit might diversify once again, and unless there's serious increase in the volume of trade in second-hand cars, Latvia and Lithuania might no longer enjoy transit exclusivity. There are also questions arising surrounding the formation of a Customs Union of Belarus, Kazakhstan and Russia, and its influence over the trade and economic activities of Russia with regards to third countries. All in all, even though there are often polar expert views on the general effect of the Customs Union for the economy of its participant countries (ranging from a very optimistic model of gaining \$400 billion in revenues by 2015 and Russia benefiting the most from integration in the mid-term, by an estimated 16.8% of current GDP [Belarus by 16.1% and Kazakhstan by 14.7%], to the view that the Customs Union presents at least short-term negative or neutral scenarios for GDP for all the participants), it is estimated that the effect on the third countries, be it EU, Ukraine, China or other countries, wouldn't be more than 0.1% of GDP.²²

3. The Baltic direction of Russian economic policy and perceived asymmetry

The Baltic countries are situated in the strategically important Baltic region, the value of which lies in transport/transit, military and geoeconomic benefits that cannot be overestimated. Latvia, Lithuania and Estonia all border Russian Federation. The second half of the 20th century remains a painful memory for those countries, but to be objective it is necessary to see what role, due to the significance that was attached to that geographic area, was given to the Baltic states. Thus, a special position for all three was acknowledged in the Soviet Union. The three Baltic republics were leaders in terms of attracting investment, with fixed capital expenditure in Estonia being 6-8% more than the USSR average,²³ and in this regard had best starting point for the development of a market economy in the whole post-Soviet area.

22 See for example S.Glaziev. "Why do we need Customs Union" Eurasian Business Council. <http://www.evrases-bc.ru/news/view/1132>, for opposing view World Bank Report by L.V. de Souza. An Initial Estimation of the Economic Effects of the Creation of the EurAsEC Customs Union on Its Members. Economic Premise, January 2011, # 47.

23 L.Grigoriev, S.Agibalov. The Baltic states: searching for the way out of crisis. Institute of Energy and Finances. April, 2010. http://www.fief.ru/img/files/baltica_crisis_grigoriev_agibalov_2010.pdf.

Following the demise of the Soviet Union, anti-Russian sentiments were ripe in those countries, especially in the 1990s, and the Baltic states for political reasons tried to reorient their economies in a western direction. But for objective reasons, European countries, and the Baltic states as well, have strong economic connections with Russia, and notwithstanding political issues the Russian market is still attractive for the Baltic states. It remains among the most interesting export destinations with a significant amount of consumers, especially in areas where local producers are less competitive than their Western European counterparts, or where the Western EU market is not very open for Baltic businesses. Further positive dimensions include geographic proximity, cultural and historical ties (though history can be, and proves to be, divisive at the same time), as well as familiar consumer habits, business ethics, and psychology (though the Balts are seen as too German for Russians and too Russian for the German culture). Russians, in turn, also have mixed feelings toward their Baltic partners. On the one hand, Russian businessmen (and politicians) view bigger European states like Germany or France as equals, while overlooking small states. On the other hand, all the former Soviet bloc countries – partially but not entirely due to a big proportion of Russian-speaking minorities – are seen as closer and easier to deal with for the above mentioned reasons of business ethics and psychology.

So when talking about the Baltic direction of Russian economic activities (although the same can be claimed about other areas of foreign policy, this is not the subject of this paper) it's been widely recognized that economic relations are rather asymmetric in nature. That is to say, economic ties for Estonia, Latvia and Lithuania with Russia (even after their reorientation toward the West and their joining the EU in 2004, with Estonia succeeding the most in distancing themselves economically from Russia) count much more than the economic value that trade and other economic activities with the Baltic states presents for the Russian Federation. Thus, for Russia as an entity, the Baltic countries occupy minor position, even including the vital importance of that direction for certain Russian enterprises.

Such ongoing economic dependence after receiving political independence was first clearly felt by those countries after the 1998 default in Russia, and in 1999 led to stagnation after a period of growth (since 1995) in all three states. This exposure to the conditions of the Russian economy and the asymmetry of relations, it seems, led to psychological discomfort and fear within the Baltic countries toward the capacities and intentions of Russia. This fear was certainly facilitated by Moscow itself, when it started using available leverage to punish the Balts for unfriendly foreign policy instruments.²⁴

24 Joining the Western structures of the EU and NATO was primarily considered as such, but other incidents will also be explored further in the paper.

This asymmetry of capabilities seems to have pushed the Baltic states further and faster into the arms of the EU and NATO. A more pragmatic approach with cooperative elements toward Russia started taking visible shape in the early 2000s, which can be seen in changes in the governments of all three Baltic states. The Latvian, Lithuanian and Estonian political elites and experts started to again revive the concept of the Baltics as a bridge between Russia and the EU. Russia certainly prefers having friendly neighbors, but the value of this change wasn't of the utmost importance for Moscow. Russia realized that this change was fostered for objective reasons – for the Baltic countries to better their own conditions it was beneficial to cooperate with their Russian neighbor. Partly in order to overcome the marginal significance they had in the Euro-Atlantic community (even the niche taken, to cooperate with Poland as severe critics of Russia, started causing more and more irritation among the bigger European players and proved eventually counter-productive to the Balts themselves), and partly for the sake of their own well-being, since Russia remained an important trading partner and accounted for a big share of national income. At the same time, anti-Russian rhetoric remained in place and a number of political and historical issues continued to loom over bilateral ties.

Asymmetry is visible in the fact that the size of economies is not comparable. This can be seen not just by measuring the size of economy and its GDP (worldwide, Russia holds 6th place, while the Lithuanian, Latvian and Estonian economies occupy 89th, 106th and 113th place in the world, respectively), but also through direct interactions between the countries – that is to say, foreign direct investment and trade. This shows not only the relative marginal importance to the Russian economy of Baltic states, but also undermines the point that there is a direct and overwhelming connection between politics and economics.²⁵

Comparing the flow of FDI flow, one would see that the Baltic states – partly due to interest from Russian investors in other directions, partly due to the high investment activity of neighboring countries (such as Sweden, Denmark, Germany, and the Netherlands), and partly due to cautious attitude of Baltic political elites toward too much Russian business (for fear of it being used as a political lever) – the Russian share of investment doesn't appear to be too big either. Although recently medium-sized Russian business (or, as Forbes jokingly put it, “poorer millionaires”) have seen Baltic economies as a very attractive option²⁶, they do not always invest in a direct way, but instead invest via offshore zones such as Cyprus, Virgin Island, Switzerland etc.

25 No one is arguing that Russia can simply put aside its relations with the Baltic states, since the transit role, even while diminishing with further transport diversification, remains quite visible.

26 The Russian economy is seen as less stable compared to EU-incorporated Baltic countries.

This non-comparability of size creates the traditional dilemma of small states versus big state. The difficulty of the situation is complicated even more by the fact that this asymmetry is double-layered. Even with the pragmatic course pursued by Putin and then Medvedev, Russia still fears an asymmetry of capabilities worldwide and adversarial actions on the part of stronger players, such as the EU or the United States, which also to an extent causes harsher reactions toward smaller neighbors such as the Baltics. On the one hand, the EU is undoubtedly Russia's largest trading partner and investor. According to statistics, up to three-quarters of total the volume of FDI stock in Russia is of EU origin. On the other hand, when the issues become more political than economic this extreme dependence can become a case for concern. And here again Russia is cautious about giving too much of a say in domestic matters to foreign investors, mirroring the attitude of small neighboring countries, which in turn see Russian businesses acquiring their assets as a threat.²⁷ This is the root of the multiple calls from the Russian leaders, both Putin and Medvedev, regarding the necessity of mutual interdependence and mutual equal investments. That is also why in response to calls to open up its strategic sectors, especially the upstream oil sector, Russia demands equal and fair exchange, often equaling investments at a one-to-one ratio.²⁸ Also, certain experts believe that Russian policy is usually more dependent on internal factors and that “Western influence is more important in terms of setting well-known limits for what Russian should not do, rather than affecting decision-making on what it should.”²⁹

In this case the Baltic countries are part of the politico-economic giant (even if not a totally consolidated one) of the EU. Thus, the demands and actions of the Baltic states, as integral part of both the EU and NATO, would receive a harsher reaction on the part of Russia, simply because they are not seen as a weak state – they have an equal status on the “chessboard” as other “queens” and are not lowered to the status of “pawn”³⁰. This complex situation also limits the political willingness of Moscow to accommodate and pushes Russia to assure with all

27 It is enough to remember statements of the leader of the conservatives in Lithuania, Andris Kubilius, or of Latvian President Valdis Zatlers, which read that Russian investments in their countries' economies present the risk of political and economic independence.

28 Although a different explanation for such calls comes from the extreme interconnection between Russian political elites and oligarchs, and the international political lobbying of certain business groups.

29 Arkady Moshes, Russian Policy Towards Ukraine, Belarus, and the Baltic States in the Putin Era. April 2000. PONARS Policy Memo 123, Institute of Europe. http://www.gwu.edu/~ieresgwu/assets/docs/ponars/pm_0123.pdf

30 One can remember Soviet foreign policy responses during the so-called nuclear monopoly of the USA in 1945-1949.

possible means its stable and respected position. Although when economic coercion and sanctions were used, this proved more harmful to the Russian image and instead of pressuring political elites it harmed business groups. Thus, a choice was made to soften economic expansion and deepen interdependence, which would make it harder for the Baltic states to pursue adversarial anti-Russian policies.

Latvia has suffered a difficult development of relations with Russia, with major arguments revolving around historical issues (or historical memory issues), the Russian minority problem, and the border treaty (the first two problems still remain). With the political “divorce”, there was, however, no way to enact an abrupt and unequivocal cut of economic ties. Although there was a certain amount of reorientation on both sides, mutual (even if asymmetric) dependence objectively remained. The mid-2000s seemed to be the a turning point in bilateral relations. First of all, in 2006 the two countries signed a bilateral agreement on economic cooperation and the establishment of an Intergovernmental Commission on economic, scientific and technological, humanitarian and cultural cooperation. In the next year the two sides finally signed a border treaty, not without the help of business lobbying groups for fishing and cargo transit. Nevertheless, a real thaw didn’t come until rather recently.

In December 2010, President of Latvia V. Zatlers came to Moscow, and as a result of negotiations with Russian President D. Medvedev there were a number of agreements signed, among them an economically important convention on the prevention of double taxation (supposed to be in force from January 2012, but is yet to be ratified by Russian Duma), as well as agreements in the area of environmental protection and tourism. Hopefully a decision on the creation of a bilateral commission of historians will bear fruit and eventually allow for full cooperation between the two countries. The current President of Latvia, Andris Berzins, has a business background and should be a pragmatic leader.³¹ Thus, we can also make the assumption that economic and commercial interests will to an even larger extent continue to be the basis of bilateral relations, with less attention paid to politically motivated actions. Currently a lot of work is being done at the level of intergovernmental commissions, with rather intensive work to assist in building business contacts among the Russian-Latvian business council, with Petr Aven and Vasiliy Melnik at its head.

31 Interestingly, when he was President of Unibanka (1993-2004), which was then considered the biggest in Latvia, the bank invested heavily in Russian equity securities, which led to losses of at least 15 million lats as a result of a default in Russia. A need to mend the financial situation led to its sale to Swedish banking group Skandinaviska Enskilda Banken (SEB). See more on A.Berzins on Peoples.ru http://www.peoples.ru/state/king/latvia/andris_berzins/.

Today, Latvia, along with Lithuania, has Russia, Germany and Poland as its top three trading partners. Lithuania and Latvia have switched places in terms of volume of trade growth – in 2010 Latvia was ahead with 42.9% growth and \$6.6 billion, while Lithuania only accounted for \$4.5 billion in trade turnover with Russia, while 2011 saw a growth of 87.3% (reaching \$8.4 billion) in trade turnover for Lithuania and a growth rate of 22.4% with \$8.04 billion of trade with Latvia. If we again look at the period of January–April 2012, Latvia’s trade reached \$3.3 billion, which is 25.9% bigger than the same period of 2011, while for Lithuania growth came to 7.4% with a total volume of \$2.4 billion.³²

The export/import structure somewhat reflects the investment structure in bilateral relations. The biggest export items are mineral products, primarily in the energy sector (with its share growing from early 2000s from less than a half of the total in the exports structure to 88%, which reflects both growing quantities and the price of hydrocarbons), chemicals (4%), metals (3.4%) and transport (1.7%), while import is dominated by machinery and electromechanical appliances (27.9%), prepared foodstuffs and agricultural products (25.7%), chemicals and pharmaceuticals (12.2%), and textiles (3.9%). Prior to Latvian accession into the EU, a bigger share was taken by prepared foodstuffs, textiles and base metals.

With all the talk about the dangers of a Russian hostile take-over of the Baltic economy, Russia’s share remains rather small, making up \$561 million, and making Russia only the 6th largest investor, holding 5% of total stocks. Most Russian investments are directed to energy and transport, industry, real estate and finances. Still, the dynamics are very positive, for over the 20 years since the demise of the Soviet Union, Russian investment in Latvia has grown almost 90 times over, with the flow having intensified over recent years.³³ Latvian investment in Russia mostly goes to wood-processing, the automobile industry and trade, the pharmaceutical business, etc, and mostly presents opportunities for the economic development of border regions.³⁴

By very often reading Latvian media and seeing general EU policies in the area, one gets the firm impression that Russian business is regarded negatively and is seen as a threat by many Latvian and European authorities, but objectively it contributes to the stability of economic relations between the two countries (here we are not talking about shadow capital, which endangers both countries

32 Federal Customs Service. Trade turnover by country. http://www.customs.ru/index2.php?option=com_content&view=article&id=15604:-----2011--&catid=125:2011-02-04-16-01-54&Itemid=1976.

33 Trade and economic relations between Russia and Latvia 2011. http://www.latvia.mid.ru/ruslat_03.html.

34 Trade and economic relations between Russia and Latvia 2011. http://www.latvia.mid.ru/ruslat_03.html.

rather than creates asymmetric dependence). What can explain those worries is a change in the investment direction of Russian businesses. While previously there were purchases of production capacities, today major interest is focused on strategic areas such as banks, telecommunications, energy, and real estate. Moreover, notwithstanding the political conjuncture, business interests usually come first. There was also a study conducted by Latvian economists³⁵ that proved that economics had prevailed and political problems were not hindering development of bilateral trade relations³⁶. Besides, with today's ongoing crisis European investors' interest has diminished, and Russian investors do have money and thereby present an additional possibility for the Latvian economy to come out of the crisis.

When talking about **Lithuania**, it is worth mentioning that from the very start it had better and more balanced relations with its big neighbor. Part of the reason for this comes from the fact that it borders the Russian exclave of Kaliningrad and thus has an extra connection with Russia and more diverse ways to influence Moscow. The significance of the region improves the possibility for package deals to be reached. Its economy went through similar stages as its Latvian counterpart.

With regards to its exports, Lithuania has a rather well developed and balanced structure. While at the end of the 1990s over 45% of Lithuanian exports to Russia were foodstuffs, in 2010 this figure went down to 25%, with a significant increase of high-tech products and semi-finished product supplies.³⁷ Today this includes refined oil products, textiles and machinery. The volume of Russian-Lithuanian trade continues to grow (with a decrease in 2009, which was in line with general trends brought on by the crisis), and this led to the fact that in 2010 Russia occupied first place as Lithuanian trading partner. Russian exports to Lithuania reflect the state of affairs between the countries, with energy resources taking up as much as 70% of total export volume. Furthermore, it is forecasted that gas demand will continue to grow, which was intensified by the Ignalina nuclear power plant closure in December 2009. Even though about 60% of Lithuanian trade happens within the EU, today the country turns more and more to the

traditional Russian market and the Customs Union.³⁸ Part of the reason is that the Baltic states find it harder now to export and invest in the other EU countries.

Russia also occupies 5th place in terms of FDI into Lithuania. The main directions for Russian capital are still manufacturing, electricity and gas, and finance, which accounts for over 95% of Russian FDI. As demonstrated earlier, Lithuanian FDI into Russia remains insignificant for the host country, but its volume is larger than that of the other two Baltic states. Almost half of all Lithuanian FDI go to manufacturing, while the rest is divided between machinery production, food production, retail, finance, and real estate. Geographically, most Lithuanian investments are concentrated in the neighboring Kaliningrad region (similarly, for Latvia it is the Pskov region).

Of the three Baltic states **Estonian-Russian** relations have experience lowest level of interaction. While general trade and business activities grow in the other two countries, with Estonia it mostly stagnates or even decreases. Due to political stagnation, which in part is caused by the absence of a border treaty, trade relations are quite unstable. Moreover, the Russian side firmly believes that a total normalization of relations and the full-blown development of economic and trade links isn't possible without a more open political stance from the other side, thus promoting the concept of a package deal. That is why the Estonian suggestion to create a bilateral economic commission, much like the ones that exist in Russia's relations with the other two Baltic countries, hasn't been met with lots of enthusiasm without Estonia's readiness to take a constructive approach on political and human rights (of the minorities) issues.³⁹ At the same time, a certain degree of interaction certainly exists and there is not only inter-regional and cross-border cooperation, but also best practices exchange between the two countries.⁴⁰

Estonian exports to Russia grew by 41% in 2010 compared to previous year and made up 10% of Estonia's total exports (in third place after Finland [17%] and Sweden [16%]). Estonian imports to Russia also increased significantly, by 25.5%

35 V.Dombrovsky and A.Vanags. Latvian-Russian Economic Relations. In *Latvian-Russian Relations: Domestic and International Dimensions*. Ed. Nils Muiznieks. LU Akadēmiskais apgāds. Latvijas Universitāte, 2006.

36 However, this is not a region- or country-specific phenomenon: similarly, a number of experts believe that existing problems with Japan regarding the Kuril islands and the absence of a peace treaty between the two countries didn't influence commercial ties negatively.

37 Alexei Chichkin. Vilnius comes out to connect. Rossiyskaya business gazeta. <http://www.rg.ru/2011/08/23/ts.html>.

38 In 2011 61% of Lithuanian exports went to EU, but on a country basis Russia came first with 17% (followed by Latvia (10%), and Germany (9%). Similar picture was seen in terms of imports to Lithuania – with 56% of imports originating in the EU, Russia also kept first place with 33%, with Germany (10%) and Poland (9%) coming next. For more details see: External Trade of Lithuania. <http://balticexport.com/?article=lietuvas-areja-tirdznieciba&lang=en>.

39 Interestingly, similar problems exist not only with regards to Russian speaking minorities in the Baltic countries, but also in connection with the other Slavic minorities living in the Baltics and certain policies of the local authorities against full exercise of the rights of minorities therein (like closure of Polish schools in Lithuania). Nevertheless, the governments of those countries do not choose to put package deals forward and continue their cooperation within the EU as members.

40 One of the most interesting aspects for Russia with Estonia is its experience with the use of electronic government and electronic voting procedures.

in the same period (Russia took 5th place after Finland, Sweden, Germany and Latvia), with total annual turnover amounting to \$2.3 billion. Last year saw an even bigger growth rate of 70%, with the total volume of trade turnover reaching \$3.86 billion⁴¹. Items of special interest for Estonia are machinery products, chemicals, metals and timber, foodstuffs and mineral products. Estonia in turn exports to Russia timber and timber products, chemicals, metals and agricultural products, as well as mechanical and electro-technical items.⁴² Altogether, Russian FDI in Estonia has positive dynamics even if presents the smallest part out of all three Baltic states.

All the developments with all three countries are actually deteriorating with regards to the fact that problems exist within Russian businesses or Russian-speaking entrepreneurs in the Baltics. There are, in fact, three major groups of interest that exist and that are eager to invest in the region (sometimes playing against their opponents with the help of bribed local functionaries, using anti-Russian sentiments as one of their tools), thus creating competition that is not always healthy and beneficial for Russian national interests in general, since all of these involve non-transparent practices. Even given that not much is happening with their Estonian counterparts, these events are non-comparable to the scale of developments in the other two countries and it is worth mentioning multilateral events with participation of both parties.

That said, for subjective reasons alongside the objective course of economic conjuncture during the world financial and economic crisis, the well known leaked program for the efficient systemic use of foreign policy factors for the long-term development of Russia was created. Its main characteristic was a very specific and pragmatic approach to each country and region, with the Baltic countries receiving three highlighted points: first, promoting use of territory and transportation infrastructure for cargo to the EU; second, expanding Russia's economic presence with the goal of a steep plunge of investing attractiveness for the EU and cheaper national assets;⁴³ and third, researching the issue of the purchase of a major share in the areas of energy, IT, logistics and transport. This program very well reflects the pragmatic view of the Russian government, which disregards the political ramifications that still exist between Russia and the Baltic states and directs the Russian foreign service to foster economic interdependence

41 Federal Customs Service. Trade turnover by country. http://www.customs.ru/index2.php?option=com_content&view=article&id=15604:-----2011--&catid=125:2011-02-04-16-01-54&Itemid=1976

42 Bank of Estonia. Statistical Yearbook 2010. http://www.stat.ee/publication-download-pdf?publication_id=25642

43 As the result of the crisis, Latvia's GDP suffered loss of 22%, Lithuania's of 16%, and Estonia's of 17%.

in the areas where Baltic states are seen as most competitive and interesting for Russia. However, this doesn't mean that Russian officials are ready to cede political differences, but rather that there is a greater resolve not to allow those things to hamper positive dynamics of Russian – Baltic economic interactions.

4. Directions and areas of economic interaction between Russia and the Baltic states

Even though in general the Baltic dimension isn't of vital importance to Russia and is asymmetric in nature, there are a number of sectors that present significant opportunities to certain Russian business groups and that add to the development of pragmatic and mutually beneficial relations for both sides. These areas include energy, the transport and banking sectors, retailers, real estate etc.

4.1 Energy policy

Energy policy is traditionally highlighted as an area of high strategic importance. It was at the suggestion of Poland and the Baltic states, and with support of the USA and the NATO Secretary General, that NATO at its Riga Summit in 2006 discussed energy security issues, and the inclusion thereof into Alliance's mandate, including the possibility to invoke Article 5, and joint military operations in guarding pipelines. Although that issue didn't receive overall support and had faded away by the time NATO elaborated its new concept three years later, this was very negatively perceived in Moscow at the time.

For all three Baltic countries, energy security presents a challenge – even though they are relatively small energy consumers, they are almost completely dependent on Russian gas exports. Up to 90% of the Baltic states' oil is also supplied by Russia. There's minimal local oil production in Estonia and Lithuania, while Latvia is completely dependent on oil imports. All these challenges are clearly seen by the Russian side and calculations are made based on how consolidated those countries would be in view of their ability to distance themselves from Russia in that area.

The situation has worsened for them after Lithuania had to close down the Ignalina nuclear power plant in late 2009 in accordance with the EU accession agreements, getting 1.5 billion euros of foreign aid in return for complying

with the decision.⁴⁴ Although there's an expressed desire to build a new NPP and there were efforts to create a joint consortium of the three Baltic states and Poland, the project kept running into variety of difficulties sparked by mutual misunderstanding among the participants. Meanwhile, the construction of the Baltijsk (in Kaliningrad) NPP in Russia and another plant in Belorussia (Ostrovetski area) causes a great deal of discontent with the Baltic elites and is seen as politically motivated. But if these plans come to fruition, Russia believes it will be less dependent on its Baltic neighbors to provide electricity to its exclave and so takes a trump out of their hands.

Estonia's energy situation, as seen from Russia, is likely to get more problematic later on as well, since it is now pretty much dependent on oil shale that's mostly used for power generation purposes in Narva power plant, which is at present not compliant with EU environmental standards. This leads to the assumption that situation might change such that the country has a higher dependence on gas imports from Russia. It is true that there are a number of conditions that might mitigate the perceived dependency risks though. Latvia imports up to 80% of its oil and is 100% dependent on Russia for gas imports, which accounts for about a third of its energy balance. For example, in 2010 the country bought from Gazprom 0.7 billion cubic meters (Estonia bought 0.4, and Lithuania bought 2.8).⁴⁵

Occasional difficulties in this area arise from the fact that – realizing there exists a certain dependence in the Baltics – Russian energy companies could push for their commercial interests, which in fact at times can cause an unnecessary deterioration in state-to-state relations, demonstrating the clear prevalence of economics over politics. Commercial and political risks are counted, and obviously *Gazprom*, or *Rosneft*, or *Transneft* or other companies are looking for a better hold over bigger market shares, which ensures a more stable position and continuous well-being. It is clear for those companies that with diversification efforts to the east, the European direction (and Baltics as a part of this) would stay vital and most beneficial. Thus there are limits to applying pressure for better benefits and it is clearly not reasonable to damage relations with their main consumers, especially the ones that will remain main consumers in the long term future as well.

At the same time, the EU is elaborating a number of policies to counter this tendency of heavy reliance on Russia among EU countries. The Baltic states are still not part of the European electrical grid, but instead stay with the former

Soviet Union-built system. Thus, the EU tries to assist with the task of decreasing Baltic dependence on their eastern neighbor. The third liberalization package, which is seen as an adversarial and non-market instrument by companies like *Gazprom*, especially when the legal arrangement starts conflicting with its acting agreements with European countries, is the most vivid example. Regionally, the EU initiated the development of the Baltic Energy Market Interconnection Plan (BEMIP), which projects the construction of gas and electricity interconnections and infrastructure around the Baltic Sea. Among the first steps toward this goal is the construction of Estlink2, an electricity cable between Finland and Estonia, by 2013. All in all, the Baltic countries rightly regard the electricity sector as a vital component of economic development and thus aim to establish a common Baltic electricity market, although from the Russian point of view this might seem more politically motivated than economically reasonable.⁴⁶ It makes more sense in this regard to work toward a common EU-Russia – or Eurasian – electricity grid instead.

Probably the first Russian company name that would come to mind with regards to European energy sector is *Gazprom*, which remains an important partner for all the energy companies in the Baltic states. Having enormous power within Russia as well, and Russian government at its disposal, while holding stakes in strategically important gas distribution companies in the Baltic states, *Gazprom* also comes as a notorious figure and occasionally causes discontent with the local public and government. *Gazprom* and *Itera* together hold 50% of shares in *Latvijas Gaze* (34% and 16% accordingly), the rest of the shares are owned by E.ON Ruhrgas International GmbH (47.2%) and minority holders. *Latvijas Gaze* was included on a privatization list in 1994 and acquired its largest investors from 1997-2002.⁴⁷ *ITERA International Energy Corporation*, one of the investors, was established in 1992 in Florida (USA) as the offshore hand of *Gazprom*, and is a very important lobbying group to ensure *Gazprom* interests in the certain countries. It is interesting to know that during the process of privatization, the political inclinations of political figures were not taken into account, but instead precedence was given to support for privatization scheme or lack of thereof. Interestingly, anti-Russian sentiments were also widely used to ensure that the privatization process went in the proper direction. There are even a lot of talk regarding threat of a so-called “Gazpromization” of Latvian elites, with its head Adrians Davis, who had been in charge of the company since the Soviet Union,

44 Harold Elletson. *Baltic Independence and Russian Foreign Energy Policy*. Series ed. Kevin Rosner. GMB Publishing Ltd., 2006.

45 See *Gazprom* <http://gazpromquestions.ru/?id=34>.

46 Harold Elletson. *Baltic Independence and Russian Foreign Energy Policy*. Series ed. Kevin Rosner. GMB Publishing Ltd., 2006.

47 *Latvijas Gaze* facts and figures 2010. http://www.lg.lv/uploads/filedir/File/Investoru_attiecibas/Skaitli_un_fakti/2010_Facts_and_Figures_RUS.pdf.

and is seen as perfect example of the “Soviet legacy in the Latvian energy sector”.⁴⁸ Another proof of this “Gazpromization” is found by a number of well established Latvian experts, namely Andris Spruds, in the discussions surrounding a new gas storage station in Dobeles, which would become the biggest storage facility in Northern Europe.⁴⁹ More concerns exist with regards to the suggestion to build a new power station utilizing Russian gas, seeing it as further deepening of the country’s dependence on Russia. Currently there’s concern, but more about *Gazprom* than about inter-state relations, since *Gazprom* might soon have difficulties with the use of Incucalns – the Latvian Ministry of Economics is considering the question of restoring state control over this gas storage facility.

Lithuania, even though it has enjoyed the most balanced relations with Russia from the very start, still seems to be the most active in trying to ensure energy independence from Russia: earlier its government undertook a number of legal steps against *Gazprom*’s presence and its control over *Lietuvos Dujos* (37.1%). At the same time, Lithuania increased Russian gas exports over the first quarter of 2011 by 3% (while the growth of gas exports to Estonia was much lower, and Latvia’s gas purchase even went down by 7%).⁵⁰ Not only does *Gazprom* have a presence in Lithuania’s gas distribution company *Lietuvos Dujos*, but it also has stakes in the Kaunas CHP power plant.

The other problem that came up rather recently was a series of searches that were conducted at European companies with ties to *Gazprom* carried out by European Commission representatives, including the offices of the Baltic states-based companies *Latvijas Gaze*, *Lietuvos Dujos* and *Eesti Gaas*, due to the fact that they were suspected of collusive behavior. No results of the searches have been made public so far, but it was certainly regarded as an adversarial step by the Russian company (but not the Russian state). Thus, it is not only the problem of the Baltic countries’ perception of Russian companies as a threat that Russia has to deal with, it is also Brussels bureaucracy regarding companies as such and probably encouraging this view at the national level in its member countries.

Russia’s policy of diversifying transit routes presents a visible danger for the Baltic countries. With the first tranche of Nord Stream in operation since the fourth quarter of this year, and the second one due to be completed by the

end of 2012, the Baltic states, as well as Poland, have even fewer levers over Russian energy flow and might end up with another set of transit revenues losses. However, in the near future Russia, and *Gazprom*, will still rely on Lithuania for supplying Kaliningrad region with electricity.

The oil sector in Latvia and Lithuania is also very much influenced by Russia, or rather Russian business. *LatRosTrans* is a joint Latvian-Russian enterprise established in 1994 that mostly transports oil and oil products to terminals in Ventspils. Around 66% of the enterprise belongs to *Ventspils Nafta*, while 34% belongs to *Transnefteproduct* (a 100% affiliate of *Transneft*).⁵¹ Overall, *Transnefteproduct* is involved in the pipeline transit, steam and hot water supply industries. Among the most successful cases is the *Lukoil-Baltija Group*, which has an enterprise in each of the Baltic countries: Latvia (*Lukoil Baltija R*), Lithuania (*Lukoil Baltija*), Estonia (*Lukoil Eesti*) and Finland (*Oy Teboil*). *Lukoil Baltija R* was established in June 1993 and now owns one oil delivery terminal and 44 petrol stations in the country, representing an important wholesale and retail oil trader in the region (a larger numbers of gasoline stations from *Lukoil Baltija* are found in Lithuania and Finland).

However, the case of *Mazeikiai Nafta*, the most prominent oil refinery complex in the region, is an example where Russian business didn’t win. In 1999 the then-Prime Minister Rolandas Paksas was forced to resign after less than half a year in power due to disagreements over the sale of *Mazeikiu Nafta*. That year, on political grounds, *Mazeikiai* was sold to the US company *Williams International*, as opposed to another bidder from Russia – *Lukoil*. Although some foreign experts tried to speculate on the case⁵², claiming that slow deliveries from *LUKOil* made *Mazeikiai* unprofitable and forced *Williams* to sell its stake, *LUKOil* never actually turned to the government for political support. In 2002, the oil refinery was sold to *Yukos* and became profitable once again, but then with the Khodorkovsky case the share went on sale again. During Paksas’s term as head of the Lithuanian state in 2003-2004, this case again led to his impeachment on grounds of suspicion over his ties with Russian organized crime. In 2006 there were two main contenders, and again Lithuanian government decided against Russia’s *Rosneft*, instead selling *Mazeikiai Nafta* to *PKN Orlen*, a Polish oil company. A couple months later, *Transneft* shut down oil deliveries via the Druzhba pipeline to *Mazeikiai* under the pretext of urgently needed repairs, but

48 Merle Maigre. Energy security concerns of the Baltic states. March 2010. http://www.icds.ee/fileadmin/failid/Merle_Maigre-Energy_Security_Concerns_of_the_Baltic_States.pdf

49 Andris Spruds. Sustainable Energy Sector Policy in the Context of Latvian Political and Economic Development: prospects and limitations. In *Latvian Energy Policy: Towards a Sustainable and Transparent Energy Sector*. Ed. Dr. Andris Spruds. Klavins & Slaidins, Soros Foundation – Latvia, 2010.

50 Alexei Grivach. The Baltics are still within the limits of planning diversification stage. <http://newsbalt.ru/detail/?ID=636>.

51 LatRosTrans official site. <http://www.latrostrans.lv/?language=rus>, Europages business information <http://www.europages.com.ru/LATROSTRANS-SIA/bcg-EUR-LVA006927-00101-25-xx/informatsiya-o-predpriyatii.html>.

52 See for example Steven Woehrel. Russian Energy Policy Towards Neighbouring countries. CRS Report for Congress, May 2009. <http://fpc.state.gov/documents/organization/125528.pdf>.

flows have never resumed since then.⁵³ *Orlen's* idea to sell the oil refinery wasn't inspired by Russian actions but rather concerned bilateral Polish–Lithuanian relations, which is not a point of discussion of this paper. In November 2011, *Orlen Lietuva* agreed on long term transportation schemes with *Klaipėdos nafta*⁵⁴, and thus the question of the Družba branch closure became irrelevant.

Another significant Russian presence is seen in *INTER RAO Lietuva*, which was called *Energijos realizacijos centras* before December 2009. The enterprise was founded in 2002; in 2005 18% of its shares were sold to *RAO Nordic Oy*, and in May 2008 that share went up to 51%. *INTER RAO Lietuva* is the biggest independent electricity producer in Lithuania, currently under the joint management of *Scaent Baltic* and Russia's *INTER RAO JES*. It's recently been very active in the area of renewable energy, including through its affiliate *IRL Wind*, which holds talks and signs agreements with *Veju spektras*, a company that is actively constructing wind mill farms in the Kreting and possibly Shiluts regions. Another direction is nuclear energy – in spring 2011 *INTER RAO Lietuva* signed an agreement with *INTER RAO JES* on receiving electricity supplies from the Baltijsk NPP, currently under construction in Kaliningrad region, which is provisionally to come into effect in 2017. This would allow for the transfer electricity not only to Lithuania, but to the other Baltic states as well.

Besides pragmatic state-to-state interests, there are presently lobbying components for the formation of the general Lithuanian policies. Thus, the biggest Lithuanian gas supplier, *Dujotekana UAB*, is believed to have serious influence on the Lithuanian elite. For example, the company participated financially in the parliamentary elections campaign of 2004.⁵⁵ Thus, it is clear that energy sector has a heavy Russian presence, which influences not only energy supply and distribution, but also social and political life in the Baltic countries. Also, often an added concern for the host countries is the fact that Russian energy companies are consolidated and have a significant state stake in them, which in theory might lead to greater vulnerability for the other side.

53 Wilileaks based on the documents from the US embassies in Moscow and Vilnius published information that in 2006 pipeline was closed down at the decision of current vice-premier Igor Sechin in attempt to prevent Orlen from buying Yukos stake in Mazeikiai. It is argued that there were also plans to try to force Russian oil companies to stop deliveries via Primorsk and Butinge ports, but was never realized after Lithuanian government threatened to close down railway to Kaliningrad region.

54 PKN Orlen stopped thinking of selling Mazeikiai oil refinery. *Telegraf.lv*. December 16, 2011. http://www.telegraf.lv/news/pkn-orlen-peredumal-prodavaty-mazheikyaiskii-npz?utm_source=feedburner&utm.

55 Merle Maigre. Energy security concerns of the Baltic states. March 2010. http://www.icds.ee/fileadmin/failid/Merle_Maigre-Energy_Security_Concerns_of_the_Baltic_States.pdf

4.2. The transport sector and transit have

The transport sector and transit have played, and continue to do so, a very important role in the economic development of all the three countries. It was mostly the transit of Russian export goods that provided stable revenue, a transport infrastructure load and transport sector employment in the 1990s. Due to objective (competition between Finnish and Russian ports) and subjective (politically motivated actions) reasons, the picture has changed somewhat over the last decade, but the transport sector still remains an important segment of overall economic development⁵⁶.

Politics have always been present, but didn't necessarily lead to real changes in economic interactions. It is enough to remember the Russian decision to reduce oil transit through Ventspils in response to Latvian authorities bashing a demonstration by Russian speaking retirees in Riga in March 1998. Nevertheless, of much greater importance was the economic aspect of the problem, since *Lukoil* was left out of the privatization scheme and was refused permission to develop its own ports. At that point, Russia didn't have ways to bypass this important transit point, and with less state consolidation the overall volume of oil surpassed figures of the previous year in the end.⁵⁷ The situation changed only after the Russian port of Primorsk was finished (and this would only become less transit oriented after finalizing the BPS-2 oil pipeline system to Ust-Luga), when most oil and cargo was rerouted there and thus Ventspils in 2003 lost most of its value for Russia; this was also seen as a way to use political mechanisms to punish Latvia for its upcoming entrance into the EU and NATO.

The main value of the Baltic countries is their significance as oil terminals for transit via ports of products brought in by *Transneft* pipelines. Until 2003, the Latvian port Ventspils was the largest port in the region and second largest terminal

56 Thus, transport sector accounts for about 8% of GDP in Latvia and Estonia, and 10% of GDP in Lithuania, which is twice as much as average transport sector role across the EU.

57 Although when talking about political leverage over business one has to be particularly cautious. Even notoriously famous OPEC with its quotas cannot in practice influence situation much, since oil trade involves long term contracts and companies making part of that exchange wouldn't want to experience losses for breaking the contract. Other instance that can be cited Tony Blairs' (then prime minister of the UK) claim that he'd tell British businessmen to withdraw from Russia when our two countries experienced the deep plunge in relations. Instead of real economic implication Mr. Blair more discredited himself, since British business continued active participation in the Russian economy. More real damage was done with the Russian internal legal situation that allowed for political pressing of BP or other such moves, that scare foreign investors for the fact of instability. Is this info relevant?

for Russian crude after Novorossiysk. In 2003, the Russian port Primorsk overtook oil transit from the Baltic Pipeline System (BPS) from Western Siberia and Timan-Pechora, and Ventspils had to at least partially compensate with oil rail delivery. One possibility that was hinted at was to cede to Russian businesses a controlling share in the port, an option which was not accepted by Latvian authorities and so instead 34% of shares in *Ventspils Nafta* were sold to the oil trader *Vitol Group* in 2006⁵⁸. Nevertheless, economic activities at the port remained robust and total cargo turnover in Ventspils remained relatively stable, with the only major reduction occurring earlier in 2002. It is currently experiencing an annual increase, with oil products occupying first place and coal coming in second.⁵⁹

Nevertheless, not only negative examples might be cited here, as this area is one of the key spheres of bilateral cooperation. Over 40 million tons of cargo from Russia goes through Latvian ports and consist of up to 70% of total volume, which has changed its structure considerably. In the early 2000s at least half of the cargo was taken by crude oil, about 20% by chemical fertilizers and about 10% by ferrous metals, while today coal takes up almost one third of transported cargo (which is ensured by the Ventspils Baltic Coal Terminal with the support of Russian capital). Nevertheless for Russia this dimension remains rather minor, with Far Eastern coal exports staying at the top of the list and China, India and Japan remaining the country's biggest consumers. Also, with Russian authorities claiming a greater necessity of building new infrastructure and reorienting towards Russian ports, the share of Baltic ports in Russian transit and their importance continue to decline. In 2010, out of the 105.4 million tons of exported coal, only 14.9 million tons (or about 14% of the total volume) were transported through Latvian ports (that is a 22.2% decrease as compared to the previous year).⁶⁰

Among the most interesting assets is also Riga freeport, with about 370 companies operating there. Out of the port enterprises, about 40% are owned by Latvia and the rest are held by foreign investors. One third of the port

58 Vitol group is the second biggest offshore trader (after Glencore), the primary business activities of which involve oil and LPG trading from the Middle East and Far East, Nigeria, the Caspian region and Russia's north-western region (Kaliningrad JSC "Baltic oil terminal company" and "Pechoraneftgas", oil refinery in North America, trade financing, metals trading in Europe (via Euromin) in particular.

59 Thus, in 2002 total cargo turnover in Ventspils amounted to 28.7 million tons, which was 24.4% less than the previous year and reduced only slightly in the following year, with gradual rise starting in 2004 and then again shrinking, but this time due to the effect of the economic crisis. For more details, as well as information on oil and coal turnover, see Port of Ventspils data: <http://www.portofventspils.lv/ru/statistika/>.

60 Order is given to him: to the West! Eastern ground isn't managing growth of coal transportation. Transport, 04/2011. <http://www.indpg.ru/transport/2011/04/41538.html>.

facilities are said to belong to Russian companies, partly registered through Switzerland, the Netherlands and other countries.⁶¹ More transport projects are being realized. Thus, the Russian agrochemical giant *Uralchem*, with D. Mazepin at its head, is planning to invest 72 million in the construction of a mineral fertilizers terminal in the Riga port. Similar interest for terminals for coal and metals in the Riga port has been expressed by the *Urals Mining and Smelting company* and *Severstal*. Talks resume regarding *Ventspils Nafta* and the *Latvian shipping company*. Russia's railways company is active not only in cooperation with the Riga electro-engineering plant, but there are also talks regarding the modernization of railways and the introduction of a rapid transit system by 2018. Progress has been reached during a bilateral intergovernmental meeting in the area of ferry service (between the national services of two countries, involving Liepaja port and ports in Germany) and highway connections between Moscow and Riga. Today, the situation is favorable for the Russian railway company and for plans to construct a rapid transit system from Moscow to Riga – due to the crisis, the Latvian government stated that does not have enough money to build Rail Baltica, while Russian investors, as in other areas, are able to bring money into the projects. Other previously EU-sponsored projects in transport were also cut down.⁶²

More transport-oriented business cooperation can be found in railways and the corresponding equipment. Riga's electric-engineering plant is part of the Russian EDS-Holding. The controlling 50.53% of shares in REEP, which previously also actively cooperated with Russian railways, was bought by EDS in 2007. With the purchase, cooperation intensified even further, with REEP producing electrical equipment for railway transport through the Demikhov and Torzhok coach manufacturing plants in Russia and the Lugansk diesel electric plant in Ukraine.⁶³

Transit is another area that is just as important for Lithuania as for its Latvian neighbor. Here, Russian plans for transport lane diversification – and as a result a lower involvement in Lithuanian transit activities – present a negative trend. It would not be the best option for Lithuanian railway company *Lietuvos geležinkeliai*, for which Kaliningrad-bound cargo takes up as much as one third of activities, if plans to build a high speed ferry lane from Saint-Petersburg to Kaliningrad are realized. As a result, the Lithuanian company could be deprived

61 Russians buy out Latvia. Delfi.lv. 06.08.2011 <http://biznes.delfi.lv/bnews/zhurnal-rossiyane-skupayut-latviyu.d?id=39973039>.

62 See Stratfor. Russia's Growing Economic Reach in Latvia. April 15, 2011 <http://www.stratfor.com/memberships/191772/analysis/20110414-russias-growing-economic-reach-latvia>

63 Russian ambassador visited Riga electro-engineering plant. 02/11/2007 <http://www.regnum.ru/news/909566.html>.

of an important part of its revenue, as was the case after the opening of the Ust-Luga-Baltiisk ferry lane.

As mentioned earlier, the most difficult partner for Russia in the Baltic area is Estonia. The big issue for Russia was the scandal surrounding the 2007 incident with the Soviet soldier monument in Tallinn. This was a case of opposition to a minorities issue, and this incident sparked popular discontent with Estonian policies on the widest possible scale in Russia. The barbaric act led to a humanitarian, political and economic response. According to research, after the case with the Soviet war memorial statue in May 2007, Russian railways halted the delivery of oil products and coal to Estonia. A transit joke circulated in Riga: "there is a monument to Estonian Prime Minister Andrus Ansip with the inscription: 'To the Liberator of the Estonian motherland from Russian transit – grateful Latvian transport workers'".⁶⁴ After the Soviet soldier case, certain Russian businesses also withdrew or limited their activities in Estonia, e.g. *Severstal*.

That is why questions surrounding Russian transit and the construction of bypassing routes have always been high on the agenda, and have been seen as politically motivated on the side of the big neighbor. Economically, with today's general decreasing tendency, the only growth is seen in increasing hydrocarbons exports from Russia.⁶⁵ On the one hand, there are a number of arguments between Tallinn and Moscow, including a scandal around mayor of Tallinn Edgar Savisaar. But on the other hand, *Eesti Raudtee*, an Estonian railway operator, recently signed a 130 million euro agreement with the Russian transport company *Rail Garant* on the construction of a container terminal in the Estonian port of Muuga that will start working in the first quarter of 2013.⁶⁶ Also, the general volume of cargo transit started growing again after the 2007 scandal (from 18.3 million tons in 2009 to 20.3 million tons in 2010), with around 80% being oil and oil products, as well as a large share of coal and fertilizers.⁶⁷

Transit activity and cooperation in the transport area goes beyond the cited examples, but what seems most important is the fact that this area accounts for a big share of the overall revenue of the Baltic countries and remains an important

vector for Russian transport companies, and that this is an area that is bound to further strengthen. It is true that after the break up of the Soviet Union there was comprehensive diversification of transit routes, building ports and terminals on Russian territory, which at the time reduced the volume of transit via the Baltic states⁶⁸. Nevertheless, this trend wasn't decisive in terms of eliminating the transport/transit area from the bilateral relations and the sector remains vital segment of Russian-Baltic activities. Today, the main factor that could play against increased turnover would be an economic conjuncture resulting from the continuing euro-zone crisis.

4.3. Beyond energy and transit

Even though particular importance is attributed to the energy and transport areas of cooperation, economic activity includes a number of other very important mutually beneficial segments. The banking sector is another area of the Latvian economy with the active participation of Russian capital. As mentioned earlier, Latvian banks were initially, and have remained, very popular with Russian businessmen, primarily for tax evasion and capital withdrawal from Russia. It is enough to look at the number of banks owned by Russian businesses to realize importance of that area to Russian businesses and their activities.⁶⁹

68 Russia, in this case, stuck with the understanding of economic security based on premises of the Western school of thought, where it is seen as means to counter external threats rather than to deal with internal deficiencies.

69 Russian depositors were active in Parex Bank until the problems it encountered in 2008, ABLB (previously Aizkraukles) Bank, Trasta Commercial Bank and Rietumu Bank. Similarly, there's interest in the ownership of local banks, including interest from Russian politicians. At the moment over 25% of banks in Latvia belong to Russian capital. In addition, there is Latvijas Krajbanka, where 94.2% belong to Lithuanian AB Bankas "Snoras", which is part of the international financial group "Conversbank", a controlling 67.28% share of which in turn belongs to the Russian businessman V. Antonov. It is also worth mentioning Latvijas Biznesa banka, LTB Bank, SMP-bank, the license for opening Rigensis bank obtained by Russian businessmen I. Tsyplov (who is in the top 500 list of Russian millionaires), and the purchase of GE Money Bank in Latvia by the "Otkrytiye" financial corporation (B. Mints, V. Belyayev, and state bank VTB, still to be approved by Latvian authorities). Other banks active in the Baltics are the previously mentioned Snoras bank, as well as Eesti Krediitipank (a Bank of Moscow affiliate, which in turn belongs to Russian state bank VTB). Latvijas Biznesa banka belongs to a Russian politician, the richest deputy of the upper chamber of the Russian parliament and №34 according to Forbes's rating of the top 100 richest businessmen in Russia in 2011, A. Molchanov. LTB Bank belongs to the Russian MDM-Bank, which became the sole owner of LTB after increasing its share from 63.31% to 100% in February 2006. SMP (Northern sea way) bank in turn belongs to the Russian entity bearing the same name, with the controlling package belonging to brothers A. and B. ►

64 Nikolai Mezhevich. Economic aspects of Russian-Baltic relations in 2007-2008. Baltijski Region Magazine. Baltic Federal University of Immanuel Kant Publishing House, 2009, pp.87-90.

65 L. Grigoriev, S. Agibalov. The Baltic states: searching for the way out of crisis. Institute of Energy and Finances. April, 2010. http://www.fief.ru/img/files/baltica_crisis_grigoriev_agibalov_2010.pdf.

66 Stratfor. Russia's Growing Economic Reach in Latvia. April 15, 2011 <http://www.stratfor.com/memberships/191772/analysis/20110414-russias-growing-economic-reach-latvia>.

67 Economic relations with Estonia. <http://www.rusemb.ee/relations/>.

Although here one cannot talk about the state's influence in business, there is still the overwhelming shadow of Russian oligarchs' presence in the Latvian economy, or rather an extreme undercover interconnection between political elites and big business, which isn't necessarily favorable for Russian national interests. Due to the non-transparent nature of business transactions, especially when they involve investments that originate offshore, it is hard to be sure whether pro-Kremlin interests are at stake or whether a better illustration is that of disgraced Russian oligarchs fleeing the country.

As demonstrated earlier, there certainly exists reciprocal interest for Latvian investors in the Russian market (although unfortunately the majority of Latvian investments come from the Russian-speaking businessmen): preference is given to industrial and transport enterprises, as well as to trade and real estate. There are several examples of these investments. *JSC Pata AV* established a big wood-processing complex in the Pskov region (it is worth mentioning that the Pskov region accounts for almost two thirds of total Latvian investment in Russia). Moscow City property department has a share in *ZIL bus production*, and last June there Riga also opened a town-hall mission in Moscow.⁷⁰ Most of the real estate in Jurmala is also owned by Russian and CIS representatives.

Other directions for Russian business activities include an acquisition of media – not through the purchase, but by crediting prospective media-projects, such as Radio 101, which was created with money provided by *Latvijas Krajbanka*. Similar crediting schemes have been suggested for the purchase of *Telegraf* newspaper. In Lithuania, *Snoras* created an affiliate *Snoro media investicijos*, which co-owns 34% of leading Lithuanian media group *Lietuvos rytas*.

As previously mentioned, with significant Russian business involvement in the Latvian economy, anti-Russian sentiment remains, and this is not only due to historical and political reasons. Hostile takeovers still remain a part of business dealings, including at the international level. Last year one can remember a scandal that came about following the attempt by Russian timber enterprise *Sveza* to acquire Latvia's largest plywood company *Latvijas finieris*, which failed last year; the state became a minority shareholder, with a purported second wave attempt at acquisition through a very convoluted offshore scheme that is very frequently practiced by Russian oligarchs.

Rotenber (№№ 92 and 170 of the richest Russian businessmen according to Forbes). Arkadii Rotenberg also has ties with current President V. Putin, since they both held leading posts in a Judo sports club at the end of the 1990s. Moreover, Latvijas Krajbanka and Snoras have gone bust in recent months.

70 A.Shvedov. Interview with the Russian ambassador, A.Veshniakov, to Latvia. *Telegraf*. 10.06.2011. <http://www.telegraf.lv/news/pyatnica-posol-rossii-razve-latvii-ne-nuzhny-investory>

The mode of participation of Russian capital in Latvian pharmaceutical company *Grindeks* was different. Instead of a direct presence of Russian capital in the pharmaceutical industry, over the years the mode changed into that of opening an affiliate company in Russia, with further talks of expanding the company into a number of Russian regions and even building a *Grindeks* plant in Russia.⁷¹ In this case, the Russian market provides great interest for the Baltic partners, as it continues to be extremely difficult for Baltic pharmaceutical companies to enter the European market, where local (especially French and German) enterprises rule. Another area of cooperation in the pharmaceutical industry is the creation of an innovative pharmaceuticals center in Olaine as the follow up to a declaration of partnership in the name of modernization, signed in Liepaja in June 2011.

Among the other important players, one could name *Lifosa*, a leading producer of fertilizers in Lithuania and the EU, a company which since 2002 has been controlled by the Russian company *Eurochem*⁷², which obtained 100% of shares last year. It is also worth mentioning metal-ware producer *Nemunas*, which in 2003 was bought by Russian steel group *Mechel*, which has a number of enterprises in various Russian regions and several companies in Romania and Bulgaria⁷³.

Thus, with the official figures leaving Russian investors in 6th place, there are suggestions that many of these investors hide behind offshore companies. When taking into account that Cyprus, Switzerland, Luxemburg and Malta all serve as transit countries for Russian capital, and that investments from Cyprus to Latvia started growing rapidly from 2006 onward, one can assume that altogether Russian capital may take up as much as 13% of total investments, making Russia the second largest foreign investor after Estonia.⁷⁴

These examples show that Russian-Baltic cooperation has strong potential for development, since it doesn't only rely on the highly contested and state consolidated areas of energy and transport. The problem that should be addressed in all areas of cooperation and business interaction, however, is the necessity to enforce a clear legal framework and transparency in business dealings, which would be highly beneficial for the national interests of both Russia and the Baltic countries, and would ensure beneficial interdependence and stable long-term cooperation.

71 Interview with Kirov Lipman. Kirov Lipman: We did the right thing not to have built the factory in Latvia. Delfi, April 18, 2011. http://www.gorod.lv/novosti/128364-kirov_lipman_myi_pravilno_postupili_ne_postroiv_zavod_v_latvii.

72 Lifosa official site. History. http://www.lifosa.com/index.php?page=Istorija_r.

73 Official Mechel site. http://www.mechel.ru/about/common_data/index.wbp.

74 Philip Hanson. Russia's Inward and Outward Foreign Direct Investment: Insights into the Economy. Eurasian Geography and Economics, 2011.

Conclusions

Based on the above arguments several conclusions and recommendations can be made with regards to developing more fruitful and mutually beneficial relations between Russia and each of the Baltic states, as well as between Russia and the EU as a whole.

Russia and all three Baltic states share a long common (though not easy) history of relations, which contributes to two mutually exclusive trends in bilateral interaction – namely, a) long standing objective economic, commercial and cultural ties, and b) political and ideological divergencies.

Today, it is often the case that so called memory and historic issues hamper normal cooperation between the countries in certain areas. However, according to some experts, political issues haven't blocked the development of economic relations between the countries. Anti-Russian sentiments have often been used on a popular level by local politicians that are closely connected to Russian business, including in achieving the necessary presence of Russian capital in the Baltic states. The problems resulting from lobbying most of the time lie within the core aspect of which business groups strive for the acquisition of this or that segment of the Baltic economy.

There exists a two-level asymmetry of power in relations between Russia and the Baltic states that leads to distrust and “dependence fears” regarding the intentions and future actions of both sides: the first level lies in traditional small state vs big state interests, and the second level represents Russia's fear of giving too much leverage to the EU and USA regarding its foreign policy and sovereignty, and the Baltic states are seen as either part of the bigger entity (EU) or as direct agents of influence (USA).

Out of all three countries, Estonia experiences the lowest level of interaction with its Russian neighbor, while Lithuania, and recently Latvia, have a very intense cooperation scheme with Russia.

After the break-up of the Soviet Union, Estonia, Latvia, and Lithuania tried to re-orient themselves both politically and economically to the West, although the default of 1998 proved that the countries are still very much linked to Russia. The most important areas of cooperation between the countries are still in the transport/transit and energy areas, where all three countries are highly dependent on Russia for revenue and sustainable economic development.

There have been a number of attempts by Russia to use economic leverage for political purposes (Ventspils port, sprats imports), but none of them had a short- or mid-term beneficial outcome for Moscow, instead exposing it to

international criticism and distrust. Besides, on both sides, business interests always prevailed. Nevertheless, even though immediate results were not visible, cases with boycotting Russian business interests have been more damaging to Baltic economies, or rather to the particular entities in question. Thus, even within conflicting cases, there should be a clear division of where state interest end, which in turn would allow for a better solution to such problems.

Common sense exists behind bilateral interactions of the Baltic countries with Russia, which includes not creating a counter-position with Russia as EU members, but rather employing in practice the concept of the “bridge”. The best case to focus on is work toward constructing a common EU-Russia (or, rather, Eurasian) electricity grid instead of dumping the Soviet-era electricity system in favor of a European-centered one.

The Baltic states are currently presented as a “London for poorer Russian millionaires”, which is in line with the MFA-leaked program on orienting to Baltic investments in times of lower interest among Western investors in the region. This presents both challenges and opportunities for the Baltic states. Opportunities largely exist with regards to the fact that a number of Russian investors are either closely connected to the government or make up part of power structure themselves, and thus their personal interest would safeguard efforts for stable economic development in the Baltic countries. The challenges are largely connected with the traditional corrupt business ethics of oligarchs, and as such present threat for both nations rather than just the Baltics.

Russia presents a very profitable prospective market for Baltic businesses (e.g. in the pharmaceutical industry) that are left out of the highly competitive and closed Western European market and thus have to turn to the east. At the same time, a number of sectors in the Baltic countries' economies have strategic importance (like transport and energy), which ensures a continued Russian presence and a minimum level of cooperation with the three countries, which is not likely to have a negative effect from the functioning of the Customs Union.

Common traditions and similar business ethics allow for the use of Baltic enterprises in the shadow economy – this is vividly seen in the banking business, which is often used for offshore operations, tax evasion and capital outflow. Nevertheless, these commonalities should be used more often for positive developments, including by raising cultural awareness between the populations, conducting cultural exchange programs and promoting corporate social responsibility among Russian and Baltic enterprises.

LUKASHENKONOMY: BELARUS'S PERILOUS 'THIRD WAY' BETWEEN RUSSIA AND THE WEST

Edijs Bošs

In 2011, after a period of relative obscurity, Belarus returned to the spotlight of international attention. The country saw some unrest in the aftermath of an unfair presidential election in December 2010, which kept veteran autocrat Alyaksandr Lukashenka in power and triggered a re-introduction of EU sanctions against Minsk. Belarus also spent the entirety of 2011 in the grip of a progressively devastating economic crisis. Its exact outcome was still indiscernible at the time of this writing. All of this renewed international interest in Belarus.⁷⁵ And curiosity about the country is quite understandable, for it is a case in point of an atypical political and economic regime in post-Communist Eastern Europe which might also be approaching a period of far-reaching transformation.

It is well known that, as far as political freedoms and liberties are concerned, the Belarusian climate is almost glacial. The country has been governed since 1994 by an autocratic leader, Alyaksandr Lukashenka. The president's retrograde political style invokes associations with the pre-perestroika, Brezhnevite Soviet Union. In all fairness, this image has not necessarily been a drawback for a leader like Lukashenka in a country like Belarus. To many among the older generation of ex-Soviet citizens – this, apparently, has traditionally been the main segment of the president's power base – the Brezhnev period with its relative affluence, predictability and tolerable levels of repression represents the golden era of the old Soviet Union. By Western standards, however, Belarus is easily one of the most repressive regimes in Eastern Europe. In the latest example, in December 2010 Belarusian authorities imprisoned dozens of opposition activists in the aftermath of what the OSCE monitoring mission described as a rigged

⁷⁵ For concise overviews of the 2011 Belarusian crisis by various observers and analysts, see Kamil Kłysiński, "On the Verge of Crisis? Mounting Economic Problems in Belarus", 6 April 2011, <<http://www.osw.waw.pl/en/print/publikacje/osw-commentary/2011-04-06/verge-crisis-mounting-economic-problems-belarus>>; Aleksei Moiseev, "U Belarussii dva puti- rasprodazha aktivov ili shokovaya terapiya", *Vedomosti*, 20 April 2011, <<http://www.vedomosti.ru/blogs/print/amoiseev/1512>>; Konstantin Sonin, "Pravila igry: Konec Lukashenko", 11 April 2011, <<http://www.vedomosti.ru/newspaper/print/2011/04/11/258230>>; "Belarus: Knowing What To Do, but without Proper Tested Commitment To Do", 11 April 2011 <<http://www.research.hsbc.com>>; for a recent policy paper by two liberal American thinktanks (*Center for European Policy Analysis* and *Freedom House*) see, "Democratic Change in Belarus: A Framework for Action", September 2011, <<http://www.freedomhouse.org/images/File/Democratic%20Change%20In%20Belarus-Final%20Report.pdf>>.

presidential election.⁷⁶ Some of the leading opponents of President Lukashenka were later given harsh prison sentences.⁷⁷ At the time of this writing in the summer of 2011, Belarusian authorities were engaged almost on a daily basis in a nasty campaign to stamp out all public displays of dissent.⁷⁸ The regime has also long been suspected of being behind a number of disappearances, most probably deaths, of opposition figures.⁷⁹

Against this backdrop of repression, Belarus's economic performance in the 20 years since the collapse of the Soviet Union may seem particularly puzzling. The Belarusian regime presides over a proto-Communist economic structure. Because of its political and economic illiberalism, Belarus has long been featured as a veritable outlaw in Western diplomacy. And yet economic indices show that Belarus achieved and sustained truly impressive levels of economic growth through the 2000s. To the country's credit, a large proportion of Belarus's GDP is created by its export-oriented industrial and agricultural capacities, and Belarus actively trades with member states of the European Union. Indeed, even a hard-headed team of IMF experts once felt compelled to note that Belarus's achievement of remarkable growth rates irrespective of its authoritarian regime and distaste for market reforms has "consistently surprised observers."⁸⁰

What are the overall traits of the Belarusian economic model? How, in economic terms, does Belarus relate to Russia and EU neighbors such as the Baltic states? The purpose of this article is to map out the patterns of Belarus's economic and foreign trade relations. It will also discuss political consequences stemming from *lukashenkonomy* (a frivolous shorthand for 'the Belarusian economic model' that I will use throughout this paper). Bearing all of that in mind, the article will conclude with observations of recent reversals in Baltic policies toward Belarus.

76 Belarus Still has Considerable Way to Go in Meeting OSCE Commitments, Despite Certain Improvements, Election Observers Say", 20 December 2010, <<http://www.osce.org/odihr/elections/74656>> ; also David Marples, "Belarus Elections End in Violence and Repressions", 5 January 2011, *Jamestown Foundation Eurasia Daily Monitor* 8:3.

77 See, for example, Michael Schwirtz, "Belarus Opposition Leader Gets a Five-Year Sentence", 14 May 2011, <<http://www.nytimes.com/2011/05/15/world/europe/15belarus.html>> .

78 Ellen Barry, "Belarus Cracks Down on Clapping Protesters", 3 July 2011, <<http://www.nytimes.com/2011/07/04/world/europe/04belarus.html>> ; Olga Berezintseva, "Belorusskia opozitsiya meniaet taktiku", 7 July 2011, <<http://www.kommersant.ru/doc/1674247>> .

79 "Tenth Anniversary of Belarus' 'Disappeared'", 16 September 2009, <http://www.rferl.org/content/Tenth_Anniversary_Of_Belarus_Disappeared/1824314.html> .

80 "Staff report for the 2011 Article IV Consultation and Proposal for Post-Program Monitoring", *IMF Country Report* No. 11/66, March 2011), p. 3.

1. Façade of the *Lukashenkonomy*

Notwithstanding its image in the West as the lamentable 'last European dictatorship,' Belarusian leaders have attempted to present their country as an island of stability in a region that has experienced huge volatility of political and economic development in the post-Cold War era. For a long time they were quite successful in fostering this image – within Belarus itself, at least. Lukashenka's political outlook might be that of a Brezhnevite, but in economic affairs he apparently prefers to see himself as a proud Eastern European Deng Xiaoping, the patriarch of the Chinese economic breakthrough. The comparison is surely far-fetched.⁸¹ However, Belarus did register a formidable average annual GDP increase of 8% in 2000-2008, which, on the face of it, should have validated Lukashenka's claim about the efficacy of the political and economic straitjacket he has modelled for Belarus.

"No matter what the skeptics and the opponents might have said," Lukashenka told the Belarusian people in April 2009, "our achievements result from our very own path of development, which is based on effective government management of the economy and the implementation of a strong social policy."⁸² The concept of Belarus's 'very own path' is evidently a source of considerable personal pride for Lukashenka. "Let us call a spade a spade, shall we?", the Belarusian President harangued before the People's Congress in the spring of 2010. "We are the only country in the civilized world that is not dancing to anyone else's tune and has not thrown itself at anyone else's feet."⁸³ Seemingly endless reiterations of such ideas form the ideological framework of contemporary Belarus. According to an analysis by American diplomats working in Minsk, the Lukashenka regime "preaches that the Belarusian nation is the only Eastern Slavic country that remains true to... traditional civilized values and ideals. Therefore... many peoples around the world look upon [it] as an example of consistent and independent politics... According to the ideology... Belarus should become a place where people are able to speak up and be free from neoliberal terror and persecution."⁸⁴

81 For an enlightening private discussion among foreign diplomats working in Minsk on the subject of Sino-Belarusian relations, see *Wikileaks* cable "07MINSK463", 1 June 2007, <<http://www.wikileaks.ch/cable/2007/06/07MINSK463.html>> .

82 "Poslaniye belorusskomu narodu i Nacionalnomu sobraniyu Respubliki Belarus", 23 April 2009, <<http://www.president.gov.by/press84268.html>> .

83 "Poslaniye Prezidenta Respubliki Belarus Alyaksandra Lukashenko belorusskomu narodu i Nacionalnomu sobraniyu", 21 April 2010, <<http://www.president.gov.by/press10256.html>> .

84 *Wikileaks* cable "05MINSK1022", 31 August 2005, <<http://www.wikileaks.ch/cable/2005/08/05MINSK1022.html>> .

While in recent years some economic restructuring has taken place in Belarus with regard to small- and medium-size enterprises and price liberalization,⁸⁵ until the crisis of 2011 Minsk persisted in operating an essentially unreformed “neo-command” economy.⁸⁶ This prompted the *Heritage Foundation* to rank Belarus in the lowly 155th spot in its 2011 global index of economic freedom.⁸⁷ EBRD data ascertains that the private sector share of the Belarusian GDP stood at only 30% in 2010, which was the second lowest score among all 29 countries of the former Communist camp in Eastern Europe and Central Asia.⁸⁸ By comparison, in the Baltic states and Poland the private sector accounts for 70-80% of GDP.⁸⁹ That figure, incidentally, is also the share of the private sector in the Chinese economy,⁹⁰ exposing limitations to the parallels which Lukashenka has attempted to draw between the Belarusian and Chinese economic models.

The average income of Belarusians remains relatively modest when measured in the euro or dollar equivalent. According to the latest available annual statistics – which combine data from both private and public sectors (2009), exclude the unsustainable wage increases on the eve of the presidential election of 2010 and include the effect of the devaluation of 2009 – the average monthly Belarusian wage at the official exchange rate was approximately \$350.⁹¹ As the authorities stimulated internal consumption ahead of the election of 2010, this figure grew to approximately \$500 and was then more than halved as a result of subsequent waves of devaluation of the Belarusian currency in 2011.⁹²

85 See *The World Bank's* “Doing Business 2011: Making a Difference for Entrepreneurs”, <<http://www.doingbusiness.org/~media/fpdkm/doing%20business/documents/annual-reports/english/db11-fullreport.pdf>>; also Aleksei Pikulik, *et al*, “Kak Belarusi popast v tricadku stran s naibolee blagorpijatnymi usloviami vedeniya biznesa”, 1 March 2010, <http://www.belinstitute.eu/images/doc-pdf/pp022010ru_db.pdf>.

86 Term borrowed from Belarusian opposition economist Yaroslav Romanchuk; see his “Respublika Belarus: genezis i perspektivy neoplanovoj ekonomiki”, 4 May 2007, <<http://3dway.org/node/6441>>.

87 “Ranking the World by Economic Freedom 2011”, <<http://www.heritage.org/index/Ranking>>.

88 *Transition Report 2010: Recovery and Reform*, <<http://www.ebrd.com/downloads/research/transition/tr10.pdf>>, p. 4.

89 *Ibid*.

90 According to the Chinese economist Fan Gang, already in 2005 the private-sector share in the Chinese economy was approximately 70% (“China is a private sector economy”, 22 August 2005, <http://www.businessweek.com/magazine/content/05_34/b3948478.htm>).

91 <http://belstat.gov.by/homep/ru/indicators/doclad/2011_1/14.pdf>, p. 4).

92 For a more detailed discussion of the exchange rate crisis in the spring of 2011 and its effects, see Olga Kuvshinova, “Krupnym planom: ‘Eto pohozhe na krah’”, 6 June 2011, <<http://www.vedomosti.ru/newspaper/print/2011/06/06/261573>>; also “Za sutki sredniaia zarplata v Belarusi snizilas na 135 dollarov”, 14 September 2011, <<http://telegraf.by/2011/09/za-sutki-srednyaya-zarplata-v-belarusi-snizilas-na-135-dollarov>>.

In the meantime, however, on top of impressive and stable GDP growth rates in the 2000s, the Belarusian economic model has yielded low levels of unemployment, even if it comes at the cost of subsidized inefficiencies of a large segment of the industrial sector and widespread under-employment.⁹³ His government’s retention and continued operation of industrial assets that were built in large numbers in Belarus during the Soviet period is something that Lukashenka especially boasts about.⁹⁴ The prevention of post-Soviet de-industrialization, as will be shown later, has produced significant political risks in Belarus’s relations with Russia, but the degree of stability this policy ensured until the crisis of 2011 appears thus far to have constituted the basis of the social contract between the Lukashenka regime and sizeable portions of the Belarusian population.⁹⁵

Even though no election campaign during Lukashenka’s presidency could be judged as free and fair by European standards and most media outlets remain government-controlled, many analysts concede that Lukashenka has enjoyed significant grass-roots support. Its level, however, might have decreased before the last presidential campaign in 2010 to a plurality instead of a majority and, in all likelihood, Lukashenka’s approval rating had by the end of 2011 dropped to all-time lows as a consequence of the economic crisis, hovering above 20%.⁹⁶

Moreover, there is a wide social safety net in Belarus; ‘socially significant’ products and services such as staple foods, fuel and utilities have traditionally been available at subsidized prices, and the government has effected a significant level of income redistribution. A credible Western source summed up this communitarian aspect of the Belarusian political economy by observing that “the benefits from the recent growth appear to be fairly broadly shared by the population, as the poverty rate declined from 47% in 1999 to 6% in 2008, and inequality remained moderate.”⁹⁷ At the time of this writing, however, the crisis-

93 As a local publicist aptly puts it, the main operating principle of most Belarusian factories is “simply keeping the people busy even if they just wipe the factory’s yard” (Viktor Martinovich, “Izhdiveyania: Vsia strana v takam sostoyanii”, 27 September 2010, <<http://belgazeta.by/20100927.38/010020141/>>).

94 See, for example, Lukashenka interview with Valeriy Tretiakov, “A. Lukashenko: My s luboviu k vam odnosimsiya”, 21 October 2010, <<http://www.kurier.lt/?r=11&a=5368>>.

95 For a discussion of Belarusian electoral trends (with reference to the previous election in 2006), see Vitali Silitski, “Signs of Hope Rather than a Color Revolution”, in *Prospects for Democracy in Belarus*, ed. by Joerg Forbrig, David R. Marples and Pavol Demeš (Washington: The German Marshall Fund of the United States, 2006), pp. 20-26; Ethan S. Burger and Viktor Minchuk, “Alyaksandr Lukashenka’s Consolidation of Power”, *ibid.*, pp. 29-36; Oleg Manaev, “Recent Trends in Belarusian Public Opinion”, *ibid.*, pp. 37-46.

96 *Polling Memo* 3, 14 October 2011, <<http://www.belinstitute.eu/images/doc-pdf/pm032011ru.pdf>>.

97 “Republic of Belarus: Selected Issues”, *IMF Country Report* No. 10/16, January 2010, p. 13; also Kiryl Haiduk, “Redistribution Policies in Belarus: Economic Growth, ▶

stricken Belarusian government was conducting a significant belt-tightening in the area of social expenditure. There were signs that as the economy began to sputter the Lukashenka regime was bound to lose these characteristics of an “inclusive authoritarianism”.⁹⁸

Having said that, the UNDP's Human Development Index still ranked Belarus highest among all the CIS countries, overtaking Russia⁹⁹. In comparison with its Baltic neighbors, Belarus experienced a relatively mild recession as a consequence of the global financial crisis in 2008-2009 and, at least ostensibly, a more immediate recovery.¹⁰⁰ In fact, before the Belarusian second-wave crisis of 2011 some GDP per capita (PPP) projections showed that Belarus was quickly catching up with its Baltic neighbours and was supposed to overtake Latvia as early as 2012.¹⁰¹

Having said that, a closer look at the Belarusian economic model, even before the crisis of 2011, should have revealed a number of serious challenges which render Belarus's long-term prospects much less promising. This could be expressed in dry macroeconomic vernacular, as IMF analysts do when they ring alarm bells about the unsustainability of Belarus's current account deficit and the slow pace of structural reform.¹⁰² It should be obvious, however, that the gravest risks emanating from the structure of the Belarusian economy are straightforwardly political and could, in the final analysis, affect Belarus's very existence as a sovereign state. The fact is that, to a large extent, Belarus's commendable economic performance under the Lukashenka regime in the 2000s was the result of Belarus's artful functioning as an offshore economic hub for the Russian Federation.¹⁰³ Accordingly, Belarus remains dangerously dependent on

the kindness of the government in Moscow. The Kremlin's stock of goodwill for Lukashenka, however, has lately been showing signs of depletion.

2. Belarus as Russia's offshore economic hub

To be sure, the argument about Belarus's economic model's dependence on Russian generosity is hotly contested in official rhetoric emanating from Minsk. However questionable, one of Lukashenka's counter-arguments is that Belarus is subsidizing “every Russian” by saturating the Russian market with relatively cheap agricultural and industrial products made in Belarus.¹⁰⁴ It is quite unmistakable, however, that Moscow has heavily subsidized Minsk since the mid-1990s up until very recently – mainly through the provision of an ‘energy grant’ worth billions of dollars in cheap oil and gas supplies.¹⁰⁵ Apparently motivated by geopolitical and ideological considerations,¹⁰⁶ Moscow had also energized the Belarusian economy by allowing its industrial and agricultural produce on the Russian market on privileged terms, while at the same time the Russian government had disregarded Minsk's total lack of reciprocity in this free trade arrangement.¹⁰⁷

Due to the high level of complexity of Russo-Belarusian interaction, it is quite impossible to precisely assess how much the Belarusian economic model depends on this privileged relationship with Russia. Estimates differ. American diplomats in their internal correspondence calculated that in 2005 the Russian

Labour Market and the Political Business Cycle”, in *Growth for All? Economy of Belarus: Challenges Ahead*, ed. by Alexander Chubrik, Kiryl Haiduk and Igor Pelipas (Minsk: IPM Research Center, 2007), pp. 74-101.

98 Aleksei Pikulik, “Predstavliaet li ekonomicheskii krizis ugrozu rezhimu Lukashenko?”, 27 October 2011, <http://www.naviny.by/rubrics/opinion/2011/10/27/ic_articles_410_175616/print/>.

99 UNDP *Human Development Index 2010*, <<http://hdr.undp.org/en/statistics/>>.

100 Whereas Estonia, Latvia and Lithuania experienced staggering double digit GDP contractions in consequence of the global financial crisis of 2008-2009, Belarus technically never entered recession with a marginally positive GDP growth in 2009 (0.2%, according to Belarus government data), <<http://www.belstat.gov.by/homep/ru/indicators/gross.php>>.

101 *World Economic Outlook* database, <<http://www.imf.org/external/pubs/ft/weo/2010/02/weodata/index.aspx>>.

102 See, “Statement by the IMF Mission to the Republic of Belarus”, 2 February 2011, <<http://www.imf.org/external/np/sec/pr/2011/pr1127.htm>>; “Statement by the IMF Mission to the Republic of Belarus”, 16 November 2010, <<http://www.imf.org/external/np/sec/pr/2010/pr10439.htm>>; “Republic of Belarus: Fourth Review Under the Stand-By Arrangement”, *IMF Country Report* No. 10/89, April 2010.

103 “Staff report for the 2011 Article IV Consultation and Proposal for Post-Program

Monitoring”, *IMF Country Report* No. 11/66, March 2011), p. 3; Valeriya Kostyugova, “Rossiysko-belorusskiye otnosheniya: usloviya, sostoianie, perspektivy”, <<http://www.belinstitute.eu/images/doc-pdf/research-kostiugova.pdf>>, Art. 4.3-5.2; Valeriy Karbalevich, “Chemodan bez ruchki”, 1 July 2010, <<http://www.nv-online.info/by/86/20/16788/>>; Vladimir Sherov, “Lights and Shades of Russia-Belarus Economic Relations” [pp. 111-131] in *External Economic Relations of Belarus*, ed. by Kari Liuhto (Turku: Turku School of Economics, 2007), pp. 129-131.

104 “Lukashenko prizval Rossiju izbavitsa ot ‘sindroma Lukashenko’”, 18 March 2011, <<http://telegraf.by/2011/03/lukashenko-prizval-rossiju-izbavit-sja-ot-sindroma-lukashenko.html>>; also “4 iulia Alyaksandr Lukashenko vstretilsia s Gossekretarem Sayznogo gosudarstva Pavlom Borodinom”, 4 July 2011, <<http://www.president.gov.by/press123140.html>>.

105 For another detailed discussion of the Russo-Belarusian economic interrelationship, see Leonid Zlotnikov, “The Belarusian ‘Economic Miracle’ - Illusions and Reality”, in *Back from the Cold? The EU and Belarus in 2009*, ed. by Sabine Fischer, *Chaillot Paper* 119 (Paris: ISS, November 2009), pp. 65-78.

106 Chloë Bruce, “Fraternal Friction or Fraternal Fiction? The Gas Factor in Russian-Belarusian Relations”, March 2005, <<http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG8-FraternalFrictionOrFraternalFictionTheGasFactorInRussianBelarusianRelations-ChloeBruce-2005.pdf>>, p. 6.

107 See, in particular, Yaroslav Romanchuk, “Respublika Belarus: genezis i perspektivy neoplanovoj ekonomiki”, 4 May 2007, <<http://3dway.org/node/6441>>.

energy subsidy to Belarus was worth approximately \$2.5 billion, which added up to a tenth of the Belarusian GDP.¹⁰⁸ IMF data for 2007 and 2008 put the value of Russia's subsidy to Belarus via cheap oil and gas deliveries at \$5.9 billion and \$8.2 billion respectively, which made up some 13% of Belarus's gross domestic product.¹⁰⁹ Other sources cite the subsidy figure at \$52 billion for the 15-year period since 1995, making up a whopping 17% of the Belarusian GDP.¹¹⁰

The alarming degree of Belarus's dependence on a preferential politico-economic arrangement with Russia is reflected in Minsk's own official statistics, which should otherwise be taken with grain of salt. Data for 2009 and 2010 shows that Russia accounted for almost 50% of Belarus's foreign trade in goods, and in 2010 Belarus ran a huge negative balance in foreign trade of almost \$10 billion¹¹¹ – most of which is accounted for by increasingly expensive imports of Russian oil and gas. In 2010 Russia also returned to its place as the most important destination for Belarusian exports, with a share of 39%.¹¹² The most recent data for 2010 also reveals a relatively significant contraction of the EU's share of Belarusian exports (from 43% in 2009 down to 31% in 2010),¹¹³ which is a reflection of Belarus's diminishing capacity to function as Russia's proxy in energy exports. True, a year earlier, in 2009, the EU's share (43%) of Belarus' exports was greater than Russia's (31%)¹¹⁴ but even then the devil was in the details. Put bluntly, most Belarusian exports to countries other than Russia are based on raw materials which Belarus itself used to source at discounted rates – with the important exception of potassium salt, which is mined locally – from Russia. Most indigenous Belarusian industrial and agricultural produce, on the other hand, is headed East and sold within the Russia-dominated Customs Union, of which Belarus is a founding member.¹¹⁵ In Lukashenka's own words, "[Belarus] used to

be the assembly department of [Soviet industries], and we are still functioning as Russia's assembly department".¹¹⁶ The competitiveness of Belarusian produce on the Russian market is highly reliant on relatively low production costs, which used to result, again, from cheap supplies of Russian energy and petro-dollar funded cross-subsidization within Belarus. From 2004 through 2009, 50-60% of Belarus's exports to non-CIS countries were composed of petroleum products¹¹⁷ churned out in huge volumes by Belarusian oil refineries, which had imported crude at a discounted rate from Russia and then exported petroleum at world market prices to Western Europe. By using this simple but effective mechanism, Belarus became the 'Eastern European Bahrain' by the mid-2000s. As a team of Russian experts noted in 2007, Belarus "is the only country in Europe which – despite the fact that it lacks any significant hydrocarbon energy deposits – runs a positive balance in its foreign trade in energy products. Increase in global energy prices has created a veritable boom in Belarus and boosted the growth of the GDP as if it was a country rich with oil and gas."¹¹⁸

During the peak years in the mid-2000s, Belarus imported more than 20 million tons of cheap Russian crude, only a third of which was consumed locally.¹¹⁹ Profits derived from this lucrative functioning as a Russian 'oil offshore hub' accounted for approximately 40% of the Belarusian budget revenues.¹²⁰

This is surely not to say that, apart from oil refineries running on discounted Russian crude, Minsk has no other assets whatsoever to keep its finances afloat. The most valuable crown jewel is the *Belaruskalii*.¹²¹ Thus far owned by the government, as almost all major Belarusian companies are, *Belaruskalii* mines

108 Wikileaks cable "06MINSK364", 31 March 2006, <<http://www.wikileaks.ch/cable/2006/03/06MINSK364.html>> . The analysis therein also nicely explains the difficulties of determining the exact price of energy subsidies.

109 "Republic of Belarus: Selected Issues", IMF Country Report No. 10/16, January 2010, fn. 6; the subsidy figure for 2008 is corroborated by Leonid Zlotnikov; see his "Zhestkaia posadka", 17 November 2008, *Belorussi i Rynok*, <<http://www.br.minsk.by/index.php?article=34018&year=2008>> .

110 Ales Alachnovič, "Recent Evolutions in the Belarusian Economic System", 19 March 2010, <<http://www.case.com.pl/dyn/plik--29062166.pdf>> , p. 5.

111 *Republic of Belarus: Statistical Yearbook 2011* (Minsk: National Statistical Committee of the Republic of Belarus, 2011), p. 599.

112 *Ibid.*

113 *Ibid.*

114 *Foreign Trade of the Republic of Belarus: Statistical Book 2010*, (Minsk: National Statistical Committee of the Republic of Belarus, 2010), section 1.4; cf. "Belarus: EU Bilateral Trade and Trade with the World", 17 March 2011, <http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113351.pdf> .

115 For a discussion of economic effects of Belarus' participation in the newly re-vitalised Customs Union (Russia, Kazakhstan, Belarus), see Irina Tochitskaia, "Tamozhenniy

soyuz Belarusi, Kazahstana i Rossiya: ekonomicheskoye posledstvie dlia Belarusi", July 2010, <<http://www.research.by/pdf/pp2010r02.pdf>> .

116 Lukashenko quoted in "4 iulia Alyksandr Lukashenko vstretilsia s Gossekretarem Sayuznogo gosudarstva Pavlom Borodinom", 4 July 2011, <<http://www.president.gov.by/press123140.html>> .

117 *Foreign Trade of the Republic of Belarus: Statistical Book 2010*, (Minsk: National Statistical Committee of the Republic of Belarus, 2010), sections 2.4, 2.5, 2.6, 3.6.; see also European Commission's DG Trade brief on Belarus, <<http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/belarus/>> .

118 Leonid Grigoriev and Sergei Agibalov, "Belorussia: Neftianoi 'tigr' v Evrope", 11 January 2007, <<http://vedomosti.ru/newspaper/print/2007/01/11/118680>> .

119 Leonid Zlotnikov, "The Foreign Exchange Crisis in Belarus: Causes and Effects", Central Europe Digest, 1 August 2011, http://www.cepa.org/file_manager/pdfstorage/streamfile.aspx?name=Zlotnikov%2c+The+Foreign+Exchange+Crisis+in+Belarus.pdf> , p. 1.

120 *Ibid.*; also interview with Petr Martsev, "Belarusskiiy krizis udarit po Latvii kontrabandoi", 16 May 2011, <<http://www.telegraf.lv/news/belarusskii-krizis-udarit-po-latvii-kontrabandoi>> .

121 In the Belarusian government's public estimate, *Belaruskalii* is worth USD 30 billion (see Tatiana Manenok, "30 mlrd USD – na stol!", June 2011, <<http://www.belmarket.by/ru/129/60/10182/30-млрд-USD---на-стол!.htm>> .

potassium salt, which is an important component in the global production of agricultural fertilizers. According to the company's own estimations, *Belaruskalii* mines a sixth of all potassium salt produced in the world.¹²² The company's conglomerate with Russia's *Uralkalii* is a major global player, controlling about 30% of the global market share in potassium salt.¹²³ Revenues that the Belarusian government derives from potassium salt exports are considerable. In Lukashenka's own words, "in the best years, it contributed up to \$3.5 billion to our budget".¹²⁴ Profits derived from exports of this raw material are highly dependent, however, on global market conditions and revenues have only recently started to recover after collapse in the aftermath of the global financial crisis of 2008-2009.

Beyond cash cows such as *Belaruskalii* and retiring cash cows such as the *Mozyr* and *Naftan* oil refineries, there are a number of other significant economic assets in the Belarusian government's possession – these include its automotive industry flagships *BelAZ*, *MAZ* and *MTZ* and the strategically important gas pipeline operator *Beltransgaz*.¹²⁵ As a rule of thumb, however, the profitability and continued functioning of these assets is deemed to be highly dependent on the accessibility of the Russian market, protective tariff barriers against producers from third countries and an uninterrupted supply of raw materials at discounted prices.¹²⁶ Furthermore, in the case of *Beltransgaz*, in 2011 the company was already 50% owned by Russia's *Gazprom* and the sale of the rest of the stock seemed all but inevitable as the crisis-stricken Belarusian government was forced to negotiate terms of financial assistance with the Kremlin.¹²⁷

Arms sales – often shady – are another significant source of revenue for the Belarusian government. According to official data, Belarus is close to the list of

the world's top ten arms exporters, with an annual turnover of up to \$1 billion.¹²⁸ It is estimated that the figure might in fact be twice as large, if turnover from illicit arms transfers to the world's hotspots are added. It is likely that, in this business, too, the Belarusian regime has gotten used to the lucrative role of a proxy to Russian suppliers.¹²⁹

3. Lukashenconomy stranded

Throughout the 2000s Belarus was thus a co-beneficiary of the windfall of Russian petro-dollars. The energy grant – in conjunction, of course, with the ubiquitous availability of cheap credit in the period before the global financial crisis – made the Belarusian 'third way' economy bloom. Minsk's special relationship with Moscow permitted the Lukashenka regime to continue to operate Soviet-era industrial assets, and even made many of these relatively competitive. It also permitted the Lukashenka regime to ensure that the economy performed reasonably well without having to undergo a painful period of reform and restructuring fraught with considerable political risks for the regime itself.¹³⁰ "[I]n the absence of economic collapse, the desire to hold on to power and assets [limits] the potential for necessary [reforms]," Western diplomats working in Minsk privately commented in the spring of 2009 as Belarus sought emergency funding from the International Monetary Fund. "[Belarus's economic] policy continues to be run by those national leaders more interested in political prestige than economic pragmatism."¹³¹

The Belarusian experience seems to show, however, that excessive risk avoidance in regard to economic restructuring can itself be a risky business. As should be fairly evident from the preceding analysis, Belarus's well-being in the 2000s was perilously dependent on Moscow not tinkering with the umbilical cord that connects the Belarusian economy to Russia. As Lukashenka himself admits,

122 See <<http://www.kali.by/russian/firm.html>> ; for an overview of global trade in potassium salt, see <http://www.potashcorp.com/annual_reports/2009/md_and_a/potash/overview/> .

123 See <<http://www.belpc.by/about/>> .

124 "17 iunია Alyaksandr Lukashenko otvetil na voprosy zhurnalistov", 17 June 2011, <<http://www.president.gov.by/press121398.html>> .

125 For an overview of the status of Belarus' most valuable industrial assets, see Tatiana Manenok, "Famillnoe serebro pervoi sherengi", May 2011, <<http://www.belmarket.by/ru/127/60/9993/Фамильное-серебро-первой-шеренги.htm>> .

126 Yaroslav Romanchuk, "Promyshlennyye ozhidaniya", 16 August 2010, <<http://liberty-belarus.info/Промышленность/Промышленные-ожидания.html>> ; also Alyaksandr Alesin, "U rulia po-prezhnemu Moskva", March 2011, <<http://www.belmarket.by/ru/118/170/9230/У-руля-по-прежнему-Москва.htm>> .

127 "Belarus Agreed to Russian Credit Terms, Kudrin", 18 May 2011, <<http://telegraf.by/2011/05/belarus-agreed-to-russian-credit-terms-kudrin.html>> ; also "Gazprom Wants to Acquire 100% Stake in Beltransgaz", 20 May 2011, <<http://telegraf.by/2011/05/belarus-agreed-to-russian-credit-terms-kudrin.html>> .

128 "H.R. 4436", 111th Congress, 2nd Session, 13 January 2010, <<http://www.gpo.gov/fdsys/pkg/BILLS-111hr4436ih/pdf/BILLS-111hr4436ih.pdf>> , p. 2.

129 Walter Kegö, Alexandru Molcean and Greg Nizhnikau, "Belarus Arms Trade", 14 March 2011, <http://www.isdp.eu/images/stories/isdp-main-pdf/2011_kego-molcean-nizhnikau_belarus-arms-trade.pdf> ; also Jerome Taylor, "EU Passes Belarus Sanctions", 20 June 2011, <<http://www.independent.co.uk/news/world/europe/eu-passes--belarus-sanctions-2300217.html>> .

130 For a more elaborate discussion, see Margarita M. Balmaceda, "At a Crossroads: the Belarusian-Russian Energy-Political Model in Crisis", in *Back from the Cold? The EU and Belarus in 2009*, ed. by Sabine Fischer, *Chaillot Paper* 119 (Paris: ISS, November 2009), pp. 79-91.

131 Wikileaks cable "09MINSK87", 17 March 2009, <<http://www.wikileaks.ch/cable/2009/03/09MINSK87.html>> .

“mother Russia” is “irreplaceable”.¹³² As is so often the case in international affairs, however, dependence on a single patron is a vulnerability which can all too easily be exploited by the patron. Over the last five years, Lukashenka has been cornered by antagonistic leaders in the Kremlin whom he finds increasingly difficult to outmanoeuvre in the way he had become accustomed to. Consequently, the Belarusian ability to underwrite its economic performance through premium revenues from Russian subsidies has steadily degenerated.

This ability had been built on two main factors, the first being the Russian government's willingness to exchange economic favors for a political and military alliance with Belarus and the prospect of a political re-integration of the country. The second factor was Belarus's leverage as a major transit route for Russian energy exports to Europe. The *Druzhba* pipeline, which crosses Belarus, transports up to 40% of Russian oil exports.¹³³ Regarding transiting Russian natural gas deliveries to Europe, Belarus is clearly a lesser player than its southern neighbor, Ukraine. The latter's transportation network carries up to 80% of Russia's deliveries to Europe. *Gazprom's* *Yamal-Europe* pipeline, which crosses Belarus and Belarus's own section of the *Northern Lights* pipeline, however, are also important conduits for Russian gas, accounting for some 15% of *Gazprom's* exports.¹³⁴

Both of these pillars of Lukashenka's influence with the Kremlin have progressively withered. Arguably, this is one of the major structural reasons behind the Belarusian crisis of 2011. Since 2006 the Kremlin has moved assertively to rid itself of loss-making commitments to neighboring countries that are not delivering the political gains foreseen at the time of their inception. Also, Belarus's influence as a transit route for Russian energy exports is past its peak due to increased Russian ownership of the Belarusian gas pipeline network and the prospect of alternative transit routes, such as the Nord Stream underwater pipeline in the Baltic Sea, becoming operational.

The price that Belarus pays for its own supplies of Russian natural gas has significantly increased since 2007, even though it still is significantly lower

than the price *Gazprom's* other European clients pay for their gas imports.¹³⁵ Nevertheless, the contraction of the Russian gas subsidy has been tremendously painful. At the time of this writing, Belarus and Russia were in the process of negotiating a new contract for gas supplies which should be in force starting from 2012, when the two countries (plus Kazakhstan) are expected to upgrade their Customs Union to a more integrated Common Economic Space. It can be discerned from Minsk's negotiating position that it is deemed to be imperative to the Belarusian economy that it is supplied with Russian natural gas at prices “equalling those charged within Russia to local consumers”.¹³⁶ Essentially, Minsk insists on restoring the generous energy grant arrangement that was operational in its relations with Russia before 2007. It is highly doubtful, however, that in today's circumstances the Kremlin would subscribe to such a scheme without subjecting Belarus to painful inroads into its political and economic sovereignty.

Supplies of cheap Russian crude for processing in Belarusian oil refineries and the opportunities for a highly profitable export of petroleum products have also dried out, with Russia imposing a full export levy in 2010. By the end of that year, Minsk succeeded in achieving an oil supply deal on relatively milder terms in exchange for Belarus' accession to Russia's Common Economic Space initiative.¹³⁷ The deal, however, is nothing like the money-spinning arrangement that Minsk enjoyed in earlier days. Its oil refineries now appear to be making significant losses¹³⁸ and have no choice but to significantly increase petroleum prices for domestic consumption.

In the estimation of an eminent Belarusian economist, the Russian energy subsidy dropped from \$7.7 billion (20% of the Belarusian GDP) in 2006 to \$3.5

132 “Poslaniye belorusskomu narodu i Nacionalnomu sobraniyu Respubliki Belarus”, 23 April 2009, <<http://www.president.gov.by/press84268.html>> .

133 Alexander M. Zaborovskiy, “Belarusian Energy Strategy Today: Improving Energy Efficiency, Reducing Energy Independence and Insuring Gas Transit to the EU”, 2011, <<http://www.iaee.org/documents/2011WinterEnergyForum.pdf>> , p. 31.

134 For a more detailed discussion of the Russo-Belarusian interaction in the sphere of supply, consumption and transit of natural gas, see, Chloë Bruce, “Fraternal Friction or Fraternal Fiction? The Gas Factor in Russian-Belarusian Relations”, March 2005, <<http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG8-FraternalFrictionOrFraternalfictionTheGasFactorInRussianBelarusianRelations-ChloeBruce-2005.pdf>> .

135 Katya Yafimova and Jonathan Stern, “The 2007 Russia-Belarus Gas Agreement”, January 2007, <<http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/01/Jan2007-The2007Russia-BelarusGasAgreement-KatjaYafimovaandJonathanStern-.pdf>> ; and Katya Yafimova, “The June 2010 Russian-Belarusian Gas Transit Dispute: A Surprise that was to be Expected”, July 2010, <<http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG43-TheJune2010RussianBelarusianGasTransitDisputeASurpriseThatWasToBeExpected-KatjaYafimova-2010.pdf>> .

136 “Belarus trebuet rossiskie ceny na gaz v obmen na Beltransgaz”, 7 June 2011, <<http://telegraf.by/2011/06/belarus--trebuet-vnutrirossijskie-ceni-na-gaz-v-obmen-na-beltransgaz.html>> ; “Oficialnii predstavitel OAO Gazprom Sergei Kuprianov (rasshifrovka vstrechy s zhurnalistami)”, 21 June 2010, <<http://www.gazprom.ru/press/russia-belarus/>> ; also *Monitoring infrastruktury Belarusi 2011*, <<http://www.research.by/pdf/pp2010r02.pdf>> , p. 30.

137 See “Update 2- Russia and Belarus agree on oil, avoid row”, <<http://www.reuters.com/article/2010/12/09/russia-belarus-idUSLDE6B81I220101209>> .

138 “Belarusskiye NPZ – samye ubytochnie predpriatia po itogam janvaria-marta”, 11 July 2011, <<http://telegraf.by/2011/07/belorusskie-npz-samie-ubitochnie-predpriatiya-po-itogam-yanvaria-marta>> .

billion (6.5% of GDP) in 2010 and was expected to fall significantly lower than that in 2011.¹³⁹ Moreover, even after cutting back on support the Russian leadership nowadays never miss an opportunity to publicly embarrass Lukashenka by underscoring the amount by which it still supports Belarus.¹⁴⁰ All of this has undermined the credibility of Lukashenka's 'third way economic miracle' and strained Belarusian finances in recent years by sending trade deficits through the roof.¹⁴¹ In conjunction with a politically motivated domestic spending spree on the eve of the presidential election of 2010, this resulted in a severe financial crisis in 2011. At the time of this writing the *lukashenconomy* was in a tailspin.

4. The Baltic vector of the *Lukashenconomy*

Thus we have established that Russia plays a definitive role in the Belarusian economic model and we have also sketched out the EU's overall position as an important destination for certain kinds of Belarusian exports. To approach more closely the discussion on Belarus's economic and political interaction with the Baltic states, we should, however, also inquire about Belarus's more specific role in its regional setting.

Overall, Belarus and the Baltics have a notable economic relationship, albeit they are clearly less than essential economic partners. In Estonian, Latvian and Lithuanian foreign trade statistics, Belarus features as the second most important partner among CIS countries, trailing Russia but overtaking Ukraine.¹⁴² The Balts' share in Belarus's foreign trade, on the other hand, is a less straightforward subject. According to official Belarusian statistics, the Baltic states taken

together were the destination for a relatively significant share – more than 6% – of Belarusian exports in 2010.¹⁴³ The real figure of trade turnover, however, is probably significantly lower due to the fact that Belarusian statisticians do not distinguish between items that are traded bilaterally and those that are destined for transit. Thus, statistically speaking, during the boom years Latvia figured as Belarus's fourth largest trading partner and second biggest importer of petroleum products, even though more than 90% of these were actually transited and exported onwards from Latvian ports, mainly Ventspils.¹⁴⁴ It also has to be noted that referencing the Baltic states as a group is slightly misleading in the Belarusian context due to straightforward geographical factors. Most importantly, Belarus does not share a border with Estonia, which inevitably makes interaction between the two countries considerably less pronounced.

With intra-EU and intra-Baltic trade dominating their economies, Belarus is not among the leading Estonian, Latvian or Lithuanian export destinations despite the fact that it is a neighboring country with a population of approximately 10 million and a comparable level of GDP per capita.¹⁴⁵ There are a number of reasons for this, and the unfavorable political context associated with Lukashenka's regime might not even be the most important one. Belarus has long attempted to pursue a policy of 'replacement of imports' behind a relatively high barrier of domestic protectionism. In many important respects the 'replacement' policy has had no chance of success – particularly regarding import articles such as crude oil and natural gas from Russia and industrial technologies from the West, which are necessary for the functioning of the Belarusian economy but simply cannot be produced domestically. The Baltic states, however, manufacture few of these irreplaceable goods and therefore their penetration of the Belarusian market is inevitably weak.

This is not say, however, that there is no mutual interest whatsoever in foreign trade between Baltic states and Belarus. Among the Balts, the Lithuanians – whose capital, Vilnius, is just 150 km away from Minsk – have been the most active. According to Lithuanian statistics, the foreign trade turnover in goods between Lithuania and Belarus exceeded 1 billion euros at the peak of the pre-crisis economic boom in 2008, then fell by almost 30% in 2009 but recovered

139 Zlotnikov, "The Foreign Exchange Crisis...", p. 2.

140 See, in particular, transcripts of Russian Prime Minister Vladimir Putin's press conferences with Belarusian premiers Sergei Sidorski and Mikhail Myasnikhovich on 29 May 2009, <<http://premier.gov.ru/events/pressconferences/4252/>> ; 15 October 2010, <<http://premier.gov.ru/events/pressconferences/12581/>> ; 20 January 2011, <<http://premier.gov.ru/events/pressconferences/13916/>> .

141 According to Belarus' own statistics, the country's trade deficit reached almost 10 billion USD in 2010 ("II.6. Vnesnnya Torgovliya", <http://belstat.gov.by/homep/ru/indicators/doclad/2011_3/8.pdf>).

142 Lithuanian-Belarusian trade volume in goods exceeded that of Lithuania-Ukraine by 34% in 2010 (EUR 1,12 billion and 740 million, respectively), see <<http://www.stat.gov.lt/lt/pages/view/?id=2795>> ; Estonian-Belarusian trade volume in goods exceed that of Estonia-Ukraine by 12% in 2010 (EUR 181 million and 160 million, respectively), see <http://pub.stat.ee/px-web.2001/Database/Majandus/25VALISK_AUBANDUS/25VALISKAUBANDUS.asp> ; Latvian-Belarusian trade volume in goods exceeded that of Latvia-Ukraine by 63% in 2009 (EUR 363 million and 135 million, respectively), <<http://www.csb.gov.lv/statistikas-temas/areja-tirdznieciba-datubaze-30104.html>> .

143 Latvia 3.69%, Lithuania 1.79%, Estonia 0.59% (*Republic of Belarus: Statistical Yearbook 2011* (Minsk: National Statistical Committee of the Republic of Belarus, 2011), ch. 1).

144 Nikolai Tolstik, "Ne kuplei-prodazhei jedinai", 19 March 2010, <http://neg.by/publication/2010_03_19_12840.html> .

145 CIA *World Factbook's* GDP per capita estimate in 2010 for Belarus is \$13'400 (Latvia - \$14'300, Lithuania - \$15'900, Estonia - \$19'000).

splendidly in 2010 and returned to levels exceeding 1 billion euros.¹⁴⁶ Latvian-Belarusian bilateral trade turnover in goods and services reached 653 million euros in 2010 with a marginally positive balance for Latvia.¹⁴⁷

In addition to bilateral trade, another keyword in Belarusian-Baltic economic interaction is 'transit'. Belarus's own role as a corridor for Russian oil and gas exports to Europe has already been discussed. Landlocked between Russia, Ukraine and three EU member states, Minsk, however, is also dependent on its neighbors for access to markets other than Russia. Hence, Belarus is a major consumer of Ukrainian, Lithuanian and Latvian transit infrastructure. It has to be observed, however, that in regard to its own exports Belarus's dependency on transit is balanced among various partners (within the EU countries such as Estonia, Latvia, Lithuania and Poland; and outside the EU countries such as Ukraine) whose seaports, pipelines and railway networks compete fiercely with each other.

Belarusian import and export shipments account for approximately one fourth of the total turnover in Lithuania's main port, Kaipėda.¹⁴⁸ Goods transited from the Belarusian border to Latvian ports account for approximately 20% of all cargoes transported on Latvian railways.¹⁴⁹ Most of these Belarusian cargoes have traditionally been petroleum products and potassium salts destined for further shipment onward from Baltic and Black Sea ports, although in 2010, as Minsk sought to supply its oil refineries with non-Russian crude, there were also significant shipments of crude oil to Belarus.¹⁵⁰

Apart from potential disruptions arising from the EU-Belarus stand-off over human rights, there are a few additional factors which could significantly affect Baltic-Belarusian economic interaction in the years to come. First, there is the question of Belarus's possible membership in the World Trade Organization, which could theoretically facilitate the penetration of the Belarusian market by Baltic companies. On hearing the news in late 2011 that its main trading partner and associate in the Customs Union, Russia, is on the brink of finally acceding to

the WTO, Minsk too announced its desire to join the free trade club and restarted the long-dormant negotiation process.¹⁵¹ It was difficult to predict the outcome of this initiative at the time of this writing. In all likelihood, however, none of this will result in a sudden opening up of Belarusian trade. Trade liberalization and the removal of protectionist barriers is quite incompatible with the overall spirit of the *lukashenkonomy* and Belarus's progress toward WTO membership should be slow. Belarusian elites do not even seem to be particularly enthused about opening up, starting from 2012, the Belarusian market to its partners in the Customs Union-cum-Single Economic Space, let alone the rest of the world. In the words of Viktor Margelov, a prominent Belarusian private sector business lobbyist: "essentially, within the Single Economic Space, the clumsy, socialist Belarusian economy will be merged with the capitalist market economies of Russia and Kazakhstan... which will result in an increase of Russian influence on the Belarusian economy... only the more energetic players will survive".¹⁵² Liberalization poses a threat to the *status quo* of the Lukashenko regime in Belarus. The Belarusian economy and its foreign trade relations will therefore be liberalized as little as possible as long as the power structure in Minsk remains unchanged.

Another factor which, in all probability, will affect Baltic-Belarusian – particularly Lithuanian-Belarusian – interaction over the course of the following years is the Astrava nuclear power plant project. Pending the resolution of questions related to Russian financing of the project, Belarus is expected to begin construction in 2012.¹⁵³ Astrava, however, is located right on the Lithuanian border, only 50 kilometres from Vilnius. The likelihood of the emergence of a Belarusian nuclear power plant is also seen as potentially undermining the feasibility of Lithuania's own nuclear power plant project at Visaginas.¹⁵⁴ It will therefore remain the source of considerable bilateral friction for the foreseeable future.

146 "Užsienio prekyba", Department of Statistics of Lithuania, <<http://www.stat.gov.lt/lt/pages/view/?id=1122>> .

147 Latvia's Ministry of Economics data <<http://www.em.gov.lv/images/modules/items/BY2010.pdf>> .

148 Gediminas Pilaitis, "Uostas nestos ties tuo, kas pasiekta", 31 December 2010, <<http://www.lrytas.lt/-12937743701291907141-uostas-nestos-ties-tuo-kas-pasiekta.htm>> .

149 24.9% in 2009 and 18.2% in 2010 (LDz data).

150 Dz data; it is doubtful, however, that these supplies of Venezuelan crude through Baltic ports are going to be continued. The deal now in the works seems to be the swapping of Venezuelan supplies for Azerbaijani oil – an arrangement which can only be carried out through Ukraine's Black sea ports, see "Odessa-Brody Pipeline Works for Lukashenka", 15 July 2011, <<http://www.belsat.eu/en/wiadomosci/a,3914,odessabrody-pipeline-works-for-lukashenka.html>> ; also Tatiana Manenok, "Azeri lait' doshla do Mozyria", July 2011, <<http://belmarket.by/ru/134/60/10570>>

151 Ivan Mikhalevich, "Vspominili pro VTO", 21 October 2011, <http://neg.by/publication/2011_10_21_15266.html> .

152 Quoted in Andrei Kozhemiakin, "Belorusskiy biznes ne vyderzit konkurencii s rossiyskim pri otkrytykh granitsah", <http://naviny.by/rubrics/economic/2011/11/03/ic_articles_113_175700/> .

153 "Generalniy kontrakt na stroitelstvo AES Belarus rasschitivyat podpisat' v nachale 2012 goda", 19 October 2011, <http://naviny.by/rubrics/economic/2011/10/19/ic_news_113_378834/> .

154 "Lietuva Baltarusijos sprendimą dėl Astravo atominės jėgainės skundžia Jungtinėms Tautoms", 12 October 2011, <<http://www.lrytas.lt/print.asp?k=news&id=13184212441317687243>>

5. The Russian mouse-trap and Minsk's abortive opening to the West

One cannot but conclude that Lukashenka's regime in Belarus is a paradoxical creature. Ever since the crumbling of his purported ambition to become a leading power-broker in Moscow by succeeding Russian president Boris Yeltsin, Lukashenka has proclaimed Belarus's sovereignty as its greatest value. He now seems serious about it – and yet the perilous political and economic model he has developed might ultimately lead to the decline of Belarus's statehood. How so?

There should be little doubt that, unlike Boris Yeltsin, the current Russian leadership despises Lukashenka. Already for a considerable while, Russian leaders have been resolutely insisting on cashing in political and economic dividends from their long investment in the Belarusian economy. The objectives of Moscow's contemporary Belarus policy seem to be two-fold. First, the Kremlin appears to be seeking progress towards the re-integration, in one form or another, of Belarus into Russia. The obvious legal path for this would be the revitalisation and rapid execution of the Russo-Belarusian 'Union State' project, which has been stalling for many years now due chiefly to Lukashenka's intransigence. The project, in its most current form, was devised in 1999 during Yeltsin's last days in office, and presupposed a quick advancement toward the creation of a single Russo-Belarusian state. According to the 'Union State's' founding documents, Belarus and Russia should have had a single Constitution and a common currency by now.¹⁵⁵ Lukashenka, however, lost his appetite for unification soon after the frail Boris Yeltsin was replaced in the Kremlin by the incomparably much more assertive Vladimir Putin. If Lukashenka had previously thought that unification initiatives allowed him to play the cat in the cat-and-mouse game with Yeltsin, then the roles were reversed under Putin.

In a public address in August 2002, Putin provided a foretaste of what would happen if the Kremlin could execute its own preferred scenario in its relations with Belarus. Putin's statement on that occasion was made in the presence of Lukashenka and it was evidently designed to persuade the Belarusian leader to scale down his negotiating position on Russian economic favors to Minsk. Nonetheless, it is helpful to quote Putin at length to give the sense that, in Moscow's policy, respect for Belarus's statehood is not necessarily a given. "What is the way forward [with regard to the project of the Union State]? There are different options. One of them is particularly straightforward and concrete. It is the creation of a unified

¹⁵⁵ Founding Treaty of the Union State, 8 December 1999 ("Dogovor o sozdanii Soyuznogo Gosudarstva", <http://www.soyuzinfo.ru/ru/juridical_library/statutory_acts/index.php?id4=16&usage4=2>).

state in the exact sense of the word. I imagine there could be a definite time frame for this to happen. Let's say [less than a year from now] we will conduct a popular vote on unification. [18 months] from now we could organize the parliamentary election [of the unified state] and then [a few months later] there would be a presidential election... Regions of Belarus would be equal in their rights to Russia's regions... [This will have to be done] on the basis of the Constitution of the Russian Federation... Not because we do not like the Belarusian Constitution... But because Belarus differs from Russia in that it is unitary state while Russia is a federation. Russia and the future unified state [of Russia and Belarus] can only exist as a federation. I can not imagine that this could be otherwise."¹⁵⁶

It should be added that, according to opinion polls conducted in the summer of 2011, more than 30% of Belarusians favored unification with Russia¹⁵⁷ despite years of anti-Kremlin rhetoric by the government-controlled Belarusian media. In other words, Moscow appears to have the interest, the instruments and the potential to effect fundamental political change in Belarus should such an opportunity present itself.

Beyond the straightforward 'political unification' track in Russia's Belarus policy there is also the more subtle approach directed at the achievement of a *de facto* hegemonic position in Belarusian affairs through the takeover by Russian businesses of the Belarusian 'family silverware', i.e., the most attractive assets such as the oil refineries, the *Belaruskalii* potassium salt mines and the *Beltransgaz* gas distribution and transit network.

The threat of unchecked Russian political and economic influence is something that Lukashenka has certainly been aware of since the departure of Yeltsin and something that he profoundly resents. In 2005 he revoked the *agrément* previously extended to an influential Russian politician, Dmitriy Ayatskov, to serve as Moscow's ambassador in Minsk following Ayatskov's statement recommending that Lukashenka stop imagining that Russia and Belarus were two separate countries.¹⁵⁸ Moreover, as Russo-Belarusian relations

¹⁵⁶ "Otvety na voprosy zhurnalistov po okonchaniy rossisko-belorusskikh peregovorov", 14 August 2002, <<http://archive.kremlin.ru/text/appears/2002/08/29261.shtml>> ; for a record of more recent reflections by Vladimir Putin on the subject of Belarus' unification with Russia, see "Predsedatel Pravitelstva Rossiskoi Federatsii V. V. Putin poobshchalsia s uchastnikami moldezhnogo obrazovatel'nogo foruma 'Seliger-2011'", 1 August 2011, <<http://premier.gov.ru/events/news/16080/>> ; also Anton Hodesevitch, "Minsk ne hotchet, chtoby Moskva promyvala emu mozgi", 4 August 2011, <http://www.ng.ru/cis/2011-08-04/6_minsk.html> .

¹⁵⁷ As reported by RFE/RL: see Ales Dashchinsky and Richard Solash, "Belarus Opposition Leaders Hail U.S. Senator's Tough Stance on Lukashenka", 3 August 2011, <<http://www.rferl.org/articleprintview/24286075.html>> .

¹⁵⁸ Sergey Stokan, "Dmitriya Ayatskova minoval Minsk", 30 August 2005, <<http://www.kommersant.ru/doc/604646>> .

deteriorated in consequence of energy price reforms, Lukashenka occasionally chose to describe the Russian menace publicly. “It is the first time I’m allowing myself to say this out loud,” Lukashenka noted in mid-2007 in the heat of an argument with the Kremlin. “Not only does Russia desire to privatize certain properties, or even snatch them on the cheap; they would wish to privatize the entire country!”¹⁵⁹

Recent public pronouncements also underscore Lukashenka’s understanding of the dangers inherent in his Russo-centric economic model. As Russian authorities demanded that Minsk undertake large-scale privatization in exchange for financial assistance at the time of the 2011 crisis, he ranted: “Many people are saying ‘we need economic reform and restructuring’... I agree. [But] who will give me a trillion dollars in order that I could change the structure of the economy? And how many years would that take? This structure is said to be ‘faulty’. Sure, when it was created [many years ago], it was not created for our country [rather, it was created for Belarus as part of the Soviet Union]. [If] we could nowadays change it, the right thing to do would be to develop it around raw materials and resources that we possess locally.”¹⁶⁰

In other words, Lukashenka owns up to the structural predicament of Belarus’s economic model. However, he also seems to be reconciled to the fact that Belarus cannot possibly wean itself off ‘Mother Russia.’ In the spring of 2009 a senior aide to Lukashenka, Uladzimir Makei, somberly admitted in a private conversation with an American diplomat: “We don’t see a way out.”¹⁶¹

Back in the 1990s Lukashenka himself initiated projects such as the Russo-Belarusian ‘Union State.’ They permitted him to institutionalize the transfer of Russian economic subsidies and might have been designed to serve his once high-flying political ambitions. But the contemporary Alyaksandr Lukashenka has, of course, no desire to be left on his own against a hostile Kremlin. Declarations of a “multi-vector” Belarusian foreign policy and the doctrine of “equal proximity toward the East and the West” have been Lukashenka’s attempts at addressing this problem.¹⁶²

Lukashenka’s problem, though, is that his room for maneuvering is extremely limited. The obvious instrument for counterbalancing Russian political

and economic influence would be to cultivate closer relations with the European Union. Opportunities at a *rapprochement* with the West, however, have constantly been undermined by the unpalatable nature of the Brezhnevite regime in Minsk.

There was, from late 2008 through to late 2010, a period of considerable warming in Minsk’s relations with the EU as both parties seemed to appreciate the perils of unchecked Russian influence on Belarus. In order to facilitate a normalization of his relations with the EU, Lukashenka tried to behave and released ‘political’ prisoners. In response, EU member states and Brussels approached a consensus on the desirability of opening to Belarus. The EU’s Belarus policy was tentatively transformed from a coercive model aimed at “regime change” to an engaging approach aimed at “incremental regime evolution” in Minsk.¹⁶³ In 2009, under the guidance of Sweden and Poland, the EU elaborated on the *Eastern Partnership* initiative aimed at encouraging reform and democratization in the six Eastern European and Southern Caucasus countries placed between the EU and Russia. Belarus was among the six.¹⁶⁴ The *rapprochement* in Minsk’s relations with the EU ground to halt, however, after the crackdown on opposition activists in the aftermath of the presidential election of December 2011.¹⁶⁵

Lukashenka has also attempted to increase his leeway between Russia and the EU by developing alignments with third parties such as China, Venezuela and Iran. Geopolitical determinants, however, cannot be overcome by sheer will alone. Belarus’s economic and political position remains defined chiefly by the European Union, whose member states it borders on the west, and much more so by Russia, whom it borders on the east.

Therefore, in all likelihood, Belarus will ultimately have to pay a heavy political price for its skewed economic model and the nature of its political regime, which forbids a compensatory opening to the West. The fact is, Lukashenka can hardly expect to preserve a sovereign Belarus and, simultaneously, to retain an economic structure whose functioning is dependent Russian subsidies. If genuine progress on the path to re-integration is not forthcoming, Russia should be expected to

163 Sabine Fischer, “Executive Summary”, in *Back from the Cold? The EU and Belarus in 2009*, ed. by Sabine Fischer, *Chaillot Paper* 119 (Paris: ISS, November 2009), pp. 12-14.

164 The other five being Ukraine, Moldova, Georgia, Armenia and Azerbaijan. For an analysis of the *Eastern Partnership* initiative, see Katarzyna Pelczyńska-Nałęcz, “Integration or Imitation? EU Policy Towards its Eastern Neighbours”, *OSW Studies* 36, April 2011.

165 See joint article by EU foreign ministers who had advocated the *rapprochement* initiative in 2008-2010: Carl Bildt, Karel Schwarzenberg, Radek Sikorski and Guido Westerwelle, “Lukashenko the Loser”, 23 December 2010, <<http://www.nytimes.com/2010/12/24/opinion/24iht-edbildt24.html>>; also “European Parliament Resolution of 20 January 2011 on the Situation in Belarus”, <<http://www.europarl.europa.eu>>.

159 Lukashenka quoted in Irina Khalip, “Gazprom perehodit vse granitsy”, 5 August 2007, <<http://www.novayagazeta.ru/data/2007/59/05.html>> .

160 Lukashenka press conference, “17 iunia Alyaksandr Lukashenko otvetil na voprosy zhurnalistov”, 17 June 2011, <<http://www.president.gov.by/press121398.html>> .

161 Wikileaks cable “09VILNIUS155”, 24 March 2009, <<http://wikileaks.ch/cable/2009/03/09VILNIUS155.html>> .

162 See, in particular, the foreign affairs sections of Lukashenka’s annual policy speeches on 23 April 2009, 21 April 2010 and 21 April 2011, <<http://www.president.gov.by>> .

continue phasing out its financial benevolence toward Belarus. Meanwhile, the Kremlin will probably not shut the door completely, as destabilization in Belarus might lead to unpredictable internal developments or inadvertently push the country too far toward the West. To put it crudely, over the next few years Moscow will probably not make Belarus starve, but it will keep Minsk on a harsh diet in order to domesticate the Belarusian autocrat. It remains to be seen whether these tactics will result in a mellowing of Lukashenka's opposition toward Russia's claim to a *droit de regard* in Belarusian affairs. In the event of this failing to happen, Moscow could also consider scenarios of side-lining Lukashenka from power.

6. A reconsideration in Baltic Belarusian policies?

What influence does all of this – the nature of Lukashenka's authoritarian regime, an economy skewed toward Russia and, simultaneously, the existence of substantial regional links with its European neighbors – have on Baltic policies toward Minsk?

Over the years, the Balts' political and diplomatic interaction with Belarus has been very limited and the relationship has at times bordered on hostility. To a large extent this state of affairs has arguably been a consequence of objective discrepancies between the Baltic states' and Belarus's trajectories of development in the 20 years since the implosion of the Soviet Union. During the 1990s and 2000s, Estonia, Latvia and Lithuania became liberal free-market democracies and, in contrast to Belarus, severed economic structural links that attached them to Russia, even if it came at the price of painful de-industrialization. In 2004, they became full members of the EU and NATO.

As Lukashenka's methods of domestic governance became increasingly unsavory and he appeared bent on pursuing various initiatives aimed at Belarus's integration with Russia, in the decade from mid-1990s to mid-2000s Belarusian relations with its Baltic neighbors were particularly cool and Lukashenka's regime was commonly perceived as case in point of how badly things could go wrong in every respect in a post-Soviet country – not only in terms of economic reform, but also in terms of internal democratization and overall foreign policy orientation.¹⁶⁶

¹⁶⁶ For scholarly papers reflecting this broadly normative approach, see Audrius Žulys, "Towards a Union State of Russia and Belarus", *Lithuanian Foreign Policy Review* 15/16 (2005), pp. 148-69; Marks Jermaks, "Latvijas dialogs ar Baltkrieviju: vērtības vai intereses? Divpusējo attiecību pieredze (1998-2004) un perspektīvas Latvijas ekonomisko un politisko interešu kontekstā", in *Latvijas ārpolitika un "robežu plašināšana"*, ed. by Žaneta Ozoliņa (Rīga: Zinātne, 2006), pp. 177-202.

The estrangement reached its peak in the mid-2000s – an occurrence at least partially brought about by the intensity of Baltic-American relations during George W. Bush's presidency. The Bush administration championed the notion of Lukashenka as 'the last European dictator'. "At a time when freedom is advancing around the world, Alyaksandr Lukashenka and his government are turning Belarus into a regime of repression in the heart of Europe," Bush noted in 2004.¹⁶⁷ At the time, Baltic policy-makers chose – at least rhetorically – to copycat Washington's approach, which, in the absence of any significant American security and economic interests vis-à-vis Belarus, seemed to boil down to one issue and one issue only – democratization. To quote from a cable sent from the U.S. embassy in Minsk in mid-2008 and recently published by *Wikileaks*, "wise leadership in the [State] Department and at [the Embassy]... has recognized that our relations with Belarus must be defined by just one parameter: Belarus's progress (or regress) in human rights and democracy."¹⁶⁸ Lukashenka's status as an international pariah was underscored by the European Union's imposition of a visa ban and an asset freeze against Belarusian leadership in 2004 and 2006.¹⁶⁹

Back then, the Balts – in line with the rest of 'the West' – seemed to base their Belarus policy on the vision of a democratic, post-Lukashenka regime in Belarus. One of the sponsors of the U.S.'s 'Belarus Democracy Act', Senator John McCain, had been on a visit to Rīga in the summer of 2004 when he spoke openly about helping to bring about a 'regime change' in Minsk. Typical of Latvian rhetoric at the time, in a news conference alongside McCain, Latvia's Minister of Foreign Affairs announced that Latvia "will do everything that is possible to support the struggle against Lukashenka."¹⁷⁰

Over the following years, Baltic capitals hosted countless seminars with the participation of Belarusian opposition groups. Occasionally, some Baltic leaders went even further than that in their denunciations of Minsk. In this vein, then Lithuanian President Valdas Adamkus once publicly implied that

¹⁶⁷ "Belarus Democracy Act Will Help Cause of Freedom, Bush Says", 21 October 2004, <<http://www.america.gov>> [last accessed 8 March 2011]. For an overview of American policy toward Belarus, see Robin Shepherd, "The United States and Europe's Last Dictatorship", in *Prospects for Democracy in Belarus*, 2nd edition, ed. by Joerg Forbrig, David R. Marples and Pavol Demeš (Washington: The German Marshall Fund of the United States, 2006), pp. 71-78.

¹⁶⁸ *Wikileaks* cable "08VILNIUS341", 9 May 2008, <<http://www.wikileaks.ch/cable/2008/05/08VILNIUS341.html>>.

¹⁶⁹ "EU-Belarus Relations: Political and Legal Foundations", <http://ec.europa.eu/world/where/belarus/index_en.htm>.

¹⁷⁰ Quoted in "S Alyaksandrom Lukashenko zagovorili po-amerikanski", <<http://www.kommersant.ru/doc.aspx?DocsID=499637>>.

the unpredictability of the regime in Belarus might pose a military threat. “You wake up in the morning and you can never know what is going on there,” Adamkus said in 2005 in an interview with a German newspaper.¹⁷¹ Thus, in the first half of the 2000s Lukashenka’s Belarus seems to have been viewed in the Baltic capitals as a hopeless Russian satellite in foreign policy terms and as an example of a repulsively illiberal domestic regime which they helped to isolate internationally.

This surely was not an environment conducive to developing normal political and economic links with Minsk. It appears to this author, however, that – at least in Latvia and Lithuania (and perhaps to a lesser extent in Estonia, due to significantly less intensive contact with Belarus) – a major modification of their Belarus policy has taken place over the last few years. This coincided with the half-hearted *rapprochement* in Minsk-EU relations in the aftermath of the Russian-Georgian war in 2008 and the establishment of the EU’s *Eastern Partnership* initiative. But Riga’s and Vilnius’ reconsideration seems now to have gained a profound dynamic of its own which, arguably, results from their increased willingness to conduct a more carefully weighed and pragmatic policy instead of focusing on broadly-defined ideological objectives such as democracy promotion.

Put simply, the contemporary Lithuanian and Latvian policy on Belarus seems to be based on three pragmatic premises. The first of these stems from geopolitical considerations and asserts that the Balts have a vital interest in the continuation of Belarusian statehood. The argument is that the existence of a Belarusian state is not at all self-evident.

As Minsk-Moscow relations have progressively soured over the last five years, Vilnius and Riga have appreciated that they have a major stake in Belarus’s continuation as at least a relatively autonomous political entity apart from Russia. Meanwhile, they understand the growing precariousness of the Belarusian position vis-à-vis Russia as Lukashenka’s economic model now seems to be falling to pieces. “We already have an extensive border with Russia,” a number of influential Baltic diplomats have explained to this author. “We do not want to see the border become even longer with Belarus’s re-integration, in one form or another, into Russia.”¹⁷² In general, contemporary Latvian and Lithuanian policy-makers do not advocate Lukashenka’s increased isolation from the West, which they think will only strengthen Russia’s hand in that country. As she defended Lithuania’s adamant opposition to initiatives within the EU aimed at potentially introducing economic sanctions against Belarus, Lithuanian President Dalia

Grybauskaitė noted that the European Union should make up its mind “about whether it needs an independent Belarus or not.”¹⁷³

The Balts – the Latvians and Lithuanians in particular – are expected to try and develop a common approach toward Belarus with their European and American allies. Yet they will not be surprised to find that many Western partners’ perspectives on Belarus differ from policies that the Balts’ own economic and political interests seem to dictate. Neither should the general public in the Baltics be astonished by the fact that their policy-makers’ perspectives on Belarus diverge from approaches advocated by Swedish, Polish or American governments. It is only natural for allies to have different perspectives toward third countries with which one or another of the allies has a particular historical, linguistic or regional connection.

In the view of this author, the introduction of the geopolitical dimension in the Balts’ thinking about Belarus is entirely warranted and, in fact, long overdue.¹⁷⁴ As regards the post-Soviet space, the Baltic states have a tremendous stake in the preservation of the *status quo* of 1991, i.e. the *status quo* of the collapse of the Soviet Union. Estonian, Latvian and Lithuanian policy-makers are right to wonder whether, by helping isolate Belarus, they would not inadvertently contribute to that country’s loss of sovereignty. As controversial as it may be in view of the dismal human rights record of the Lukashenka regime, there is a legitimate argument to be made that the Balts’ national interest and their liberal values do not necessarily coincide as far as policy toward Minsk is concerned.

In one of the diplomatic cables published by *Wikileaks*, the U.S. Ambassador in Minsk commented in the spring of 2007 that the Kremlin was “using its considerable economic leverage to catalyze Lukashenka’s downfall, which is not in itself a bad thing; the more pressure on the Belarusian dictator the better... While we would not want to see Moscow determining any succession of leadership, it must be admitted that Russian economic pressure... will be a major factor in future political changes

173 Grybauskaitė interview with Rudolf Hermann, “Nenorime alkanų ir piktų kaimynų: Lietuvos Respublikos Prezidentė Dalia Grybauskaitė apie sudėtingą kaimynystę su Baltarusija”, 27 June 2011, <http://www.president.lt/lt/prezidento_veikla/prezidente_ziniasklaidoje/straipsniai_apie_prezidente/sveicarijos_dienrastis_neue_zuercher_zeitung_nenorime_alkanu_ir_piktu_kaimynu_lietuvos_respublikos_prezidente_dalia_grybauskaite_apie_sudetinga_kaimynyste_su_baltarusija.html?backlink=%252F%252Fpaieska%252Fresults%252Fp0.html> .

174 A recent American policy study has also concluded that “the Western policy community should elevate Belarus’ strategic importance for the EU and the United States, alongside values-based priorities like democratization” (“Democratic Change in Belarus...”, p. 28). Yet, in the view of this author, that study still suffers from an unwillingness to grapple with the possibility that strategic and values-based priorities might in fact be in conflict in the case of Belarus.

171 “Litauens Präsident provoziert einen Streit mit Schröder”, 26 October 2005, <www.welt.de>.

172 Unattributable personal interviews and policy documents.

here.”¹⁷⁵ Surely, as Belarus’s neighbours, the Balts cannot be this casual about the possibility of Western *ideal-politik* potentially leading to a ‘loss of Belarus’.

The second premise on which contemporary Baltic Belarusian policy is built is a steely determination for the Balts to look after their own economic interest. Understandably enough, the focus on economic expediency has been particularly manifest over the last couple of years as the Baltics strive to recover from a deep economic recession. As shown above, Belarus and its Baltic neighbors might be significantly less than irreplaceable economic partners. That does not mean, however, that in trying times such as these – having recently experienced staggering decreases of their GDPs, soaring levels of unemployment and falling budget incomes – the Balts would willingly put at risk their economic links even with non-critical partners. Therefore, in various EU fora Baltic policy-makers should be expected to resist initiatives aimed at introducing meaningful economic sanctions against Belarus.¹⁷⁶

The third premise on which contemporary Latvian and Lithuanian Belarusian policy seems to be built is inherently connected to the geopolitical line of reasoning espoused above – it is Rīga’s and Vilnius’ new-found reluctance to put much faith in the emergence in the foreseeable future of a liberal, westward leaning Belarus. In a reversal of their earlier policies, they seem now to agree with the argument recently made by Edward Lucas, a veteran observer of East European politics, that the West’s instinctive focus on supporting the Belarusian opposition – “a ragtag mix of idealists, has-beens, never-weres, turncoats, nationalist extremists and eccentrics”¹⁷⁷ – has been largely futile. In off-the-record conversations, some Baltic Belarusian specialists go as far as to make the argument that, as repulsive as Lukashenka is, he is probably still a cornerstone of Belarusian statehood. The argument goes that, in the event of a sudden regime change in Belarus, any succeeding regime would be much more, rather than less, dependent on Moscow. Such a scenario is considered likely because of Belarus’s weak grass-roots impulses toward national self-determination and its vulnerability – if push came to shove and Lukashenka’s autocratic grip was loosened – to Russia’s ‘soft power’. Again, as far as this author can judge from conversations with Estonian policy-makers and the appraisal of their policy, Tallinn’s position does not seem to be particularly well defined due to their more

removed position from Belarus and, consequently, smaller geopolitical and economic stake in that country.

The reconsideration in Latvian and Lithuanian policies seems entirely reasonable to this author. In the 1990s, the Balts’ skepticism toward Minsk was dictated by Lukashenka’s image as the chieftain of neo-Communist re-integrators in the post-Soviet space. In the mid-2000s Latvia’s policy of actively undercutting the Minsk regime seemed to be predicated on the euphoria injected by the wave of ‘color’ revolutions in the post-Soviet space. But have not the circumstances changed since then? Daniel Fried, the U.S. Assistant Secretary of State for European and Eurasian Affairs, said in 2006: “to put [Ukraine and Belarus] in a larger context, the question we are dealing with is how far in Europe will the democratic wave that began in 1989 extend? How far will the frontiers of freedom move?”¹⁷⁸ Should we not critically inquire as to whether the liberal optimism of the mid-2000s is still valid, and whether it was ever valid with regard to Belarus where, in comparison with countries like Georgia and Ukraine, the liberalizing impulse has never been firmly intertwined with a nationalist drive toward self-determination? It is true that, in conversations with his Western interlocutors, the eccentric and pretentious Belarusian autocrat now likes to refer to himself “as the real guarantor of Belarusian independence and sovereignty” – but is he necessarily wrong?

A number (though the point is contested by others) of Western diplomats working on Belarus admitted in background interviews with this author that they could easily imagine a scenario in which a sudden regime change in Minsk could result in a swift opening of Belarus to Russian soft power influence; it could then be followed by a speedy takeover of the Belarusian economy by Russian companies and the introduction of the Russian rouble as the ‘common’ Russo-Belarusian currency. In other words, a sudden liberalization of the regime in Minsk would provide Moscow with ample opportunities to rapidly execute the dormant project of the Russo-Belarusian ‘Union State’ – and to do it on Moscow’s terms, which would in essence presuppose Belarus’s accession to the Russian Federation.¹⁷⁹ This line of reasoning helps to understand why some of the leading Baltic policy-makers seem now to be advocating an EU policy toward Belarus that is predicated on a strategy aimed at ‘incremental regime evolution’ rather than abrupt ‘regime change’.

175 Wikileaks cable “07MINSK222”, 15 March 2007, <<http://wikileaks.ch/cable/2007/03/07MINSK222.html>> .

176 Some of this opposition has already been observable publicly; see, for example, Jerome Taylor, “EU Passes Belarus Sanctions”, 20 June 2011, <<http://www.independent.co.uk/news/world/europe/eu-passes--belarus-sanctions-2300217.html>> .

177 Edward Lucas, “What the West Gets Wrong About Belarus”, 2 May 2011, <http://www.cepa.org/ced/view.aspx?record_id=301> .

178 Daniel Fried, “Who’ll Vote for Freedom? Elections in Belarus and Ukraine”, 9 March 2006, <http://csis.org/files/media/csis/events/060309_ruseur_friedtranscript.pdf> .

179 Luihto aptly calls this the “Karelian” of Belarus’ future (Kari Luihto “Future Options of Belarus” [pp. 200-212] in *External Economic Relations of Belarus*, ed. by Kari Luihto (Turku: Turku School of Economics, 2007), p. 208).

STATE INSTITUTIONS, INTERDEPENDENCE AND PERCEPTIONS IN LATVIA'S ECONOMIC RELATIONS WITH THE RUSSIAN FEDERATION AND BELARUS

Kārlis Bukovskis

Official state institutions – at both the national and municipal level – are essential players in attracting and promoting economic activity between countries and businesses in the modern global economy. Because of their traditional regulatory and legislative power, state institutions perform two functions – they must both promote and restrain business activity according to the political and ideational situation in a particular country. The Republic of Latvia, with a small open market economy, is no different in this respect from any country in the world. This chapter addresses the legal and institutional frameworks, as well as the political/economic reasoning and motivations of official Latvian authorities, regarding welcoming or confronting Russian and Belarusian economic interests in Latvia.

In order to investigate the personal predispositions of decision makers and the legal and institutional boundaries that Latvian authorities operate within, two main sources of information were used for this research. First, legal documents and official reports; second, in-depth interviews with officials directly involved in the process of formulating and achieving state and municipal economic interests on an everyday basis. In total, 15 officials from the Ministry of Economics (EM), the Latvian Investment and Development Agency (LIAA), the Ministry of Foreign Affairs (MFA), the Ministry of Transport (SAM), and the largest Latvian municipalities – Riga, Daugavpils, Ventspils, Jelgava and Liepāja – were interviewed to obtain the widest possible range of views from both institutional and professional experience¹⁸⁰. The research investigates the practical possibilities and cognitive aspects that motivate the main decision-makers of Latvian state and municipal institutions in relations with Russian and Belarusian businesses and government counterparts.

The last 20 years have seen the establishment of functional administrative interaction between Latvia and Russia, and between Latvia and Belarus. For 20 years Latvian authorities have been facing a transition in the domestic and external environment. The internal environment saw not only institutional restructuring, but also shifts in political leadership with different approaches toward Russia and Belarus. Externally, Latvian authorities have been coping with European Union membership and a changing legal, institutional and political

¹⁸⁰ On the request of interviewees, the identities of experts will not be revealed unless agreed otherwise.

environment for economic cooperation. This research, therefore, investigates the current trends and the need for additional streamlining in the legal, institutional and motivational readiness of Latvian authorities to facilitate the country's economic interdependence with Russia and Belarus.

1. Legal framework and official policies

The legal framework and the institutionalized economic cooperation between Latvia and Russia/Belarus is tightly related to Latvia's membership in the European Union and is aimed at the facilitation of business activity. Latvia's membership in the EU has not only introduced a necessity for alterations in bilateral economic agreements, but it has also improved the level and intensity of cooperation between Latvia and Russia in particular. This sub-chapter deals with the legal and political framework that Latvian and Russian/Belarusian businesses operate in. It attempts to identify problems with the legal and official political positions that could be a hurdle to enhanced economic cooperation between the countries.

Since Latvia joined the European Union (EU) in May 2004, its trade policy with third countries like the Russian Federation and Belarus has been bound by the EU legal framework. The abolition of specific Latvian protectionist or free trade measures with regards to individual countries was followed by the introduction of common EU tariffs and regulations that were negotiated at the EU level. Even though EU competence could be considered restrictive, the multilateral decision making framework allows for the possibility to gain additional political support and weight for Latvia's specific interests.

The European Union, according to the Article 3 of the Treaty on the Functioning of the European Union (TFEU), has exclusive competence over the European common commercial policy and the common trading policy. Besides the common commercial policy, article 207 of the TFEU (introduced by the Lisbon Treaty and entering into force on December 1, 2009) also establishes exclusive EU competence in the sphere of FDI. But as "no transition was worked out for the member states or any guidelines for the way the Commission would have to deal with FDI henceforth, [...] no common interpretation existed yet of the exact meaning and implications of the new treaty text,"¹⁸¹ FDI has continued to be dealt

181 Maes M. The Lisbon Treaty and the new EU investment competence. In: EU Investment Agreements In The Lisbon Treaty Era: A Reader. Ed. R. Eventon. Amsterdam: Transnational Institute on behalf of the Investment Working Group of the Seattle to Brussels Network, 2010, p. 12, http://www.s2bnetwork.org/fileadmin/dateien/downloads/eu_investment_reader.pdf.

with mainly on a bilateral basis. Thus, most of the economic cooperation areas between Latvia and Russia/Belarus are covered by the EU's legal and institutional decision making framework.

The bilateral investment treaties of individual member states aim to protect their investors' capital against uncompensated nationalization or expropriation in third countries, similar to how it is regulated within the European Union. While "the EU has been developing a common platform on investment for some time and has concluded a number of FTAs [free trade agreements] with investment chapters,"¹⁸² the European Commission also negotiates bilateral investment treaties with its largest trading partners, including Russia¹⁸³. For instance, the inclusion of a chapter on investment is being negotiated in the planned EU-Russia Partnership and Cooperation Agreement (PCA), but this does not necessarily mean that the end result will deal with standard investment regulations. EU-Russia relations are based on the PCA that entered into force December 1, 1997, and will continue to be in force until the new agreement is signed. The PCA, with its complimentary sectoral agreements, is the legal basis for EU-Russia economic relations on the bilateral level, as Russia is not yet (at the time of writing) a party of the World Trade Organization (WTO)¹⁸⁴. The EU-Russia PCA was extended to Latvia upon its accession into the EU, but because of a lack of all-inclusive regulations on the EU level, bilateral, legally subordinated agreements have been concluded between Latvia and Russia as well as between Latvia and Belarus.

The Common Economic Space within the PCA framework is one of the instruments for the convergence of economic approaches and increasing trade liberalisation, as well as working on infrastructure projects and several trade related dialogue formats. Latvia has been among the EU member states that has supported both the new PCA negotiations and Russia's membership in the WTO. The main benefit, of course, is more stable and predictable trade and investment relations with Russia – relations which would be governed on the EU level rather than bilaterally between Latvia and Russia.

These expectations for EU level regulation and the occasional worsening of political relations between countries have resulted in a situation whereby

182 Woolcock S. EU Trade and Investment Policymaking After the Lisbon Treaty. *Intereconomics*, 2010, No. 1, p. 24, http://www.ceps.eu/system/files/article/2010/02/22-25-Woolcock_0.pdf.

183 Maes M. The Lisbon Treaty and the new EU investment competence. In: EU Investment Agreements In The Lisbon Treaty Era: A Reader. Ed. R. Eventon. Amsterdam: Transnational Institute on behalf of the Investment Working Group of the Seattle to Brussels Network, 2010, p. 13, http://www.s2bnetwork.org/fileadmin/dateien/downloads/eu_investment_reader.pdf.

184 Russia was invited to join the WTO in December 2011. The Duma ratified the accession on July 10, 2012 and currently Presidential assent is pending.

bilateral agreements concluded between Latvia and Russia/Belarus are mainly managed by establishing principles and intentions in economic relations, rather than regulating specific aspects. The latter are generally regulated by EU level agreements. For instance, “the economic co-operation provided for in this Agreement, shall be carried out, mainly, on the basis of agreements and contracts between Latvian and Belarusian economic operators, according to the national legislation of each Party and, in the case of Latvia, all obligations arising from its membership in the European Union.”¹⁸⁵ At the same time, the Agreement on Economic Cooperation between Latvia and Russia is more specific and includes the exchange of technical and legal information between the involved parties, and is aimed at establishing different mechanisms for the organization of investments and financing as well as constructing and modernizing objects on the territory of one of the parties or in third countries¹⁸⁶.

Because of a previous lack of political commitment, Latvia does not have any bilateral investment agreements concluded with Russia (though has an agreement with Belarus¹⁸⁷). At the same time, it is expected that the Latvian-Russian declaration on cooperation in modernization¹⁸⁸, which was signed in June 2011, could change the intensity and character of economic cooperation between both countries and could include additional regulation on investment protection. The Latvian – Russian Intergovernmental Commission of June 2011 also resulted in prioritizing the drafting and conclusion of the investment agreement, but this issue is still dependent on the success and sincerity of the Russia’s modernization as well as the domestic coordination of the issue in both countries.

Politics are still essential in relations with countries like Russia or Belarus, where economic activity tends to be strongly tied with or even controlled by official authorities: “Russian businesses are active, but they also take into account official state policy and statements made by the highest officials. Therefore, the

investments are going to countries which are friendlier towards Russia,”¹⁸⁹ and, “good political relations may not influence economic relations, but bad ones definitely can,” was emphasized by one of the interviewed state officials. The duration of more friendly or pragmatic Latvian-Russian relations is constantly a question. The occasional improvement of Latvian-Russian relations – involving examples such as B. Yeltsin’s visit to Latvia in 2006, the signing of border agreement, and V. Zatlers’ official visit to Russia in 2010 – are periodic improvements and the next worsening of the relations, it is widely argued, is generally unpredictable.

Nevertheless, Latvia’s official political position toward Russia over the last few years has been based on the pragmatic improvement of relations. “Strengthening equal and mutually beneficial relations with Russia ... within the common EU foreign policy,”¹⁹⁰ for instance, is stated as a priority in the declaration of the Valdis Dombrovskis government on foreign policy. Not only has the legal and institutional framework shifted, but also the image of Latvia in Russia, according to officials, since Latvia joined the EU and NATO in 2004. This geopolitical and strategic realignment of the Baltic countries has affected the political background Latvia has in relations with any other third country in the world.

Even though Belarus is a part of the European Neighbourhood Policy and also one of the priority countries for Latvia’s bilateral development¹⁹¹, neither the EU nor Belarus has strongly committed to more active cooperation. The basis for Latvia’s and the EU’s economic relations with Belarus is the Trade and Cooperation Agreement, concluded in 1989 by the Soviet Union and endorsed by Belarus. “The TCA provides for MFN [most favored nation] treatment with respect to tariffs, but does not contain any provisions on regulatory approximation to the EU’s most important trade related acquis.”¹⁹² Thus, by not ratifying the PCA with Belarus, since 1995 the EU has been protesting against the political regime in Belarus and implementing indirect economic sanctions by not introducing a more liberalized regime.

Traditionally Latvia has adopted the ‘wait and see’ type policy regarding the EU sanctions against Belarus. But the December 2006 decision on the reintroduction of a non-preferential tariff rate, and especially the March 2012 decision to introduce restrictions on several businesses loyal to the regime, serve

¹⁸⁵ *Agreement Between the Government of the Republic of Latvia and the Government of the Republic of Belarus on Economic, Scientific and Technical Co-Operation.* (Concluded 21.04.2004), Article 3, point 1.

¹⁸⁶ *Agreement between the Government of the Republic of Latvia and the Government of the Russian Federation on Economic Cooperation.* (concluded 13.10.2006.), Article 2.

¹⁸⁷ *Agreement of the Government of the Republic of Latvia and the Government of the Republic of Belarus on the Enhancement and Protection of Investments* (Latvijas Republikas valdības un Baltkrievijas Republikas valdības vienošanās par ieguldījumu veicināšanu un aizsardzību). (Active since 21.12.1998.), [http://www.mfa.gov.lv/lv/Arpolitika/bilateral/?mode=out&state=BLR&title=&branch=18&day1=dd%2Fmm%2Fyyyy&day2=dd%2Fmm%2Fyyyy&status=0&day3=dd%2Fmm%2Fyyyy&signer=.](http://www.mfa.gov.lv/lv/Arpolitika/bilateral/?mode=out&state=BLR&title=&branch=18&day1=dd%2Fmm%2Fyyyy&day2=dd%2Fmm%2Fyyyy&status=0&day3=dd%2Fmm%2Fyyyy&signer=)

¹⁸⁸ Signed during the Latvian-Russian IGC between the Latvian Minister of Economy Artis Kampars and the Minister of Transport of Russia Igor Levitin. The declaration on partnership includes cooperation principles in mutual investments, innovation, the improvement of the business and legal environments for investment projects, including mutual protection.

¹⁸⁹ Author’s interview with a representative of Ventspils City Council, in April 2011.

¹⁹⁰ Cabinet of Ministers of the Republic of Latvia. Order No. 67. Valdis Dombrovskis Government Action Plan. (23.02.2011.), article 4.5, <http://www.mfa.gov.lv/lv/Arpolitika/15-02-2011/>.

¹⁹¹ Development co-operation projects and priority countries. Riga: The Ministry of Foreign Affairs of the Republic of Latvia, 2012, <http://www.mfa.gov.lv/lv/Arpolitika/Attistibas-sadarbiba/valstis/>

¹⁹² *EU-Belarus Relations.* Brussels: EEAS, 2011, p. 1, http://www.eeas.europa.eu/belarus/pdf/belarus_trade_en.pdf.

as examples of the political positioning of the EU against Lukashenka's regime. This marked a change in Latvia when many businesses and politicians clearly stated their dissatisfaction and opposition to full scale economic sanctions against Belarus. The public debates resulted in a clearer position for the Latvian MFA on the sanctions against Belarus¹⁹³. The classical Latvian approach to Belarus has been aimed at promoting pragmatic bilateral economic relations, though Latvia has also regarded the European Union common position as legitimate – including toward economic restrictions (though not isolation) on the basis of civil liberty violations in Belarus¹⁹⁴. Nevertheless, Latvia has been open for dialogue with Belarus not only because of close its geographical proximity and historic ties, but also because of a strong economic relationship, especially in relation to the transit of Belarusian goods and the import of energy resources. All of the officials interviewed for this research strongly advocated the necessity of increasing cooperation with Belarusian businesses in the future: "Latvia must look to Belarus, because in Belarus, as we know, all the European countries and their enterprises work."¹⁹⁵ Belarus is seen as a perspective market and a growing partner for Latvia.

Last but not least, it is essential to highlight that both municipalities and state institutions admit to not having strict and pre-prepared legal mechanisms to protect Latvia's economy from unwanted investment or from the acquiring of local companies by foreign companies. The main approach would include specific political decisions on territorial planning, environmental protection, security, etc. Concerning the unwanted acquisition of enterprises with strategic importance to Latvia's economy, the extreme solution would be the nationalization of a particular company through purchasing stocks – if, of course, they are available on the stock exchange. Otherwise, company or industry representatives could ask for the political support of the government against economic and political pressure from foreign investors and their respective governments. Thus, even though Latvia has a liberal and open economy, if it becomes necessary then *ad hoc* political, economic, and legal instruments could be still introduced in order to protect strategic industries from unwanted acquisition and external pressure.

193 Latvia's reluctance towards economic sanctions against Belarus is based in the fact that Latvian economic ties with Belarus are more extensive than of many other EU member states. For the MFA's position, please see, <http://www.mfa.gov.lv/lv/jaunumi/zinas/2012/marts/23-1/>.

194 Ministry of Foreign Affairs of the Republic of Latvia. Report on State Foreign Policy and the European Union Issues. Presented to Saeima on 14.01.2011., p. 29, <http://www.mfa.gov.lv/data/file/Arpolitika/zinojums.pdf>.

195 Author's interview with a representative of Liepāja City Council, in May 2011.

The fundamental achievement of the agreements that are currently in place is that they establish important bilateral cooperation mechanisms between Latvia and Russia/Belarus – the intergovernmental commissions (IGC)¹⁹⁶, which may be accompanied by business forums and, for instance, the Latvian–Russian Business Cooperation Council meetings. The annual Intergovernmental Commission meetings are the central institutionalized framework for cooperation between state institutions, big businesses, representatives from the chambers of commerce and industry, and representatives from municipalities, as well as being a well-established dispute settlement mechanism. Collaboration on the reduction of legal and technical disparity, as well as the facilitation of particular business projects through inter-institutional consultation, is an essential part of Latvia's economic involvement with Russia/Belarus on the official level. The IGC helps to facilitate solutions to issues that businesses encounter, mainly regarding more specific issues rather than political issues of tariffs, customs, etc. The fact that the IGC allows businesses to raise issues and problems they encounter on a higher political level, problems which would otherwise be unsolvable, was admitted by the interviewed officials.

It can be concluded that business cooperation between Latvia and Russia/Belarus takes place on a legal and institutional framework meant for assisting businesses and monitoring overall bilateral relations, rather than on grand political bargains. Political relations between Latvia and Russia/Belarus are clearly the central explanation for missing agreements and regulations in the economic sphere. All of the countries involved have been following their own domestic and foreign policy agenda, which has resulted in the conclusion of missing agreements and the filling of gaps in the legal framework of the external economic sphere. In the case of Latvia, and consequently also in the Belarusian and Russian cases, legal streamlining does not necessarily depend only on political success in bilateral relations. It is mainly tied with EU level negotiations on the new PCA with Russia, or on the EU's economic sanctions or openness toward Belarus.

As neighboring countries, both Russia and Belarus have economic interest in and historical infrastructural ties with Latvia. These legacies have influenced the readiness and necessity to intensify legal and administrative cooperation with the Baltic state, even in spite of the occasionally hostile political rhetoric. But, major differences in the Belarusian and Russian positions with regard to

196 Namely these include the *Agreement between the Government of the Republic of Latvia and the Government of the Russian Federation on Establishing the Intergovernmental Commission on Cooperation in Economic, Scientific, Humanitarian and Culture Spheres* (concluded 13.10.2006) and the *Agreement Between the Government of the Republic of Latvia and the Government of the Republic of Belarus on Economic, Scientific and Technical Co-Operation*. (concluded 21.04.2004.).

the European Union, including Latvia, affect bilateral relations as well. Namely, Russia's economic, political and administrative resources put it on an equal level with the EU, while the Belarusian regime faces constant pressure from the EU.

2. Functions and role of state and municipal institutions

Following the identification of the general external and domestic legal framework, this chapter will deal with the functions and the role of the relevant Latvian national and municipal actors. The legal and institutional frameworks according to which the official institutions and businesses operate are clear and are intended to liberalize private business activity. At the same time, the practical implementation of trade policy and the intensity of official support are in the hands of state and municipal authorities. An analysis of their functions and their domestic institutional positioning helps to understand the overall role, capacities and performance of not only individual institutions, but also of the whole Latvian state in promoting its economic interests with regard to Russia and Belarus.

All of the interviewed officials admitted that state and municipal institutions generally have limited or assistive functions regarding Latvian and Russian/Belarusian businesses because of the chosen open market liberal deregulated approach. Many established Latvian enterprises have already built a significant number of contacts and ties with Russian and Belarusian companies on their own. Generally, the Latvian state and municipal authorities assist large and well established Latvian enterprises only if it is specifically requested by the companies themselves. At the same time, the role of 'political support' or 'political muscle' that Latvian authorities perform and the administrative support or specific consultative work they can do for small and medium enterprises is still seen as necessary from the point of view of both private and public actors.

The Ministry of Foreign Affairs of Latvia and its embassies have been considered natural administrators of external policy, including external economic relations. At the same time, the role and influence of the MFA in economic issues has been gradually diminishing. Since its re-establishment in the beginning of 1990s, the MFA has been gradually losing its monitoring role over external economic affairs¹⁹⁷. General political or military issues – such as the foreign investment policy, trade in strategic goods, and bilateral agreements – have

remained its main responsibilities in Latvia's economic policy. Moreover, during the economic crisis the amount and presence of Latvian diplomatic staff has also been significantly decreased¹⁹⁸.

All of the interviewed officials, except for the representatives of the MFA and the Ministry of Economics, concluded that the role and presence of the central apparatus of the MFA in everyday business interactions is low. Generally, businesses that express their interest in Latvia are technically supported and advised on the legal and institutional specifics of the economic environment either by the Latvian Investment and Development Agency (LIAA) and its representation in Moscow, by the Latvian Embassies in Minsk or Moscow, or by the trade and business associations each respective country. Latvian embassies are responsible for providing general information and for the promotion of the Latvian economy abroad, rather than dealing with individual businesses and their administrative, legal, and other issues, except for cases where LIAA representations are not present.

It must be noted that some respondents expressed satisfaction that the MFA and its embassies do not disturb economic activity by introducing unnecessary political arguments. In some municipalities and even state institutions, the MFA is considered to be an additional regulative authority that creates obstacles for free and unrestrained economic activity. This, however, depends either on the interviewees' personal understanding of the functions the MFA performs or on their personal experiences with individual Latvian ambassadors. Most answered that the preferable role of the MFA was as a promoter of Latvia's political interests, an improver of Latvia's public image in the world, and an implementer of the country's general interests in the international legal and institutional arena. Most importantly, the MFA's functions are seen essential in creating a positive environment for Latvian businesses.

The involvement of Latvian embassies is dependent on the allocation of responsibilities between the embassies and LIAA representations. Latvian austerity measures, cuts and reorganization of the public sector have been aimed at improving state assistance for businesses. Naturally, the Ministry of Economics and the LIAA have been allocated with more resources and also with former MFA personnel. Thus "unlike the MFA, whose capacity at the moment is very limited, the LIAA [...] has multiple spheres under their auspices [...]"¹⁹⁹

It is the Ministry of Economics (EM) that is in charge of the implementation

197 See, for instance, Bukovskis K. The Responsibilities of Diplomats in External Economic Relations from the Economism Perspective: A Case Study Of Latvia, Stockholm: SIPRI, 2011, <http://www.sipri.org/research/security/euroatlantic/eu-seminar/documentation/bukovskis-bgpaper>

198 According to the Report on State Foreign Policy and the European Union Issues (14.01.2011.) the number of staff members of the Latvian diplomatic service (including MFA) was reduced from 719 in its peak in 2008 to 528 in 2010.

199 Author's interview with Vice Mayor of Riga Andris Ameriks, May 2011.

of the general legislative framework, and responsible for the formulation and realization of Latvia's economic interests externally. The EM shapes policy in most of spheres of domestic economic activity, including the energy sector, industry, tourism, construction, trade, and innovation. In external economic policy, in particular, the EM formulates and implements the promotion of exports and the policy to attract foreign investment, coordinates the creation and activities of the external economic representation network of the Republic of Latvia, secures the representation of the interests of the Republic of Latvia in the World Trade Organization and European Union institutions, and formulates and implements external trade policy²⁰⁰.

The LIAA is the central agency with the responsibility of helping and promoting both Latvian businesses abroad and investments in Latvia. The LIAA has become the main coordinating institution for Latvia's external economic activity. All of the interviewed representatives of municipalities also clearly state the important and positive role that the LIAA has in cooperation between businesses from different countries. The main achievement of the agency was mentioned to be the advisory and networking functions for foreign investors and exporters. Assistance provided by both the LIAA and the municipalities is based on contact building, legal consultation, and the advertisement of Latvia's economy through various meetings, conferences, seminars, and exhibitions. Municipalities naturally get involved in the promotion of their local businesses, as well as the attraction and management of foreign investment into their administrative area.

The LIAA and municipalities have gradually established, and continue expanding and improving on, the available formats for cooperation and institutional cooperation mechanisms with Russian and Belarusian authorities. Important institutionalized cooperation mechanisms include the LIAA representations in Moscow and the planned office in Minsk. The lack of similarly well established counterpart organizations in Minsk or Moscow, meanwhile, causes problems in organizing business conferences, forums, and exhibitions such as the annual BELEXPO in Riga. Another example of attempts to improve the institutional presence and build personal contacts is the establishment of a representation of the Riga City Council in Moscow in March 2011 in order to work with official Russian state and municipal authorities and assist Latvian businesses in acquiring permission to operate in the country.

While the Ministry of Economics and its agency the LIAA are the main responsible institutions for external trade and determining Latvia's external economic policy and energy policy, the Ministry of Transportation (SAM)

²⁰⁰ Cabinet of Ministers of the Republic of Latvia. Regulation No. 271. *The Rules of Procedure of the Ministry of Economics*. (23.03.2010.)

remains the coordinator, and legislator or co-legislator of transport and telecommunication related issues. The SAM is the most important actor in the transit sector, as it manages state owned enterprises and infrastructure related to railways, marine ways, aviation, and roads. In addition, the SAM is responsible for the legislation and monitoring of the electronic and radio communication infrastructure, which is traditionally seen as one of the core spheres for a modern, high-intensity product driven economy to emerge.

The state and municipal authorities in Latvia, with the exception of the LIAA and Ministry of Economics, admit that their contact with actual private businesses, especially Belarusian and Russian one, is not regular. Most contact-building business activity takes place among private companies themselves. The traditional support that the municipalities can exercise includes international cooperation between regional and municipal authorities and forming partner cities²⁰¹, while simultaneously remaining an important contact point for regional investment and economic activity. One of the reasons for this lack of interest from businesses to address municipalities mentioned by the interviewees was that some, for instance, perceive them as repressive institutions that would put additional regulations or taxation on businesses²⁰².

Latvian municipalities and the relevant embassies organize regular meetings with their Russian and Belarusian counterparts. Even though engagement with official Russian or Belarusian diplomatic representations often depends on the problems a particular foreign company is experiencing or the significance of one particular project or investment, Latvian municipalities underline their positive experience with representatives of both Russian and Belarusian embassies and consulates. The quality of relations of municipal authorities with diplomats and representatives of Russian/Belarusian state authorities tends to be dependent not only on their institutional proximity (the presence of an embassy or consulate in a particular city) or the intensity and structure of economic cooperation, but also on personal sympathies, and most importantly on the tasks that diplomatic personnel are invested with.

²⁰¹ List of partner cities includes only Russian and Belarusian cities or administrative units with the date when the last agreement was concluded or partnership established: Ventspils partner cities are Polotsk and Novopolotsk (2008); Jelgava partner cities are Baranovichy (2003), Magadan (2006) and Moscow Southern Administrative Unit (2003); Daugavpils partner cities are Vitebsk (1998), Narofominsk (1997), St. Petersburg (2004) and Moscow Central Administrative Unit (2003); Liepāja partner cities are Gomel (1999) and Moscow City Western Administrative Unit (2004); Riga partner cities are Moscow (2001), St. Petersburg (1997 (2006)) and Minsk (1999).

²⁰² Author's interview with Jānis Prūsis, Head of the External Economic Relations Division of Economic Administration of Riga City Council City Development Department, May 2011.

Some of the interviewed representatives of municipalities and state institutions pointed to closer cooperation with Russian (Liepāja) or Belarusian (Daugavpils, Riga, LIAA) diplomats and Consulate workers. Daugavpils is the only one of the biggest Latvian cities that has closer cooperation with Belarusian businesses than Russian, as apparently the Russian Consulate in Daugavpils has not been as active as their Belarusian colleagues. Vladimirs Nadeždins explains this by the fact that during the economic recession, the Belarusian Consulate-General reoriented its priorities toward economic issues and cooperation²⁰³. A lack of Russian interest cannot be seen in the case of successful cooperation between city of Liepāja and Russian Consulate there.

These cooperation trends can be explained by the historically dominant economic spheres of particular cities. For instance, the representatives of Rīga, Ventspils, and Liepāja are the strongest supporters of Eastern investment and see Russia and Belarus as natural and necessary partners in the transit sector. Liepāja and Ventspils mostly emphasize either investments and increasing transit volumes or the supply of energy resources and raw materials (the supply of metals to *Liepājas Metalurģs* or metal transit through Liepāja). But neither the transit cities nor the other largest municipalities expect Russian or Belarusian investment to take place only in transit sector. While Liepāja, for instance, lacks Belarusian investment, the presence of Latvian businesses from Liepāja working in Belarus in the timber industry, or transit companies working with Belarusian transit of pulp or peat through Liepāja, is evaluated as significant.

A number of practical legal and institutional problems surrounding inter-institutional cooperation and the promotion of Latvia's economic interests and businesses have been highlighted by the interviewed officials during this research. Even though state institutions do not openly criticize each other for lacking cooperation or for disagreements, some coordination problems were admitted. Most of the issues raised, however, are systemic problems rather than ones traceable back to the failures of individuals or organizations.

Firstly, the limited number of officials and an insufficient or inefficient division of labor between institutions and/or municipalities, which results in overlapping and potentially unhealthy competition, reduces the ability of authorities to work with more businesses or to engage in lobbying more thoroughly. Secondly, national legal regulations, anti-corruption measures, and numerous audit and controlling institutions, along with the general level of distrust among state and municipal institutions, are seen by Latvian

203 Author's interview with Vladimirs Nadeždins, Head of Business Development Division of the Department of Development of Daugavpils City Council, April 2011.

municipalities as the main hurdle in the allocation of infrastructure for potential large investors, immediately following financial problems. Thirdly, the distribution of information and lobbying of particular Latvian enterprises by municipal authorities or state institutions most likely will involve big companies rather than small or medium sized ones. This is not only related with the reduced capacity of the authorities, but also with the point that the interests of small businesses rarely extend beyond the Latvian market and the simple fact that such companies have not expressed any interest in cooperation with the municipality²⁰⁴, for instance. Differences in the legal and institutional approaches between Latvia and Russia/Belarus tend to cause practical problems in promoting Latvian businesses abroad. Latvia is a small and open economy that supports free market principles and liberalization domestically, within the European Union, and also in relation with third countries. The activities of Belarusian state authorities, meanwhile, demonstrate quite the opposite – widely used sanctions against private Belarusian enterprises in the form of penalty fees, additional taxation, or even expropriation cause distrust and unpredictability in both doing business and also arranging business meetings within Belarus. This over-politicization and militarization of the economic sphere, in contrast to depoliticization tendencies in the Latvian economy, is the central difference that Latvian institutions take into account when dealing with Belarusian businesses.

Moreover, in the case of Belarus there is also a somewhat vague, non-transparent and occasionally contradictory legal framework. "There are regulations and an unpredictability in Belarus that we [Latvians] are used to working without in Europe. Businesses are used to working within a normal, refined environment and [in Belarus] there appear various factors that are absolutely non-existent in Russia."²⁰⁵ These regulations tend to be unclear mainly because of a lack of explanatory and communication work by state institutions, but most importantly, because of legal acts and regulations that oppose each other or are even retroactive.

The legal system in Russia is evaluated as more predictable, but at the same time based more on personal relations than the Belarusian situation. The Latvian legal system is seen as more orderly and more based in institutional rather than personal relations. As an illustration of this, the interviewed LIAA officials stressed the fact that big Russian businesses tend to use direct personal contacts with politicians or Latvian businesses rather than the services of the LIAA. The largest Russian projects that the LIAA has coordinated are 2-3 million euros in

204 Author's interview with Vladimirs Nadeždins, Head of Business Development Division of the Department of Development of Daugavpils City Council, April 2011.

205 Author's interview with a representative of Liepāja City Council, in May 2011.

value, while it is usual for European companies to have turnover in the billions²⁰⁶.

Therefore it can be seen that Latvian state institutions and municipalities understand themselves as promoters and assistants of businesses. They use their administrative influence and political status to lobby regional or national businesses or to attract investment from abroad, including Russia and Belarus. Greater streamlining possibilities can not be found to a large degree in the activities or division of labour between institutions and municipalities – streamlining or the improvement of efficiency is instead related with increasing the level of trust among Latvian authorities, as well as between authorities and businesses. One of recommendations is therefore to establish transparent and open public procurement procedures and stricter punishment mechanisms for corruptive actions and the intentional mismanagement of state resources, instead of the currently somewhat resource-heavy scrutiny procedures.

Generally it is understood that more support for Latvian businesses is needed, and that this is more necessary and thus more extensive in countries like Belarus compared to Lithuania, for instance. The specific economic approach in Russia and Belarus, varying standards and regulations versus unified standards and open, free, unrestrained business activity principles inside the European Union significantly affect the procedures and the amount of time and energy that businesses and Latvian state institutions have to invest. And, naturally, Latvian businesses seek help in the form of administrative resources from their national political and state institutions and figures when it is seen as beneficial.

3. Perceiving further economic engagements

This subchapter is solely based upon the interviews with decision makers from municipalities and state institutions, and addresses their motivations and reasoning on the facilitation or reduction of Latvia's exposure to Russian and Belarusian economic activity. Establishing the dominating perceptions is an essential part in the evaluation of the willingness of Latvian officials to promote economic relations with Russia or Belarus. This originates from the fact that the predispositions and attitudes of officials, including those interviewed, directly affects the quality and intensity of administrative engagement in dealing with Russia and Belarus. Politically, Russia perceived in Latvia differently than Belarus, not only because of the historical legacy but also because of its economy's size and the continuous presence of political involvement therein. Therefore, this sub-

²⁰⁶ Author's interview with representatives of the Latvian Investment and Development Agency in May 2011.

chapter deals with the identification of general fears and perspectives on Latvian and Russian/Belarusian economic interdependence.

Extensive economic exposure to another country's influence is a form of pragmatist (mercantile realist) reasoning that traditionally dominates the thinking of municipal and state officials. One of the central arguments voiced for this matter is that more resourceful countries tend to establish and use economic ties for achieving political goals. Thus, increasing Latvia's economic interdependence with Russia and Belarus, especially through investment, is from time to time argued to be preventable. The role and influence of Russia's economic presence in the Baltic States and in Latvia has been assessed by many politicians and experts as dangerous, and potentially resulting in economic and political dependence. However, interviews conducted for this research showed that only representatives from the ministries demonstrated concern and expressed the necessity for a diversification of Latvia's external trade and investments. Ministries clearly follow a pragmatist understanding about the political influence of economic instruments. This can be explained by the fact that they are invested with the responsibility of defending national interests on the state level. In the case of municipalities and the LIAA, the defense of national interests does not prevail over their main function, which is to promote business activity and attract investments. Thus, Latvian state and municipal officials demonstrated a strong set of views that emphasize economic and profit-making business aspects and downgrade the necessity to pursue political principles or arguments – such as human rights, democracy, historical justice, etc. – in relations with both Russia and Belarus. The interviewed representatives of municipalities argue that businesses operate quite independently, but that political quarrels can still be very damaging.

One of the central trends of Russian business activity in Latvia that is seen as worrisome to some of the interviewed officials is the acquisition of a majority stake in companies that Russians invest in. This political-economic principle is traditionally a deal-breaker for Russian investors and is strictly followed. This, according to some officials, it is also one of the reasons that Russian investments are currently limited to individual sectors, rather than being widely present in all spheres of the Latvian economy. Moreover, this Russian business principle in the understanding of officials is often viewed alongside the fact that Russian investment and ownership in Latvia is not always evident or clearly assessable because of the extensive use of offshore companies.

What Latvian institutions must deal with is primarily the size of both the Russian state apparatus and Russian businesses. The volume of human, financial and administrative resources is not the only difference – the significantly larger

number of issues that Russian authorities are dealing with is also a factor. Latvia, and economic relations with Latvia, aren't the most important point on Russia's agenda as the Russian leadership is projecting their country as a global player. Thus, Latvian authorities as well as Latvian and Russian businesses themselves take into account the vast coordination work that is usually done within Russian state structures surrounding the conclusion of agreements and other issues.

In addition to this, the current financial and economic recession, as noted by representatives of Ventspils, Liepāja and Riga, has increased the interest of Russian businesses in acquiring infrastructure and companies that operate in ports and transit routes. The availability of resources and cheapening of assets has increased the activity of Russian investors in such sectors as energy, logistics and transit, and the food industry. Unlike many EU companies experiencing financial problems and restructuring, Russian investors do not appear to be hurt by the crisis on the same scale, and have free capital. This trend naturally causes additional concern among state authorities, though none of the interviewed clearly condemned such investment.

Moreover, the interviewed municipality representatives anxiously see Russian investment as potentially reasonable, mostly because of Russia's financial capacity. Ventspils, for instance, requires an expansion of its port's capacity through the construction of the Northern Port project, worth 100 million euros, which could come from capital intensive energy transit (oil or liquefied natural gas) and is most likely to come from Russia rather than the EU, Latvia or Belarus²⁰⁷. As V. Nadeždins of the Daugavpils City Council concludes: "hundreds of millions of euros cannot be afforded either by Belarus or Latvia,"²⁰⁸ thus leaving only the European Union, individual EU member states, or Russian investment in Latvia as the most likely partners for major projects. From the opposite side, top level state institutions do not neglect Russia's specific economic characteristic of close ties between Russian businesses, especially large enterprises, and state institutions. The so called 'political blessing' or 'diplomatic accompaniment' (*дипломатическая сопровождения*) factor is always taken into account when major Russian investment or acquisition plans are inspected and evaluated. Big Russian businesses are always considered while keeping potential political implications in mind.

Belarusia's presence in Latvia's economy, however, is considered very differently. It is not seen as either crucial or as a threat to Latvia's political stance. Firstly, all the interviewed representatives of municipalities (except for

Daugavpils) admitted that economic cooperation with Belarus takes place either on a low level or exclusively in the transit sector. The Belarusian 'trade country' approach dominates and is visible through the structure of Belarusian investment in Latvia. Most of the investments are made by private individuals, are shared with Latvian businesses, and are predominantly in trade and trade related sectors. Thus, the Belarusian business model evidently follows the political establishment and economic approach – trade instead of investment abroad.

One of the explanations for this Belarusian reluctance is the political attempt by A. Lukashenka to strike a balance between Russian and European interests. From the point of view of cooperation between Latvian and Belarusian state and municipal authorities, this negatively affects the coherence of activities, their intensity and consequently the possibility to trust Latvia's Belarusian counterparts on their seriousness and long term perspective.

Concerning the role of political arguments like human rights violations and the non-democratic regime in Belarus, the interviewed representatives of Latvian state institutions indicate that these factors are more visible through cooperation with larger businesses, because small ones tend to neglect political differences. Even the Latvian–Belarusian Intergovernmental Commission meetings are not dominated by issues related to democracy and human rights²⁰⁹. The IGC is devoted to businesses and economic cooperation rather than discussions on different political approaches or the issues that are constantly on agenda in bilateral relations between the EU and Belarus. Representatives of the Latvian transit cities support this depoliticized approach, as they themselves try to produce the image of a neutral hub indifferent to the origin of the clients and their specific characteristics other than volume and financial solvency.

Thus, the Latvian approach in the case of Belarus is based on economic and political pragmatism in relations with the neighboring country. Indirect socialization is perceived as the most significant and efficient way to influence and promote changes in the Belarusian political system. Vocal opposition and a renouncement of the regime is evidently not perceived as a favorable option among Latvian state institutions and municipalities, largely because of rational economic interests and the potentially growing economic interdependence between the countries.

It is interesting that the interviewed state and municipal officials underlined that political arguments are from time to time disregarded by Russia and Belarus themselves: "for each country [Russia and Belarus], income is very important."²¹⁰

207 Author's interview with a representative of Ventspils City Council, in April 2011.

208 Author's interview with Vladimirs Nadeždins, Head of Business Development Division of the Department of Development of Daugavpils City Council, April 2011.

209 Author's interview with a representative from the Latvian Ministry of Foreign Affairs, June 2011.

210 Author's interview with Vice Mayor of Riga Andris Ameriks, May 2011.

The central perspective for this is the economic benefit and, again, the economic cost of political maneuvering. Neither Russia nor Belarus are consistently ready to give up their economic interests based solely on political differences with Latvia. Political arguments, thus, come into play as an additional weight when the economic advantages and disadvantages of a particular project are examined.

Some of the factors that contribute to favoring Russian and Belarusian enterprises over European are language skills and the level of personal familiarity with the Russian/Belarusian and the Western business culture, and business traditions in general. Some state representatives claimed that a more positive predisposition of individual municipalities toward Russia/Belarusia is a result of insufficient language skills other than Russian. However, in some cases the interest of municipalities can be explained instead by a pragmatic inability to attract investments or simply by being too unattractive and uncompetitive for foreign or even national businesses.

Thus, municipalities do not openly disregard Eastern investments as politically unacceptable. On the contrary, municipalities tend to compete for all potential FDI using all available resources. A number of instruments have been developed that demonstrate Latvia's competitiveness for Russian and Belarusian investment in general. The primary attractiveness of the Latvian economy, the main advantage that Latvian state facilitates have, is based in significant structural and operational differences from the Russian economy. Limited and sporadic political or administrative involvement in the activities of private businesses appears to be attractive for Russian economic groups. Additionally, for several Russian-owned banks the prospect of investing and trading within the European Union, and the recently introduced²¹¹ permanent residence regulation in the Immigration Law of Latvia, are perceived by most of the interviewed officials as important factors in attracting investment.

Despite the attractiveness of doing business within Latvia and with Latvian state authorities, four out of five interviewed municipalities denied that any interest had been expressed by their Eastern neighbors in public procurement tenders. Formal requirements and specifications that require compliance with EU standards, especially if a particular project involves EU co-financing, is the main explanation for this lack of interest. Only representatives from the Riga City Council testified that Belarusian companies have considered participating in building trams for Riga, though this was together with Latvian businesses.

211 Amendments of 22.04.2010. and 26.05.2011. in the Immigration Law of Latvia (adopted by Saeima) introducing a possibility of receiving long term status of permanent resident in Latvia (and automatically in the EU) after significant capital investments into Latvian economy.

Therefore, it can be concluded that instead of political arguments, productivity and price have become the central reference points and decisive arguments for deepening Latvia's economic interdependence with Belarus, and on a slightly lesser scale with Russia. Factors like production capacity, trade costs, and the participation of transnational or well established companies or brands play an increasingly more important role in business decisions. The understanding of and feelings toward Russia's economic presence in Latvia are diverse; ranging from distrust and worry about a potential takeover of Latvia's economy, to seeing Russia as yet another investor with the economic potential to contribute to Latvia's economy. In case of Belarus, the institutional scenery is dominated by attempts to embrace Belarusian businesses both as another investment opportunity and as a promising socialization element of Belarusian authorities and private entrepreneurs. Evidently, streamlining the readiness of Latvian authorities to engage in more intense cooperation with their Russian and Belarusian counterparts depends not only on an individual decision maker's motivations and arguments, but also on practical concerns and *ad hoc* situations. The dominating factor, though, is the economic interest of either the particular municipality or of the Latvia in general.

Concluding observations and remarks

It is evident that one must lower their expectations when Latvian state institutions and businesses are considered in the context of a global or regional economy. The first reason for this is the fact that Latvia is a small state with a rather small economy and a limited capacity to direct or significantly influence either legislation on the EU level or regional economic structures and dynamics. The legal framework Latvia that is operating within, however, is flexible enough to allow Latvian authorities to pursue their own agenda in relations with Russia, and especially with Belarus. Moreover, the current EU framework is somewhat insufficient for Latvia to be adequately protected. Foreign direct investment protection is one of the most obvious examples of this.

Secondly, research reveals the limited resources that Latvian institutions have to promote and lobby Latvian businesses. The economic crisis has deepened this problem, and logically the institutions are increasingly considering themselves as only monitors and occasional assistants to businesses. In addition, among likely administrative problems are potential quarrels between institutions, especially at the level of ministries. While competition among municipalities is natural,

disagreements between ministries on specific issues can be morally damaging to bureaucrats considering broader and more fundamental issues.

The third important conclusion is that there exists a perception of smallness and limitations among the Latvian state and municipal authorities. The municipal and state authorities tend to view Latvian businesses and the Latvian state as less able and less capable of defending their interests as is actually the case. Thus, unlike the objective limitations on Latvian institutions that originate from the international legal framework and the relatively insufficient amount of human and financial resources, the psychological feeling of smallness and limitations is more discouraging for involved state and municipal actors. On the other hand, it provides some with psychological comfort in justification of their unwillingness to change the traditional operational habits and framework.

The presence of Belarusian businesses – and the asymmetrical presence of Russian businesses – in Latvia is not only based on objective aspects, such as the number and scale of foreign companies (Russian ones in particular). It is also based on subjective criteria, like an unwillingness to limit the Russian and Belarusian economic presence because of additional financial gains and the inability to balance the amount of projected influence. Balancing influence, however, does not mean only an accumulation of capital and an ability to invest extensively in other countries. It also includes the use of administrative and political resources in the promotion of a country's economic interests. Governmental assistance for national businesses is not only a normal trend in the global economic system. In many cases it has helped companies acquire a beneficial position in foreign markets and accumulate wealth.

An active engagement of both state institutions and municipal authorities, with active and coordinated lobbying of their companies abroad, including in Belarus and Russia, is an essential requisite for the accumulation of capital. Many of the interviewed decision-makers admitted the necessity for more active lobbying and support for the most promising companies and ideas. Technical support is important, but actual assistance and intensive engagement are more likely to have positive results. This aspect, however, not only involves additional administrative capacity through increasing the number of officials dealing with the economic issues, but also a change in the attitude toward businesses and the role that state authorities should perform. State institutions must perceive themselves as both a coordinator or short term assistant in the free market, and also as additional means and instruments for business activity. Of course, the number of instruments available to countries such as Russia is significantly larger, but this does not necessarily mean they are more efficient.

Therefore the POLARIS process²¹² developed by the LIAA and Latvian government is and should be seen as the central instrument for the sustainable development of Latvia's economy through the identification and advancement of the most promising national businesses, by allocating state assistance and improving foreign investment facilitation. The newly established mechanism is one of the most important steps toward both administrative enhancement and also expanding the general perception about the roles and responsibilities of each of the involved state and municipal actors and the level of their capacity.

Finally, if Belarus is seen as a potentially equal partner with internal administrative and self-positioning problems, then Russia's economic might over the small Latvian economy draws a different picture from the point of view of potential political influences. As was argued by Latvian ministry officials, even if the capacity of the Russian economy is not necessarily sufficient to obtain full control over all its neighboring countries, Russian businesses are and should be treated with caution.

The size of Russian economy is asymmetric to Latvia's, and Russian businesses could acquire a significant part of the Baltic State's economy. But the generally cautious and balance-oriented approach toward Russian businesses by Latvian ministry officials, and an unwillingness for the country's economic development to break away from one particular investor or country, are the main driving forces behind Latvia's approach toward external economic relations and increasing economic interdependence. Economic interdependence itself traditionally involves not only additional economic gains for both individuals and the state, but is also perceived as potentially damaging to autonomous decision making in economic spheres and to the country's independence in general. The perception of threats originating from one country's dominant economic presence in another country involves multiple structural factors. For instance, control over monopolies, especially surrounding the supply of goods vital to the existence of the population – such as food, drinking water, or energy resources – is a rational perception of potentially asymmetric and dominating influence.

At the same time, if a country has strong anti-monopoly regulations and efficient punishment mechanisms, the establishment of an alternative production or supply site of a good can be secured. Namely, it is essential for a country to preserve the potential ability to supply vital goods and services via national or private means in case the public well-being is damaged by economic or political manipulations on the part of the monopolistic enterprise. National control over

212 Foreign investment coordination strategy based upon efficient use of limited administrative and financial resources. See <http://www.polarisprocess.com/> for more information.

infrastructure, disregarding whether it is physical transport routes for goods or IT infrastructure, and key resources like the water supply, or arable land and forests, is thus essential.

Therefore, in the case of Russia's and Belarusia's economic presence in Latvia, it is fundamental to remember that the economic means and related business activity of foreign countries are instruments that can lead to increased wealth, but also to incapacitation if dealt inappropriately. Foreign investment, irrespective of its origin, can be dangerous if it monopolizes vital spheres, but otherwise free economic activity and the liberal market approach that Latvia has chosen can benefit the country's economy through the inflow of the additional capital that Latvia tends to lack. Aside from some legal and institutional discrepancies, the Latvian state and municipal authorities are relatively well set for attracting additional capital. No major streamlining of the three observed constitutive elements is urgently needed. The administrative system that has been established over the last 20 years is aimed at pragmatic economic relations with neighboring countries, including the Russian Federation and Belarus. In addition, good relations with neighboring countries, of course, will also be of benefit indirectly by constructing an image of the Republic of Latvia as a safe place for investments from all around the world.

BUSINESS INTERESTS IN THE LATVIA-RUSSIA ECONOMIC RELATIONSHIP

Arvils Zeltniņš

In recent years both Latvian and Russian politicians have showed the will to establish a pragmatic and mutually beneficial relationship between Latvia and Russia. The terms “pragmatic” and “mutually beneficial” are directly connected to economic relations. The visit by the president of Latvia, Valdis Zatlers, to Moscow in December 2010 was the first official presidential visit to Russia since President Guntis Ulmanis in 1994, when an agreement on the withdrawal of troops was signed. Does this visit really represent a new page in interstate relations, and what are the implications for businesses in this regard? This chapter is devoted to the assessment of bilateral economic relations over past three years, which leaders of both countries have named as the best ever for Latvia-Russia relations. Are such statements well grounded, considering the background of relations between the two countries? How do leading business actors (companies and business groups) react to this change in the interstate political climate? Have the legal framework and bilateral format for cooperation been elaborated properly?

To answer these questions, the chapter is divided into four parts. The first subdivision is devoted to an analysis of the general framework of Latvian-Russian economic relations. The legal and political framework between Latvian and Russian business interests was created based on transformational nature of post-Soviet era. With a new climate of political relations, there is the opportunity to transform the juridical basis of business and economic relations. Are the existing mechanisms properly developed to best exploit economic advantages? In the second part, the author focuses on the opportunities and risks facing Latvian companies that have business in Russia. What changes are expected for business after the improvement of political relations, and what are main strategies Latvian businesses employ to enter the Russian market? The activity of Russian companies in Latvia is examined in the third part. The main focus is on the political and economic risks and opportunities of having Russian capital in Latvia. In the Russian case it is important to analyze and evaluate the origin of investments (whether they are independent business groups or connected with Russian political elite) and where they are directed (into small or large businesses, speculative or real economics). The author also focuses on the business culture that exists in the business environment between Latvia and Russia. An assessment of general trends in Latvian-Russian economic relations

and recommendations on the further development of interstate business relations for politicians, public authorities and business people are provided in the concluding part of this chapter.

1. General framework of Latvian-Russian economic relations

In order to analyze Latvian-Russian economic relations it is necessary to consider the major formats for cooperation in the business area, the legal framework and Latvia's status as a member of the EU within the context of EU-Russia relations. Another important determinant is the Soviet legacy for the economy of Latvia, with regards to infrastructural integration with Russia and elements of the business culture. In addition, between the countries there exists a mutual business relationship that can not be explained by the institutional framework or by political heritage, this being geo-political – namely, the incentive to cooperate with the closest neighbor.

Since 2007 Latvia and Russia have intensified their interstate relations within the framework of the Intergovernmental commission (IGC). The main task of the IGC is to improve cooperation in the field of economics, scientific technical cooperation, and in the humanitarian and cultural area. An idea to establish the IGC already existed in the 90s, when occasional meetings were held. However, the commission started to function *de jure* in 2007²¹³. Since 2007, meetings within the framework of the IGC have been taking place regularly once in a year. In the fifth meeting of the IGC on June 2011 in Liepāja, one of the basic fields of interest was the transit business and the development of an East-West transport corridor²¹⁴. The next meetings of the IGC will include further discussion by Latvian and Russian politicians on economic issues. It is much easier for both countries to find a basis for cooperation on transport, logistics and transit than it is on humanitarian and historical issues. There are three important aspects for cooperation within the IGC. First, the agenda of the IGC is a mirror of the basic interests that are most important for both countries. Second, it is an arena for local business people trying to get their issues on the agenda of the IGC. Third, there is an official bilateral dialogue between both states, showing a willingness to improve cooperation in a wide range of areas.

213 Latvija apstiprina Latvijas-Krievijas starpvaldību komisijas Latvijas puses sastāvu. LR Ārlietu ministrija, 20.03.2007. <http://www.mfa.gov.lv/lv/Jaunami/PazinojumiPresei/2007/marts/20-2/>.

214 Основная наша функция — убрать преграды. Бизнес & Балтия, 13.06.2011. p. 5.

In January 2012, the new head of the IGC from Latvia, Edgars Rinkēvičs, Minister of Foreign Affairs, was affirmed²¹⁵. He replaced the former Minister of Economics Artis Kampars. This change is promising for a much wider agenda for the IGC in the future. Up to now, economic issues have played a major role in the IGC, but there are a lot of legal, social, interior and humanitarian issues that could be solved with more significant involvement from the foreign ministries. Moreover, the affirmation of Rinkēvičs will be fruitful in terms of coordination, because the secretariat of the IGC is the Ministry of Foreign Affairs of Latvia. Changes occurred also in the Russian leadership of the IGC. The new co-chairman of the IGC will be the Minister of Transport Maxim Sokolov, who will replace its predecessor (also the Minister of Transport), Igor Levitin. This proves that the transport and transit issues are topical from the Russian side in mutual cooperation, regardless of the IGC head.

The exchange of personnel in the leadership of the IGC will not result in a marginalization of economic issues. An important role within the framework of the Latvia-Russia IGC is played by a special Business Council, which was formed from business people of both countries. The heads of the Council, Vasilijš Meļņiks from the Latvian side and Pyotr Aven from the Russian side, notice that there is no economic development without development at the political level.²¹⁶ As an example, they mention the visit made by Valdis Zatlers to Russia in December 2010. This included the signing of an agreement to abolish double taxation between Latvia and Russia, and pushed forward the process for signing an agreement on investment protection²¹⁷, which is necessary for the normative basis of Latvian and Russian businesses. Cooperation between Latvia and Russia's regions has become another channel for business interaction. The Latvian Chamber on Commerce and Industry organized business delegations from Latvia to Pskov, Krasnoyarsk, Kaliningrad and Nizhny-Novgorod in 2011²¹⁸. The trend to cooperate with the regions of Russian Federation has been intensified in the post-economic crisis period of the past two years. Until May of 2012, Latvia's Ministry of Economics had signed special agreements on cooperation with the regions of Pskov, Omsk, Vologda, Kirov and the republics of Karelia, Bashkorstan and Chuvashia²¹⁹. There is also a plan to sign similar agreements

215 Apstiprināts Latvijas un Krievijas starpvaldību komisijas ekonomiskās, zinātniski-tehniskās, humanitārās un kultūras sadarbības jomās sastāvs. Ministru Kabinets, 31.01.2012. <http://www.mk.gov.lv/lv/aktuali/zinas/2012gads/2012-01/310112-am-08/>.

216 Основная наша функция — убрать преграды. Бизнес & Балтия, 13.06.2011. p. 5.

217 *Ibid.*, p.5.

218 LTRK šogad plāno vairākas eksporta veicināšanas aktivitātes. LETA, 20.02.2011. <http://www.leta.lv/lat/arhivsn/>.

219 Paraksta programmu ekonomiskās sadarbības veicināšanai ar Pleskavas apgabalu. Baltic Export, 02.05.2012. <http://balticexport.com/?lang=lv&article=paraksta-programmu-ekonomiskas-sadarbibas-veicinasanai-ar-pleskavas-apgabalu>.

with other regions in Russia. The main idea from Latvian side is to acquire new export markets, especially for the Latvian food industry, and also the chance to attract new investment in the field of production, transit, and tourism.

Apart from the institutional framework, another strong connector of Latvian-Russian businesses is the former Soviet energy and transport infrastructure that connects both countries. Latvia inherited the Soviet infrastructure, including railways, roads, ports, pipelines and other infrastructure. After regaining independence, Latvia took advantage of the Soviet-era infrastructure in its economic development through the early 90s. Latvian ports were especially crucial for both Latvia's and Russia's economic development. Ventspils port was the main route for Russian oil products being shipped to the West, providing an important contribution to Russia's GDP. Through Ventspils, Russia exported about 13-15% of its total oil export²²⁰. Russian transit fees contributed substantially to the Latvian GDP, reaching 20-25% of Latvia's GDP in the 90s²²¹. The mayor of Ventspils, Aivars Lembergs, even called Ventspils port "Russia's port" pointing out that there are mutual economic benefits²²². In 2001 the construction of Primorsk port in northern Russia was completed, and as a result the Russian government has gradually reduced crude oil transit through Ventspils. At the same time, Russia still uses the oil product pipeline for the transit of diesel. Nevertheless, Latvia's importance as a transit corridor for Russia is still notable. Before the economic crisis, about 84% of Latvia's income in the transit sector was related to Russia and CIS countries²²³. Latvia's ports, railway system, and roads are still an important component in the long chain of Russian transit. Corresponding to Russia's dependence on Latvian ports for oil transit until 2003 is Latvia's dependence on Russia's energy resources. Due to the Soviet legacy, the natural gas infrastructure is well developed in Latvia. Natural gas makes up about 30% of Latvia's total primary energy sources²²⁴, and the only suppliers of natural gas are *Gazprom* (51% of shares are owned by the government of the Russian Federation) and *Itera Latvija*²²⁵, which has successfully developed their business in Latvia.

220 Sprūds A. Latvian-Russian Energy Relations: Between Economics and Politics. In *edition of Nils Muižnieks Latvian-Russian Relations: Domestic and International Dimensions*. University of Latvia, 2006, p.111.

221 *Ibid.*, p.111.

222 Ceplis K. Lembergs Baltijas Biznesa konferencē paziņo, ka Latvijas valsts ir nestabils un riskants partneris. LETA, 19.05.2000. <http://www.leta.lv/lat/arhivs/>.

223 Galbreath D.J., Lašas A., Lamoreaux, J. *Continuity and change in the Baltic Sea Region: comparing foreign policies*. Rodopi B.V. Amsterdam, 2008. p. 66.

224 Skaitļi un fakti: Latvijas primāro energoresursu balance %. Latvijas Gāze, Rīga. 2010. http://www.lg.lv/uploads/filedir/File/Investoru_attiecibas/Skaitli_un_fakti/2009_Skaitli_un_fakti.pdf.

225 By the official data shareholders of "Itera Latvija" are "Davonte Holding Limited" registered in Cyprus (66% pf shares) and "Itera Energia Holding ApS" registered in

Besides the improvement of the political climate and infrastructural ties, there is a geographic factor that has an impact on Latvian-Russian business relations. Rīga is the closest capital city of any EU member state to Moscow, and its port is the closest EU port to Moscow. The distance, easily covered by any transport (Rīga–Moscow, 920 km; Rīga–Saint-Petersburg, 560 km), provides a basis for mobility between industrial, financial, intellectual and human resource centers in Latvia and Russia. This is also a reason for business cooperation in the areas of financial brokerage, the real estate market, transport and logistics, that exists relatively independently from the political climate between both countries.

Considering Latvia's membership in the EU and border with Russia, there is a potential for business cooperation within the framework of EU-Russia relations. The development of an East-West transport corridor is also on the agenda of EU-Russia relations. For Russian companies, Latvia is a gateway to the European market. From the other side, Russian companies dealing with Latvia should also respect the rules and standards of the EU. A liberalized market and free capital flow exists within the borders of the EU. In Russia, it is still proving difficult to finalize the liberalization of the market and the privatization of state owned enterprises. In Latvia, the liberalization of the natural gas market is seen as a main clash between European and Russian business models over the coming years.

An additional contributory factor to Latvian-Russian economic relations is Russia's forthcoming accession to the World Trade Organization (WTO). This will open the border for more intensive trade and economic cooperation. The main advantage for Latvian entrepreneurs will be a more transparent trading process and tariff relief on agriculture and the production of food²²⁶. Health standards and other norms used by Russia for the purpose of internal market protection will be adapted to international principles²²⁷. On the other hand, Russian entrepreneurs will have the same opportunities on the other part of the border. Experts mention that the main winners will be Russian metal companies and the losers will be Russian IT companies in regard to Russia's accession to the WTO²²⁸. Competitiveness will be a key for business development.

Denmark (34% of shares). (Lursoft).

226 Oficiāli apstiprināta Krievijas uzņemšana PTO. Delfi Bizness, 16.12.2011. <http://bizness.delfi.lv/pasaule/oficiali-apstiprinata-krievijas-uznemsana-ptol-latvijas-saskata-iespeju-audzet-eksportu-uz-kaiminvalsti-1925.d?id=41990148>.

227 Kursiņa G. Pēc 18 gadu sarunām Krievija pievienojas PTO. Dienas Bizness, 16.12.2011. <http://www.db.lv/tirdznieciba/pec-18-gadu-sarunam-krievija-pievienojas-pto-249743>.

228 Oficiāli apstiprināta Krievijas uzņemšana PTO. Delfi Bizness 16.12.2011. <http://bizness.delfi.lv/pasaule/oficiali-apstiprinata-krievijas-uznemsana-ptol-latvijas-saskata-iespeju-audzet-eksportu-uz-kaiminvalsti-1925.d?id=41990148>.

The general framework for Latvian-Russian business cooperation is multifaceted and ambiguous. The main bilateral trend is the improvement of the political climate, starting political dialogue at the highest level, which helps improve the institutional and legal framework of cooperation. Also important is the comprehensive trend – the improvement of the business climate between Russia and Western countries, marked by Russia's accession to the WTO. Theoretically all these aspects speak of better business cooperation and greater interdependence in the future. However, unlike the EU as a united political actor, Latvia's "red lines" for greater economic interdependence are limited. The political and economic capacity of Latvia is much smaller than for Russia, and some areas of cooperation could result in a dependency on Russia.

2. Latvian business interests in Russia

The presence of Latvian businesses in Russia is small compared to presence of Russian companies in Latvia. At the same time, the large market in Russia is often seen as a market with unexploited potential for the Latvian economy. The visit of President Zatlers to Moscow was a political gesture to show the willingness for cooperation from the Latvian side. But apart from this willingness, it is important to assess and define our comparative advantages and weaknesses (in investment and trade sectors) when trying to make business in the Russian market.

The economic crisis that started in 2008 substantially influenced Latvia's investors in Russia. Before the crisis, the total amount of direct investment from Latvia to Russia reached 45.1 million lats in 2008, and then this amount decreased to 25 million lats in 2009²²⁹. In 2011, the total amount of accumulated direct investment from Latvia to Russia was 27.6 million lats²³⁰, indicating a minimal recovery after the recession. Most intensive business cooperation from Latvia's side takes place in the border regions of Russia. According to data from the municipality of the Pskov Oblast, Latvia is the second biggest investor (after Austria) in the Pskov Oblast, making up about 36% of total FDI in Pskov²³¹. Until 2011 Latvia was the FDI leader in the Pskov, making up about one half of total

FDI in the region. The Austrian company *Tannpapier* GMBH started to build a factory in Pskov with a value of more than 21 million EUR²³². Latvia has more than 80 companies that are investing in Pskov, but except for *Pata AB*²³³ none can afford to invest several tens of million euros. Latvian businessmen mostly invest their money in distribution, real estate and finance brokerage. Both sides signed a bilateral agreement on economic cooperation between Latvia and Pskov Oblast in 2010²³⁴. This agreement, as well as others signed between Latvia and Russian municipalities, is considered part of the general improvement of institutional framework between businesses in Latvia and Russia. The biggest Latvian investor in Russia is the wood-processing company *Pata AB*, which invested about 10.5 million lats in the Pskov factory *Dok 5*²³⁵. This factory, opened in 2009, gives jobs to 120 local people in Pskov Oblast. The transfer of production to Russia was mainly attributed to the fact that Russia raised its export rates for untreated wood²³⁶. It has become more profitable to set up a plant in Russia and export the production to the EU countries with added value.

However, the main obstacle for the increase of Latvian investment is the macroeconomic problems in Russia, as well as the business culture, both from the side of business people and official bureaucracy. Credit is still expensive in Russia, which is negatively influencing production and consumption, and consequently weakening Russia's ability to attract investments²³⁷. Problems with Russia's bureaucracy and customs control are the most frequently named arguments for a lack of business cooperation from people in the transit business. Besides this, the financial capacity of Latvian companies that would like to invest in the Russian market is small. Though Latvia's investment into Russia is not significant for Latvia's economy, trade with Russia has been one of the central issues since early 90s. Until the 1998 Russian default, Latvia's exports to Russia were a major driving force for Latvian economic growth. After the ruble crisis, Latvia suffered a minor economic decline. Russia's share of total Latvian exports decreased from

229 Latvijas ekonomiskā sadarbība ar Krieviju. Latvijas Investīciju Attīstības aģentūra, http://www.liaa.gov.lv/uploaded_files/EKSPORTETAJIEM%20sadala/Krievija/2012.03.LV_Krievija_ekon_LIAA.pdf.

230 *Ibid.*

231 Краткая характеристика Псковской области. Инвестиционные возможности Псковской области http://invest.pskov.ru/sites/default/files/investicionnyy_potencial_pskovskoy_oblasti.pdf.

232 Андрей Турчак: В 2011г. мы запустили инвестпроекты в стратегических для Псковской области секторах. РосБизнесКонсалтинг, 28.12.2011. <http://top.rbc.ru/pressconf/28/12/2011/631832.shtml>.

233 Ķirsons M. Apalkokus pārstrādās Pleskāvē. Dienas Bizness, 27.12.2012. <http://www.db.lv/citas-zinas/apalkokus-parstradas-pleskava-142093>.

234 Latvijas – Krievijas Reģionālās sadarbības darba grupa vienojas par sadarbības padziļināšanu. Ekonomikas ministrijas, 17.03.2011. <http://www.em.gov.lv/em/2nd/?id=31519&cat=621>.

235 Ķirsons M. Apalkokus pārstrādās Pleskāvē. Dienas Bizness, 27.12.2012. <http://www.db.lv/citas-zinas/apalkokus-parstradas-pleskava-142093>.

236 *Ibid.*

237 LIAA: bieži Latvijas uzņēmēji ir pārāk uzmanīgi Krievijas tirgū. Diena, 03.01.2011. <http://www.diena.lv/lat/business/expert/expertopinion/liaa-biezi-latvijas-uznemeji-ir-parak-uzmanigi-krievijas-tirgu>

21% in 1997 to 7% in 1999²³⁸. After this, Latvian exporters quickly adapted to new export markets outside Russia. Today, Latvia's exports to Russia reach 11% of the total volume of Latvia's exports, following Lithuania and Estonia, which are the two largest Latvian export markets²³⁹. Latvian companies doing business with Russia mainly focus on the food industry, transit, the engineering industry and the chemical industry. The Latvian export of food and agriculture products is estimated to be about 29% of Latvia's total exports to Russia²⁴⁰. One half of total food items are alcoholic drinks²⁴¹. This phenomenon can be explained by re-exporting. The biggest part of alcoholic drinks exported to Russia are whiskey, fortified wines and brandy²⁴², which are not typically produced by alcohol producers in Latvia. The export of other food products is gradually increasing, including the export of canned fish (by 35% in 2011)²⁴³. However, this industry has almost reached its potential because of a lack of raw fish. In 2011, the export of live pigs to Russia was also increased. Currently, due to the Shmallenberg virus, an export embargo from Russia is in place. Russia's eventual accession to the WTO could be a positive turning point that would cancel such ungrounded embargoes. The engineering industry is estimated to be about 19% of total Latvian exports to Russia, while chemical industry (mostly medical supplies) makes up 12%²⁴⁴. Latvian exports to Russia may increase in the future, provided there is a positive tendency of growth for Latvia's GDP.

To strengthen the position of Latvian exporters to Russia, cooperation between Latvian state institutions – such as the Investment and Development Agency of Latvia and the Ministry of Foreign Affairs – and Latvian exporters is needed. Considering the relatively small amount of Latvian production, consolidation between Latvian companies is important in terms of competitiveness, capacity, expertise, business contacts and business direction. The words of Latvian farmer Juris Lazdins, that “Moscow *eats* us in 15 minutes”²⁴⁵, are still an appropriate symbolic analogy.

238 LIAA: bieži Latvijas uzņēmēji ir pārāk uzmanīgi Krievijas tirgū. Diena, 03.01.2011. <http://www.diena.lv/lat/business/expert/expertopinion/liaa-biezi-latvijas-uznemeji-ir-parak-uzmanigi-krievijas-tirgu>

239 Latvijas un Krievijas attiecības/ Sadarbība ekonomikā. LR Ārlietu ministrija, 18.04.2012. <http://www.mfa.gov.lv/lv/Arpolitika/divpusejas-attiecibas/Krievija/>

240 *Ibid.*

241 *Ibid.*

242 Dieziņa S. Izrāvienā pārtikas eksports uz Krieviju. Dienas Bizness, 17.04.2012. <http://www.db.lv/razosana/partika/izraviena-partikas-eksports-uz-krieviju-370312>

243 *Ibid.*

244 Latvijas un Krievijas attiecības/ Sadarbība ekonomikā. LR Ārlietu ministrija, 18.04.2012. <http://www.mfa.gov.lv/lv/Arpolitika/divpusejas-attiecibas/Krievija/>

245 Veidmane E. Maskava apēd mūs 15 minūtēs. Neatkarīgā Rīta Avīze, 05.02.2009. <http://nra.lv/articles/print.htm?id=16533>.

The main problem of trading with Russia starts in Latvia – weak internal cooperation and export capacity. In some high-potential production areas for the Russian market, the main problem is counterproductive competition between local companies. Two examples in which the fragmentation between Latvian companies is an obstacle to having more competitive exports to Russia and other states are the dairy industry and the pharmaceutical industry. Both of these industries have been important for Latvian exports to Russia since Soviet times. Notwithstanding this, their competitiveness today is weakening because of internal competition and fragmentation. There are 38 producers (eight of which have about 80% of the market) of milk and milk products in Latvia. In contrast, Lithuania has only three major milk producing companies²⁴⁶. Consequently, the Latvian dairy industry, with its small capacity per company, is less export competitive in comparison to Lithuanian companies. Therefore, any attempt to seriously move into the Russian market is problematic. The amount companies can export is too small for the size of the Russian market. The Latvian dairy industry, however, is undergoing some structural changes due to interest from Russian investors. Despite the several implications (discussed in the next subchapter) of Russian investment, Latvia may increase its export capacity and competitiveness in the export of milk products to Russia.

The sharpest competition among the biggest Latvian brands is between Latvian pharmaceutical companies *Olainfarm* and *Grindeks*²⁴⁷. Both companies mainly export their production to markets in CIS countries. Their methods to overcome their rival are simple: both *Olainfarm* and *Grindeks* are beginning to produce very similar products, and the heads of the companies, Valērijs Maligins from *Olainfarm* and Kirovs Lipmans from *Grindeks* blame each other for the use of unfair corporate actions. Cooperation, at least in exporting to Russia²⁴⁸, between the companies would strengthen their positions in external markets by having a common branding strategy, more capacity, united administration and a more diversified production line. As with investment politics, Latvian companies and state agencies dealing with Russia must analyze not only internal obstacles for better competitiveness in trade, but also look at competitors from neighboring countries: Lithuania, Estonia and Poland. The Investment and Development Agency of Latvia mentions the restraints on Latvian exporters to the Russian market in comparison with entrepreneurs from the other Baltic States and Poland²⁴⁹. Financial resources and a large volume of production are needed to efficiently access the Russian market. Many Latvian

246 Kļavis A. Stratēģiskās spēles piena tirgū. *Kapitāls*, 02/2011. 5.lpp.

247 Pavlovs S. Olainfarm vs Grindeks. *Kapitāls*, 09/2011 74. lpp.

248 There was one united pharmacy company *Riga Factory for medical preparations* in Soviet times. It was divided into *Grindeks* and *Olainfarm* in the privatization process in the 90s.

249 LIAA: bieži Latvijas uzņēmēji ir pārāk uzmanīgi Krievijas tirgū. Diena, 03.01.2011. <http://www.diena.lv/lat/business/expert/expertopinion/liaa-biezi-latvijas-uznemeji-ir-parak-uzmanigi-krievijas-tirgu>.

entrepreneurs consider all the bureaucratic formalities to register their company in the Russian Federation to be troublesome. To do business with Russia each company needs to invest not only financial resources and a business idea, but also many working hours for market research and monitoring of market changes²⁵⁰. The best solution for a company would be opening its own official business representation, but such expenses are beyond the capabilities of Latvian companies²⁵¹. This shows that the issue of consolidating capacities is still open. Both a common export strategy and also common marketing and branding are needed dealing in the Russian market.

The first steps have been already made in this regard. In 2011 the City Council of Riga opened an official representation to Moscow. One of the central aims of Riga's representation is the direct stimulation of Latvian goods in the Russian market²⁵². The first results have been the opening of stands with Latvian food items under the name "Rizhskiy Dvorik" (Riga Ranch) in several supermarkets in Moscow. Latvian products such as Riga black balsam (*SPI Group*), sprats (*Unda, Columbia Ltd.*), bread (*Lāči*), cabbage (*Dimdiņi*), mineral water (*Ķekavas avots*), mayonnaise (*Spilva*) and dairy products (*Valmieras piens*) are promoted in the Russian market under the trademark "Rizhskiy Dvorik."²⁵³ There are plans to also open such stands in Pskov. At the same time, Riga's representation is planning to cooperate with Moscow also in on cultural, education and social issues, which overlaps similar functions of the Latvian Embassy to Russia and raises the issue of the practical significance of the institution. In any case, the official representation of Riga to Moscow could develop the attractiveness of Latvian businesses to Russian capital. The status of municipality representation is more effective for the development of the business climate than is the status of a State embassy. The Mayor of Riga has to deal with much less difficult political issues than the Embassy in Moscow. The risk of potential conflicts is much smaller in this scenario. At the same time, this kind of representation could not act effectively without financing, operating in a variety of capacities, and providing coordination. Therefore, the involvement of other state institutions and Latvian businessmen would be welcome in the planning of a strategy of action for the Riga representation.

Another project – the cooperation between the municipality of Riga and Latvian food exporters with the "Riga trademark" – involving a special line of food production from Latvian companies for the Russian market was planned

250 LIAA: bieži Latvijas uzņēmēji ir pārāk uzmanīgi Krievijas tirgū. Diena, 03.01.2011. <http://www.diena.lv/lat/business/expert/expertopinion/liaa-biezi-latvijas-uznemeji-ir-parak-uzmanigi-krievijas-tirgu>.

251 *Ibid.*

252 Rīgas Pārstāvniecības Maskavā vadītāja aicina uzņēmējus uz tikšanos. Rīgas pašvaldības portāls, 06.04.2011. <http://www.riga.lv/LV/PostingData/News/2011/4/parstavnieciba.htm?Date=12.04.2011>.

253 Kluinis A. Rīga virza Latvijas preču eksportu. Neatkarīgā Rīta Avīze, 25.06.2012. <http://nra.lv/latvija/liga/74564-riga-virza-latvijas-precu-eksportu.htm>.

as one of the key elements in business cooperation between Riga and Moscow. This idea, however, did not result in successful business cooperation. The project was tightly connected with the former mayor of Moscow, Yuri Luzhkov, and his business partners in Russia²⁵⁴. Latvian producers lost the backing of Moscow's supermarkets after his dismissal. Now they are looking for a direct connection with Russian companies without mediators.

The heads of the Latvia-Russia Business Council, Vasiļijs Meļņiks and Pyotr Aven, along with Latvian entrepreneur Beslans Abdulmuslimovs, have realized a project for promoting Latvian food production to the Russian market called the "Baltic Trademark."²⁵⁵ Products with this brand have been sold in Moscow since 2010. The project provides the option to buy raw materials – for example, raw fish – in Russia for manufacturing and processing in Latvia²⁵⁶. This helps to solve the problem of a lack of raw materials, which is observable in almost every sector of Latvia's production: meat products, fishing products, milk products, grain etc. Another strong point for the project is its realization within the framework of the Latvia-Russia IGC, which improves the credibility of such businesses. Further harmony between the IGC and Baltic Trademark is seen in the subsidiary approach – entrepreneurs from Latvia directly deal with counterparts from the regions of Russia.

The successes of several Latvian businessmen in dealing business with Russia can also be explained by their knowledge of the Russian business culture and language, which is also the business language in other CIS countries. Businessmen from Latvia characterized Russian businessmen as representatives of an Eastern business culture that is contrary to the West²⁵⁷. Yet in both culture it is important to have both a good understanding between potential business partners and a profitable business plan. As stated by the CEO of *Trasta Komerbanka* Igors Buimisters, relations come first and business comes second when dealing with businesses from the East (namely Russia)²⁵⁸. Another important characteristic in the Russian business culture is that successful businesses in Russia almost cannot exist without the participation of political mediators. It is possible to work in the area of small and medium businesses, as in case with Buimisters (his bank is small by the measures of Russia and CIS countries). Large projects like a common branding campaign, investment in the Pskov region and even marketing in the biggest supermarkets of Moscow need political backing. And this is perhaps the most important feature of the business culture in Russia – big business goes hand in hand with politics.

254 Основная наша функция — убрать преграды. *Бизнес & Балтия*. 13.06.2011. p. 5.

255 For example food producers "Rezekne meat factory" and "Kaija" are integrated under this brand.

256 Основная наша функция — убрать преграды. *Бизнес & Балтия*. 13.06.2011. p. 5.

257 Intervija ar Igoru Buimisteru „Klusi pelnītā nauda”. *Forbes*, Janvāris 2011. 71. lpp.

258 *Ibid.*

Russia is an attractive country for potential investors from Latvia, considering the size of the market. At the same time a lot of barriers still exist in getting into the Russian market. Our businessmen carefully assess their opportunities in Russia, consider problems with its bureaucracy, the politics of credit, and the general investment climate. The majority of Latvian financial resources are invested following the principle of geography – namely, into the neighboring Pskov Oblast. On the other hand, trade with Russia has been a strategic matter for Latvia's economy since the 90s. In times of economic crisis Russia is looked as a potential market for Latvia's export capabilities. The official visit by President Zatlers to Russia corresponds to the efforts of Latvia's businesses. The intensification of political/economic dialogue within the framework of IGC and cooperation between the regions indicates Russia's interest in Latvian goods and services. At the same time, the use of political institutions to gain business advantages confirms one of the most characteristic features of the Russian business culture – large businesses are made using political contacts.

3. Russian business interests in Latvia

The presence of Russian companies in the Latvian economy is significant both for trade and investments. Although trade links are important, Russia's financial presence in Latvia's economy is a central issue as it is debated whether an economic presence may be transformed into political influence. The main objective in this subchapter is to evaluate the general conditions of Russia's businesses in Latvia and the link between Russian investment and the political aims of the Eastern neighbor toward Latvia. The author will assess the structures used by the largest Russian investors in Latvia, analyzing their business interests and political connections. In addition, an analysis on the newest areas of investment (real estate, the dairy industry, and banks) as well as more traditional ones (energy, railways, and ports) will be provided.

The Russian Federation is the third biggest source for Latvian imports after Lithuania and Germany, composing about 11.4% of overall imports to Latvia²⁵⁹. Most importantly, Russian export products to Latvia are mineral products (about 56% of Russia's total export to Latvia) and metals (about 19%)²⁶⁰. Trade between Latvia and Russia is typical of cases in which one country specializes in the export

259 Latvijas un Krievijas attiecības/ Sadarbība ekonomikā. LR Ārlietu ministrija. 18.04.2012. <http://www.mfa.gov.lv/lv/Arpolitika/divpusejas-attiecibas/Krievija/>.

260 *Ibid.*

of raw materials, namely Russia, and the other has no serious source of energy resources and raw materials.

Russia's total investment into Latvia is estimated to be 281.7 million lats, compared to Latvia's 27.6 million lats of investment in Russia²⁶¹. Compared to other foreign investors, Russia is the eighth biggest investor to Latvia²⁶². The biggest share of investment from Russia is in the energy sector at 27.4%, while 26.3% of Russian investment in Latvia is in finance brokerage and 14.9% is in real estate²⁶³. In comparison, Russian direct investment in industry makes up only 9.4% of total investments²⁶⁴. Analyzing the biggest companies/investors for Latvia's economy, there are prominent companies from the energy business and finance brokerage²⁶⁵. While the origin of cooperation in the energy sector is related to the well connected oil and natural gas infrastructure from Soviet times, the interest of Russian banks in Latvia is related to Latvia's membership in the EU.

Table 1. Largest investors from Russia in Latvia
(companies and private persons)

Nr.	Company	Investments ML LVL	Business area
1.	TRANSNEFTEPRODUKT AO	36.55	Pipeline transport, oil transit (owns 34% of "Latrotrans")
2.	City Council of Moscow	20.09	Machine industry (owns 92.6% of "Amo Plant")
3.	GAZPROM	13.57	Energy, natural gas sector (owns 34% of "Latvijas gāze")
4.	The Bank of Moscow	10.82	Finance brokerage (owns 99.7% of "Latvijas biznesa banka")
5.	Yuri Ciplakov	10.54	Finance brokerage (owns 99% of "Rigensis Bank")
6.	Yuri Shefler	7.90	Real estate (owns 100% of "Meierovica 35")
7.	Coal mining company "Zarechnaja"	7.48	Transit business (owns 57.6% of "Baltic Coal Terminal")

Source: Lursoft, 2011.

261 Latvijas un Krievijas attiecības/ Sadarbība ekonomikā. LR Ārlietu ministrija. 18.04.2012. <http://www.mfa.gov.lv/lv/Arpolitika/divpusejas-attiecibas/Krievija/>.

262 Lielākie ārvalstu investori Latvijā pēc tiešo investīciju kopapjoma. *Lursoft*. 05.05.2011.

263 Latvijas Ekonomiskā sadarbība ar Krieviju (2011). Latvijas Investīciju un Attīstības aģentūra, http://www.liaa.gov.lv/uploaded_files/EKSPORTETAJIEM%20sadala/Krievija/2012.03.LV_Krievija_ekon_LIAA.pdf.

264 *Ibid.*

265 See the Table Nr.1.

The largest Russian investor to Latvia remains *Transnefteprodukt*. It owns 34% of the Latvian company *Latrostrans*, which owns the oil pipeline Polocka-Ventspils²⁶⁶. Since 2003 crude oil transit through the pipeline has been stopped (the transit of oil products still exists) because Russia started to extensively use its own ports in Murmansk and, more importantly, Primorsk. Furthermore, Russia has finished building a new port for the transit of oil and other products in Ust-luga. The return of Russian oil transit through Ventspils port is not expected. On the other hand, the lack of Russian oil transit through Latvia reduces the importance of the transit business to Latvia's GDP and the presence of Russia in Latvia's economy, which lessens the political risks that existed in the 90s.

The second biggest Russian investor to Latvia is the Department of Property of the Moscow City Council (about 20 million lats), which is the main shareholder in the machine building company *Amo Plant* in Jelgava²⁶⁷. The investment by Moscow City to the machine building company *Amo Plant* was directly related to a decision made by Yuri Luzhkov. After he became a *persona non grata* both in the Kremlin and in Latvia, the continued existence of *Amo Plant* was under question. The present administration of the Moscow City Council at first had no plans for further investment in the Latvian company and wanted to sell its shares in *Amo Plant*²⁶⁸. Two potential investors from Western Europe (VDL from the Netherlands and MAN from Germany) were named as potential buyers²⁶⁹. Now the Moscow City Council wants to continue production in Latvia, including the company in a wider chain of production under the brand of ZI²⁷⁰. *Sberbank* will be a partner of the Moscow City Council in the project²⁷¹, but hasn't given a clear signal on further investment into *Amo Plant*.

The third largest investor is the Russian gas monopoly *Gazprom*, which invested about 13.5 million lats into Latvian gas company *Latvijas Gāze*²⁷². This data does not show the real picture. In reality, the value of capital owned by *Gazprom* in Latvia is much bigger than 13.5 million lats (even considering

the investment from *EON Ruhrgas* and *Itera Latvija*), because the market value of *Latvijas Gāze* has considerably increased since 1997, when *Gazprom* bought the *Latvijas Gāze* shares. According to the the chief of *Itera Latvija*, Juris Savickis, the total value of *Gazprom* and *Itera Latvija* capital in Latvia is at least 600 million lats²⁷³. *Gazprom* also has a monopoly on natural gas deliveries to Latvia. *Itera Latvija*, which is the other gas supplier to Latvia, allegedly sells gas from Turkmenistan²⁷⁴ to a *Gazprom* daughter company, *Gazprom export*. As result, *Itera* gas deliveries to Latvia are formal. Both *Gazprom* and *Itera Latvija* oppose Latvia's plans for gas market liberalization, which would bring it in line with EU directives known as the Third energy package (TEP). The Latvian state actually has little control over its natural gas sector. State regulations cannot prevent a monopoly and only the implementation of TEP could be a solution for this. As a result of the final privatization process of the Latvian national gas company *Latvijas Gāze* in 2002, the three major shareholders became *Gazprom*, *E.ON Ruhrgas*, and *Itera Latvija*. All three companies have mutually beneficial relations with European and post-Soviet gas markets. *Ruhrgas* together with *Gazprom* have been partners since the 1970s, when they started building gas infrastructure from the Soviet Union to GDR and GFR²⁷⁵. *Itera* and *Gazprom* have a special contract for using natural gas from Turkmenistan. In the early 1990s *Itera* became the largest owner of Turkmenistan's gas fields²⁷⁶. For Latvia's energy security, mutually beneficial relations between *Gazprom* and *Itera Latvija* are central to influencing the capital of Russian gas. In the foreseeable future the key indicators of the impact of Russian gas companies on Latvian politics will be the implementation of the TEP and the project to construct a liquid natural gas terminal (LNGT) in the Baltic States. The strategic aim for the LNGT project is to stop the *Gazprom* monopoly on natural gas deliveries to the Baltic States, and starting to import from other countries supplying LNG. Regarding the Russian company's presence in the LNGT project, the LNG suppliers will feasibly utilize the same gas pipeline (*Gazprom*). First, the person who presented an idea of an LNGT

266 Latvijas – Krievijas attiecības/ Lielākie KF investori Latvijā. LR Ārlietu ministrija, 25.01.2011. <http://www.mfa.gov.lv/lv/Arpolitika/divpusejas-attiecibas/Krievija/>.

267 *Ibid.*

268 Maskava pārdos savas daļas „Amo Plant”. Delfi Bizness, 21.12.2010. <http://bizness.delfi.lv/uznemumi/maskava-pardos-savas-dalas-amo-plant.d?id=35870607>.

269 Par „Amo Plant” akciju iegādi interesējas Nīderlandes „VDL” un Vācijas „MAN”. Delfi Bizness, 02.04.2012. <http://bizness.delfi.lv/uznemumi/par-amo-plant-akciju-iegadi-interesejas-niderlandes-vdl-un-vacijas-man.d?id=42255300>.

270 Maskava atsakās no plāniem pārdot „Amo Plant”. Delfi, 28.05.2012. <http://bizness.delfi.lv/uznemumi/maskava-atsakas-no-planiem-pardot-amo-plant-ieguldis-zil-glabsana.d?id=42388906>

271 *Ibid.*

272 See the Table No. 1.

273 *Gazprom* un *Itera* negrib atteikties no Inčukalna gāzes krātuves. Baltic News Network, 23.05.2011. <http://bnn.lv/gazprom-itera-negrib-atteikties-incukalna-gazes-kratuves-32137>.

274 Bogatyreva O. Itera boss blames press for firm's travails. The Russia Journal, 21.06.2002. <http://www.russajournal.com/node/6319>.

275 Stern J.P. Gas pipeline cooperation between political adversaries: examples from Europe. Royal Institute of International Affairs, London. 2005. p.2. http://www.chathamhouse.org.uk/files/3222_jsjan05.pdf.

276 Bogatyreva O. Itera boss blames press for firm's travails. The Russia Journal, 21.06.2002. <http://www.russajournal.com/node/6319>.

in 2005 in Latvia was Juris Savickis²⁷⁷, the chief of *Itera Latvija* and a close ally to *Gazprom*. Although *Itera Latvija* presented its LNGT project to the Ministry of Economics of Latvia in 2011 and was rejected, plans for the LNGT in the Baltic States are still topical. Neither a location for building nor the involved stakeholders have been announced.

According to an unofficial document made by the Ministry of Foreign affairs (MFA) of the Russian Federation in 2010, the Program for the Effective Utilization of Foreign Political Factors on a Systematic Basis for the Purposes of Long-Term Development of the Russian Federation, Russia will try to gain bigger influence over Latvian strategic enterprises in the fields of logistics, transport and energy²⁷⁸. Several indicators verify that Russian companies follow the statements made in the unofficial program by Russia's MFA. American think-tank "Stratfor" pointed to Russia's efforts to weaken the unity of Baltic States, with Latvia being the closest partner for Moscow in the Baltics²⁷⁹. One example of this is the construction of the LNGT, where a willingness to participate from the Russian side is clearly seen. A second one is the project to build a high speed rail line between Rīga and Moscow, which is now on the bilateral agenda. This theoretical project would be a serious competitor to the "Rail Baltica" project that would run between the three Baltic States.

Russian interest in Latvian enterprises is not exclusively in the field of transport and logistics – there are Latvian companies in industry and the banking sector that also have strategic significance for Latvia's economy. The main approach used by Russian businessmen to enter the Latvian market is buying companies or shares of companies with some financial problems and/or clearly visible business potential for the future. It is cheaper to buy a company with existing assets and an operating business plan than it is to start as an entrepreneur. The task is to assess which cases are a matter of political interests – to take a control of Latvian enterprises with strategic importance – and which are simply business interests to earn a profit.

Russian interest in Latvian banks over the past years few years has been remarkable. For Russian companies, Latvian banks mean an access to the Western financial market. Some Latvian finance experts even describe Russian

interest in Latvian banks as an invasion, while at the same time Russian capital in Latvia's finance sector is assessed as positive²⁸⁰. Following a scandal in 2005 when two Latvian banks, VEF Banka and Multibanka, were accused of money laundering, Latvia's banking system has become more transparent and stable²⁸¹. This creates more mutually beneficial conditions both for new investors and for Latvia's economy because the Financial and Capital Market Commission regularly inspects the financial situation of each bank.

Indicative of this is the connection between new Russian bankers in Latvia and the Russian political elite. The owners of the former Multibanka – currently SMP (Severny Morskoy Putj) bank – since 2008 have been the brothers Arkady and Boris Rotenbergs from Saint Petersburg²⁸². Arkady Rotenberg has known Russian President Vladimir Putin for more than 40 years, when they went to the same judo training group²⁸³. With about 0.5% of the market share²⁸⁴ in the Latvian banking sector, SMP Bank has no systemic importance to Latvian macroeconomics. A. Rotenberg has no further interest in developing its banking business in Russia because of the financial crisis²⁸⁵, but expanding in the European direction is seen as more desirable. SMP bank is a small bank dealing with small and medium sized entrepreneurs in Russia. The main function of the Latvian bank is to serve the interests of its clients from Russia and CIS countries that have businesses in Europe. The connection between the Rotenbergs family and Putin, as well as the achievements of the Rotenbergs in other business areas, can be assessed positively both from the perspective of the "political stability" and the economic stability of the bank. The Rotenbergs brothers have businesses in many areas in Russia, including: construction, hotels, insurance, the banking sector, the alcohol industry and the food industry²⁸⁶. For the most part these businesses can be characterized as adhering to the post-soviet traditional business style known as "kupi i prodaj" (buy and sell). The Rotenbergs simply buy companies with debt

277 *Itera Latvija* iecerētais sašķidrinātās gāzes termināļa projekts ir izstrādes stadijā. BNS, 25.04.2005. <http://terminal.bns.lv/archiveNewsBody.jsp>.

278 О Программе эффективного использования на системной основе внешнеполитических факторов в целях долгосрочного развития Российской Федерации. Русский Newsweek, Россия - 11 мая 2010 г. <http://perevodika.ru/articles/13590.html>.

279 Clinton's deliberate visits on Russia's doorstep. EuroActiv, 27.06.2012. <http://www.euractiv.com/security/us-clintons-deliberate-visits-ru-analysis-513597>.

280 Mārtiņa I. Latvijas banku sektorā Krievijas bankjeru invāzija. Dienas Bizness, 03.08.2011. <http://www.db.lv/finanses/bankas/latvijas-banku-sektora-krievijas-bankjeru-invazija-242507>.

281 *Ibid.*

282 Бигман В. Новые Русские Банки. *Открытый город*, Август 2011. p.12.

283 Интервью с Аркадием Ротенбергом - Никто не может сказать, что я кого-то унизил, у кого-то что-то отнял. Коммерсант, 28.04.2010. <http://www.kommersant.ru/doc/1361793>.

284 Banku darbības rādītāji 2011.gada 3.ceturksnī. Latvijas Komerbanku asociācija, <http://www.bankasoc.lv/lka/statistika/bankas/article.php?id=3665>.

285 Интервью с Аркадием Ротенбергом - Никто не может сказать, что я кого-то унизил, у кого-то что-то отнял. Коммерсант, 28.04.2010. <http://www.kommersant.ru/doc/1361793>.

286 *Ibid.*

to SMP bank and sells them to others²⁸⁷. At the moment there is no indication of their other business interests in Latvia, but the presence of such influential Russian capital in Latvia is notable per se.

In the summer of 2011, a billionaire from Saint Petersburg, Andrei Molchanov, bought Latvijas Biznesa Banka²⁸⁸ and some weeks later received a penalty fine (of 80,000 lats) from the Financial and capital market commission of Latvia for procedural offenses in the takeover process²⁸⁹. The buying of only a banking license, and approaching the procedures carelessly, is evidence that it is not the Latvian banking sector, but rather a banking license in the EU that really matters for A.Molchanov. He owns the largest construction company in Saint Petersburg, Group LCR (Lenstroirekonstrukcija). Molchanov is also a politician – a member of the Federal Council from Saint Petersburg. His stepfather, Yuri Molchanov was a colleague of V.Putin in the Saint Petersburg City Council in the early 90s²⁹⁰. It is unlikely that he would begin a construction business to Latvia. The local market is still saturated by Latvian construction companies, and moreover the market is small compared to Saint Petersburg. Molchanov's name has been mentioned in the context of Latvia's Russian-language press acquisitions²⁹¹. In such case two new dimensions for Russian investments to Latvia would be open. First, it will help to develop the local media market and offer better products for consumers in the competition with the local and Scandinavian press businessmen. Second, the businessman, media mogul and politician - this combination is known under the term oligarchy in the post-Soviet space. The direct impact of politician on foreign media space indirectly implies the use of soft power strategies.

Igor Ciplakov bought the American-owned GE Money Bank (currently Rigensis Bank), changing American capital to Russian²⁹². Igor Ciplakov had a banking business in Russia until 2007, when he was a shareholder in Nomos Bank. Currently, he is the head of carriage building facility Tikhvin Freight Car Building Plant, which makes him a private entrepreneur²⁹³. As with other new Russian bankers in Latvia, he plans to build a bridge between Russian businesses

and the EU. The bank in Latvia has no systemic importance for the Latvian economy. It could serve as a platform for further investment from Russia and CIS countries, but instead it will be as transaction point for Russian businessmen to the EU and vice-versa.

Despite some prominent business figures with a presence in both Russia and Latvia that have good relations with Russia's political elite, the impact of Russian capital on the Latvian finance sector is relatively weak. Russian bankers look at the Latvian banking sector as an almost saturated market in which the Scandinavian banks have a huge and stable base of clients. Russian banks will therefore focus their client-base on Russia²⁹⁴. The main function for new Russian banks in Latvia is to serve the interests of their shareholders and their businesses. Investment in real sectors of Latvia's economy is not expected at moment from the Rotenbergs brothers, A.Molchanov or I.Ciplakov. However, the presence of these new Russian bankers in the Latvian financial market indicates several things. Firstly, none of these are random bankers from medium-sized businesses in Russia. The Rotenbergs brothers, A.Molchanov and I.Ciplakov are prominent business figures in Moscow and Saint Petersburg, and they have good connections with Russia's political elite. This once again confirms that political connections are desirable even for opening a medium sized bank in Latvia. Secondly, none of the new Russian bankers have a plan to develop a serious commercial structure in Latvia. They instead want to use Latvia as a window for financial transactions between Russia and other EU countries. It is useful both as the closest capital city to Moscow and because of a similar business culture. This is likely only the beginning of a larger invasion of Russian bankers and finance brokers to Rīga. For Russians in Latvia, the distance is close, the business language is the same, and it is a way to open the EU market.

One of the largest and most controversial cases of Russia's business presence in the Latvian financial sector has been case of Latvijas Krājbanka. Until November 2011, the activities of Russian billionaire Vladimir Antonov seemed like those of a typical Western-minded investor who wants to earn money and provide advantages to Latvia's economy. He was the very picture of a Russian investor from a respected bank in Lithuania. Transatlantic Holdings Company, where Antonov was a member of board, invested in Latvijas Krājbanka (with a 45% share) and airBaltic (with an 11% share)²⁹⁵. Both of these enterprises are

287 Интервью с Аркадием Ротенбергом - Никто не может сказать, что я кого-то унизил, у кого-то что-то отнял. Коммерсант, 28.04.2010. <http://www.kommersant.ru/doc/1361793>.

288 Formerly owned by the Bank of Moscow.

289 FKTK piemēro 80 000 latu sodu «Latvijas Biznesa bankas» jaunajam īpašniekam. Apollo. 07.07.2011. <http://www.apollo.lv/portal/news/articles/243226>.

290 Бигман В. Новые Русские Банки. *Открытый город*, Август 2011. p.13.

291 Prasa atzīt par maksātnespējīgu SIA „Telegraf”. Latvijas Avīze, 10.07.2012. http://la.lv/index2.php?option=com_content&view=article&id=354834:prasa-atzt-par-makstnespigu-sia-qtelegrafq&layout=print&tmpl=component&Itemid=.

292 *Ibid.*, p.14.

293 Akcionāri. *Rigensis Bank*, http://www.rigensis.lv/lv/par_banku/akcionari.html

294 Pavlovs S. Biznesa medības. *Ir*, 04.-10.08. 2011. 17. lpp.

295 Par airBaltic akcijām samaksājis ar Antonova biznesu saistīts Luksemburgas finanšu uzņēmums. *Dienas Bizness*, 14.09.2011. <http://www.db.lv/razosana/transports-logistika/par-airbaltic-akcijam-samaksajis-ar-antonova-biznesu-saistits-luksemburgas-finansu-uznemums-244590>.

less dependent on Latvian-Russian political relations, but both have strategic importance to the banking and transport sectors of the Latvia's economy. Furthermore, in the case of Antonov there were no clear signals about his connections with Russia's political elite, which meant there was also the lack of a connection with Kremlin politics. Antonov highlighted the factors that are attractive for Russian investment to Latvia: the mentality, general knowledge of the Russian language, a similar historical experience and well known brands from the Soviet period, for example the seaside resort town of Jūrmala. Unfortunately, the Antonov case became a new experience for Latvia not as a success story but as the worst example of investment in Latvia.

In November 2011, the institutions that monitor the financial sector in Latvia and Lithuania discovered a shortage of hundreds of million of euros both in Snoras Bank in Lithuania and in Latvijas Krājbanka in Latvia. The main shareholder in both banks, Antonov, was accused of illegal activities, namely transferring the missing money to his other businesses. The result was the closure of both banks and a growing dissatisfaction with banking system and the banking sector's supervisory institutions. The example of Sweden (which is the direction that Latvian politicians would like to go in terms of investment policy) could again be enlightening for Latvia. Sweden refused to allow any of Antonov's capital into the pride of the Swedish motor industry, Saab even at a time when the company was close to bankruptcy²⁹⁶. The oldest commercial bank in Latvia was closed and difficulties in the biggest airline in the Baltic States arose following the activity of Antonov. The case of Antonov proved that there is a need for more scrupulous and deeper monitoring over potential investments, especially from Russia. At the same time, it showed that enterprises with strategic importance could also be endangered by businessmen with no clear contacts with the Russian political elite and no mention in strategic documents from Russia's MFA.

An example of unwelcome investment from Russia in terms of its economic strategy toward Baltic States is the Russian company Sveza's attempt to buy Latvijas Finieris. The owners of Latvijas Finieris claimed that the Russian company did not have the aim to develop infrastructure or improve the financial results of Latvijas Finieris, but instead had the purpose to move Latvian technologies to Russia²⁹⁷. In this case, Sveza would like to buy a brand and entry to the EU market, but produce the goods in Russia. To save Latvijas Finieris, the Latvian

296 Kinnander O. EIB Says Decision to Block Antonov From Saab Investment Stands. Bloomberg, 28.0.2011. <http://www.bloomberg.com/news/2011-07-28/eib-says-decision-to-block-antonov-from-saab-investment-stands.html>.

297 "Sveza" īsteno rupju mežonīga kapitālisma uzbrukumu. *Financenet*, 24.10.2010. http://www.financenet.lv/viedokli/351216-sveza_isteno_rupju_mezoniga_kapitalisma_uzbrukumu.

government (namely JSC "Latvijas Valsts meži") bought a considerable package of shares of "Latvijas Finieris", thereby preventing its buying from "Sveza" from buying it. These actions helped to maintain the Latvian capital in the "Latvijas Finieris". However, this has been a rather an extraordinary case, as the Latvian government and state enterprises can not prevent each attempt to buy a Latvian enterprise with an assumed strategic importance.

Despite the competitiveness problems of the Latvian dairy industry, these companies are another object of interest for Russian investors. For example, Andrei Beskhmelnickiy bought *Rīgas Piena Kombināts* and Yevgeniy Varov bought *Valmieras piens* in 2011. They are planning to expand milk production, then export milk products to Russia. Another plan is to unite the two enterprises, thereby establishing one explicit leader of the Latvian dairy business. This seems to be very progressive considering the structural problems of the industry that were noted in the previous section of the paper. Beskhmelnickiy notes that in becoming a Russian milk-magnate, he merged 35 Russian dairy enterprises²⁹⁸. By merging *Rīgas Piena Kombināts* and *Valmieras piens*, the new enterprise will become the biggest milk producer in Latvia, and the fifth biggest in the Baltic States. In the present situation, when Lithuanian milk companies are squeezing Latvian companies out of the market, the emergence of one big player could be a solution for better competitiveness in the local market. Furthermore, the aim of Russian businessmen is to export Latvian products to the Russian market and CIS countries²⁹⁹. If the deal would really boost the export of Latvian milk products eastward, this case may serve as an example of how Russian investment can contribute to solving structural problems in some sectors of the Latvian economy. However, a look at the previous business deals made by Beskhmelnickiy in Russia may also reveal serious risks for the future existence of the Latvian dairy industry. His previous activity in the dairy industry gives the picture of a speculator, rather than a developer. Beskhmelnickiy has merged dozens of dairy companies under his *Unimilk* brand in Russia and sold them to French company *Danone*³⁰⁰. The result of merging several dairy companies was bankruptcy in Russia's regions. The key issue to Beskhmelnickiy's business in Latvia: does he really want to develop milk exports to Russia, or does he simply want to sell the business on? Hence, his previous businesses activity in the dairy industry raises some concerns about his business goals in Latvia.

One of the best examples of how Latvian and Russian businesses could

298 Petrāne L. Beshmelnickis: Šķēlem noteikti patiks piena ražošanas bizness. *Dienas Bizness* 15.11.2011. <http://www.db.lv/razosana/partika/beshmelnickis-skelem-noteikti-patiks-piena-razosanas-bizness-248150>.

299 *Ibid.*

300 Сикорский Р. Поменял «Омский бекон» на «Манрос-М». *Коммерческие Вести*, 17.07.2006. <http://kvnews.ru/archive/2006/jur26%28749%29/business/4975/>.

result in mutual benefit is the company *Severstallat*. Originally it was a joint stock company composed of the Russian *Severstal* and the Latvian holding company *Felix*³⁰¹ that bought metal from Russia, gave it additional value in Latvia and finally sold the metal products to EU countries³⁰². After the economic crisis, Latvia has been especially interested in sectors that are related to the real economy, such as production. *Severstallat* is such a company, and the chief of *Severstallat*, Andrei Alekseev, mentions the significance of stability, especially in fiscal policy³⁰³. Without predictable business conditions (stable tax rates in the long term, support mechanisms for exports, a small bureaucracy) it will be a problem to attract investment for foreign entrepreneurs, including those from Russia.

One of the few examples where a former flagship of Soviet production has been recovered is tied to Russian investment. The Latvian company *RER* (*Rīga Electric Machine Building Works*) is part of Russian holding company *EDS*³⁰⁴. *RER* produces electric trains and carriages. About 90% of overall production goes to Russia³⁰⁵. The company gives jobs to more than one thousand employees, with plans to expand and triple their output in the next few years.

The real estate sector has increasingly been attracting Russian investments. In 2010, the Latvian government changed the Law on Immigration to provide a residence permit for foreigners who invest in the real estate market in the amount of 50-100 thousands lats. One year after the law change came into force³⁰⁶, Latvia has obtained about 1.6 million lats from taxes³⁰⁷. The total value of real estate deals totals about 45 million lats, and about 800 people have gotten the temporary residence permit³⁰⁸. About 80% of the deals have been signed with residents of Russia³⁰⁹. The gains for Latvia are small, but interest from Russia is pretty high. Also, some prominent business figures from Russia – including Yuri Shefler (*Z-Towers*, *LB Agro*) and Viktor Vekselberg (*New Europe*) – have invested

in real estate projects in Latvia. The expansion from Russia and other CIS countries into the Latvian real estate market has a two impacts on the economy. First, it helps to provide a relatively small additional amount of taxes to the Latvian GDP. Second, by keeping this law in long-term there is the possibility of a jump in prices in the Latvian real estate market, which could result in another bubble of real estate prices.

While finance brokerage, industry and real estate businesses are mostly dependent on the market situation, Latvia-Russia cooperation in transport and logistics is mostly dependent on bilateral solutions to improve these areas. Within the framework of the Latvia-Russia IGC, Russia is trying to gain the use of Latvia's territory as a transport corridor for its road shipments to Europe. The main problem that needs to be solved is the cumbersome procedure at the interstate border crossing. Latvian road carrier association *Latvijas auto* has several times asked the Latvian government to solve the problem of the queue at the Latvian-Russian border³¹⁰. Russian road carriers have an interest in the Latvian transit corridor using maritime traffic from Liepāja to Germany, with the aim of avoiding Poland for their logistics. The intergovernmental commission is working to solve this problem by trying to double the rate of passage at the Latvia-Russia border in both directions, and to improve logistics between Latvian ports and European countries³¹¹. The future task for Intergovernmental Commission in the field of transport and logistics will be the continued development of the West-East transport corridor and its harmonization with North-South transit. Today, the potential of Latvia's geographical advantages is not used properly, because the West-East direction (Russia and Belarus) through the road, railroad and port system is used less frequently than in the 90s, and development in the North-South direction is still in the early stages.

Despite the development of Russian ports in the Baltic Sea, Latvian ports still have many relative advantages for Russian businesses. Theoretically, the development of the Ust-luga port could decrease the total amount of Russian freight traffic in Latvian ports by 50%. Today, 80% of all freight cargo in the Rīga port comes from Russia and other CIS countries³¹². The Ventspils and Liepāja ports are also working with partners from the East. One recommendation on how to keep Russian companies in Latvian ports is to sign long-term agreements with them and allow them to build their own terminals. One example is the long-

301 Currently owned by the Austrian company "Severstal Trade GMBH". "Severstal Trade GMBH" has invested 10,5 million lats in Latvia. (Lursoft).

302 Ладигин С. Северсталлат завоевывает Европу. *Открытый Город*, 05/2011. p. 31.

303 *Ibid*.

304 Kaļūznis: Latvijai nav jābaidās no Krievijas investīcijām. *Delfi Bizness*, 02.12.2007. http://business.delfi.lv/biznesa_vidē/kaluznijs-latvijai-nav-jabaidas-no-krievijas-investicijam.d?id=19403180.

305 Rīgas Elektromašīnbūves rūpnīca plāno trīskāršot ražošanas apjomus. *Diena*, 08.06.2012. <http://www.diena.lv/bizness/razosana/rigas-elektromasinbuves-rupnica-plano-triskarsot-razosanas-apjomus-13951649>.

306 The law change came into force on July 1 of 2010.

307 Saeimas deputāti vērtēs termiņuzturēšanās izsniegšanu ārzemniekiem apmaiņā pret ieguldījumiem un īpašumiem Latvijā. *Diena*, 02.10.2011. <http://www.diena.lv/latvija/zinas/saeimas-deputati-vertes-terminuzturesanas-izsniegšanu-arzemniekiem-apmaina-pret-ieguldijumiem-un-ipa-13906741>.

308 *Ibid*.

309 Pavlovs S. Biznesa medības. *Ir*, 04.-10.08.2011. 18.lpp.

310 Autopārvadātāji lūdz palīdzību valstij un pieļauj protestus. *Diena*, 20.02.2009. <http://www.diena.lv/papildinata-autoparvadataji-ludz-palidzibu-valstij-un-pielauj-protestus-653035>.

311 Noslēgusies Latvijas un Krievijas Starpvaldību komisijas pietā sēde. LR Ekonomikas ministrija, 10.06.2011. <http://www.em.gov.lv/em/2nd/?id=31718&cat=621>.

312 Iļjinska K. Ostu miljoni. *Forbes*, 05/2011. 50.lpp.

term contract between Riga port and the biggest producer of ammonium nitrate in Russia, *Uralchem*. In 2012 *Uralchem* is scheduled to finish its own fertilizer terminal in Riga Commercial Port³¹³, which will confirm its presence in the Riga port for the long-term.

Generally, Latvian ports have three main advantages over Russia. First, the free-port status means there are cheaper port services – for example, service providers do not need to pay taxes for fuel and electricity³¹⁴. Second, Russian ports are mainly controlled by particular business interests and groups, which establishes a business strategy for ports in the name of particular groups, rather than the rules of the free market. For example, a magnate of metallurgy, Vladimir Lisin, is named as a main controller of the Ust-Luga port³¹⁵. Third, Latvian ports mean direct entry to the market of the EU for Russian businessmen. These arguments should be united in a common practical strategy for planning the development of Latvian ports, and these advantages can serve as arguments for deeper business cooperation with Russian companies. According to the data of the Latvian Maritime Academy, Latvian ports every year contribute about 6% of the total GDP of Latvia³¹⁶. In this example, the development of cooperation with Russian companies through Latvian ports would be very valuable for the entire economy of Latvia.

In railway transport, where Latvian company *LDz Cargo* holds 75% of all freight traffic in Latvia, the newcomer from Russia, *Eiro Rail Trans*, could make a claims for a considerable share of the market. The shareholders of *Eiro Rail Trans* are *Russian Railway Logistics* (owned by Russia) and *TranstradeRiga* (owned by two Estonian companies)³¹⁷. The new company is planning to focus on the transport of oil products, coal and chemicals from Russia and Belarus to Latvian ports. The activity of the new company will inevitably weaken the position of *LDz Cargo* in Latvia. At the same time, it will develop competition in Latvia's railway services. Another aspect of this is that presence of a Russian state owned railway company in the chain of Russian oil, coal and chemical transit to Latvian ports indicates commitment to a long term strategy for Russia. It will continue to use Latvian railway and ports for its exports, independently of the development of Russia's own ports in the north.

Russia is an important trading and investment partner for Latvia. However,

313 Rīga Fertilizer Terminal. *Rīgas tirdzniecības osta*, <http://www.rto.lv/lv/pakalpojumi2/terminalis/riga-fertilizer-terminal-x/>.

314 Iljinska K. Ostu miljoni. *Forbes*, 05/2011. 50.lpp.

315 *Ibid.*

316 Iljinska K. Ostu miljoni. *Forbes*, 05/2011. 50.lpp.

317 Krievijas Dzelzceļš Latvijā dibina uzņēmumu – potenciālu LDz konkurentu kravu nogādāšanā līdz Latvijas ostām. Delfi Bizness, 13.03.2012. <http://bizness.delfi.lv/uznemumi/krievijas-dzelzcelis-latvija-dibina-uznemumu-potencialu-ldz-konkurentu-kravu-nogadasana-lidz-latvijas-ostam-1448.d?id=42203114>.

Russia's investments are a more relevant indicator of its political interests than its trading figures. Still, Russia's biggest impact is seen on the energy sector in Latvia. Investments from Russia in the natural gas sector made in the 90s are still cost-effective today. The influence of *Gazprom* on Latvia's energy policy is growing gradually through the market value of *Latvijas Gāze*. Another trend is observable with regards to Russia's investment in oil transit in Latvia. Investments made by the *Transnefteprodukt* in the 90s are of minor value after the closure of the crude oil transit route via Ventspils. Until the economic crisis of 2008, there were particular sectors (energy, transport, and heavy industry) with a notable amount of Russian investment. The economic crisis and the improvement of political relations lessen both financial and political barriers for Russian companies to have business in Latvia. Since 2008, Russian capital has been invested more in Latvia's banking sector, food production and real estate. Some of the companies with Russian capital (*Latvijas Krājbanka*, *Rīgas Piena Kombināts*, *Valmieras piens*, etc.) or with a relative dependency on Russian capital (*airBaltic*) also have strategic importance for Latvia's economy. Considering the document of Russia's MFA, the Program for the Effective Utilization of Foreign Political Factors on a Systematic Basis for the Purpose of the Long-Term Development of the Russian Federation, every Russian investment to an enterprise with strategic significance should be monitored. The crash of *Latvijas Krājbanka* is not a case of this, but the efforts to buy *Latvijas Finieris* at any cost or the idea to merge the flagships of Latvia's dairy industry should be considered more seriously.

There are two aspects of why Russia would like to do business in Latvia that are independent of the economic crisis and the development business interests at the political level. First is Latvia's geographical advantages, especially in the transit sector, which could be used for linkage between the EU and Russia. Latvian transport companies and ports should identify and strengthen their comparative advantages with regard to Russian competitors. Second, informal networking in the political and economic environment in Latvia is the basis for new business deals. Serious businessmen from Russia usually also have good contacts with the Russian political elite. Earlier there was Yuri Luzhkov, who was a politician. Today there are new bankers who are willing to use Latvia as a financial corridor to the EU.

Finally, the contribution of Russian investors to sectors of the real economy (excluding energy and transport) of Latvia is still small. Moreover, the portion of Russian investment into speculative economic sectors, such as banks and real estate, could be based more in the real economy. Investment in the banking sector and real estate are also growing from third countries that traditionally

handle Russian capital: Malta³¹⁸, Cyprus³¹⁹, Switzerland³²⁰ and Luxembourg³²¹. These investments have not had a negative impact on the Latvian economy *per se*. Nonetheless, investments into sectors of the real economy – such as industry, infrastructure, and services with added value – have to be a priority for the attraction of investment from every country. Public authorities from both Latvia and Russia are not interested in promoting an original “offshorization” of Latvia, whereby gray or black capital from Russian private investors flows into Latvia in large amounts. The biggest exceptions are energy company *Itera Latvija*, which is officially owned by Cyprian and Danish companies and Russian entrepreneur with Israeli citizenship Yuri Shefler, who mediatedly³²² owns the biggest alcohol producer in Latvia – *Latvijas Balzams*.

Conclusions and recommendations

The general trend of Latvian-Russian economic relations over the past three years has been the improvement of the legal framework, institutional cooperation and political dialogue at both the highest level and at the municipality lever. The visit by President Zatlers to Russia did not become a sharp turning point in bilateral relations, but was rather a necessary part of a wider process in which both countries are trying to define areas of mutual political and economic interest. For instance, regional cooperation, the development of a legal framework, and focusing on transport and logistics issues at the highest level have been the main achievements of this process.

Another task for this process is the development of new areas of business cooperation, using the fact that the political and business climate is improving. Russian investment in Latvia's banking sector, production and real estate is a relatively new tendency. This is partly explainable by the current improvement in interstate relations. The other part of the explanation are the aspects of

geography and the business culture, which are both favorable for mutual business cooperation. In addition, Latvia is a member of the EU and Russia will become a member of the WTO, which also creates greater potential for new areas of business cooperation in both directions.

The intensification of business cooperation also means there will be a deeper mutual interdependency. Considering Russia's economic capacity compared to Latvia's, it is important to define where interdependency could transform into dependency on Russia. Latvia already has experience on relative GDP dependency on incomes from Russia's crude oil transit through Ventspils, and ongoing dependency on Russia's gas. Those are still dependencies that are bound to Latvia's integration in the Soviet energy infrastructure, which is not easy to break even in over a period of twenty years. Latvia's economy in every sector is relatively small compared to the opportunities for serious Russian investors. Besides, at the moment big investments from Russia only come from entrepreneurs related to the political elite of Russia. It does not matter whether this phenomenon is related to Russia's special foreign policy interests or simple business culture of Russians. The reality is that every investment from Russia in the strategic sectors is systemically significant for the future of Latvia's economy.

Four recommendations may be provided to those involved in the decision making process for Latvian economy. First, it is important to use the existing positive political climate for the further improvement of the legal framework surrounding business cooperation between Latvia and Russia. The main format of the political dialogue – the IGC – should be at the top of the pyramid of solutions for better business cooperation. Experience indicates that this format could be successful. It helps to take practical steps in the fields of transport and logistics, and Business Council of the IGC is mainly a forum for businessmen related to politicians. The IGC and Business Council should not become a forum only accessible for businessmen who are closely related to the political elite. It must be an open format for every kind of business cooperation between Latvia and Russia.

Second, there is the unused potential to strengthen both Latvia's export capacities and our comparative advantage in attracting Russian investments. Food exporters from Latvia mainly use a market strategy of tying themselves to the most famous brands from Soviet times, which is suitable for Russian consumers. For other sectors, the starting point should be the same as for food producers – the unification of export capabilities using a common brand for the Russian market. After that is necessary to find a common marketing strategy. The example of food production and real estate reveals that Russians still buy production

318 Company “Boswell Consulting Limited” (registered in Malta) has invested 33,1 million lats to the “Rietumu Banka”. (Lursoft).

319 The “LTB bank” (owned by the Russian entrepreneur Igor Kim) has its EU branches only in Latvia and Cyprus; “AR Entertainment Limited” (registered in Cyprus) and owned by the “Rietumu banka” invested 11,4 million lats in buying “Arēna Rīga” in 2010. (Lursoft).

320 Investments of private person Yuri Shefler (7,9 million lats) in his real estate projects officially comes from the Switzerland. (Lursoft).

321 Muižnieks N. Latvian-Russian Relations: Dynamics since Latvia's Accession to the EU and NATO. *University Of Latvia Press*, 2011, p.56.

322 Y.Shefler owns the Dutch company *S.P.I. Regional Business Unit*, which is the biggest shareholder of *Latvijas Balzams* (by 85%).

facilities where there is the added value of Soviet sentiment. To strengthen Latvia's comparative advantage in the attraction of Russian investment, at first it is necessary to define these advantages clearly at the national level and in the context of foreign competitors. Russian entrepreneurs are still interested in using Latvia's transport infrastructure for their exports to the EU. The new trend is to exploit Latvia's status as a member state of the EU to utilize the finance brokerage business in Europe. In the future, Latvia should continue the development of transport infrastructure (namely in the East-West direction), and also improve the business climate and interstate legal framework.

Third, Latvia's public authorities responsible for monitoring foreign investment and economic crimes should improve their coordination at both the local level and with foreign partners, including Russia. An intensification of business relations with Russia is present, but it requires additional capacity and expertise for institutions working with this topic. It is important to remember that close connections between Russian business and politics is characteristic of the country. The case of Yuri Luzhkov's dismissal confirms the amount of risk inherent in investments from Russian companies closely tied to individual people who are not on good terms with Russia's political elite. Any nontransparent and uncertain investment from Russia could potentially hurt the reputation of Latvia as a reliable business partner in both Russia and the EU. The improvement of the banking sector after the 2005 money laundering scandal is an example of how to manage the investment climate. However, for Latvia's public authorities it is still hard to prevent financial crimes related to apparently welcome investments (as the case of Antonov and *Latvijas Krājbanka*). The country should be wary of indirect Russian influence, whereby different business groups related to Russia hamper infrastructure projects in the Baltic States that are not favorable to Russian geopolitical interests.

Fourth, Latvia's approach to business relations with Russia should be included into the wider scope of investment politics. To accomplish this the main task is to keep the strategic sectors of the Latvian economy under control, and to try to diversify the total amount of foreign direct investment. It is important for the Latvian government to assess not only the origin of Russian capital and investments in Latvia, but also the sectors of the economy that they are affecting. Investments from Russia are mainly large-scale and related to Russia's political elite. In every Latvian economic sector such investments are significant. Taking into account the role of finance brokerage and the real estate business in the economic crisis of 2008, there must be defined limits for foreign capital to avoid another real estate breakdown. In the energy sector, as well as in manufacturing,

the same requirements have to be taken into account to stop successful Latvian-Russian economic cooperation from turning into unwanted Latvian economic dependence on investment from Russia.

BUSINESS INTERESTS BETWEEN LATVIA AND BELARUS: LOOKING BEYOND THE OBVIOUS

Didzis Kļaviņš

This chapter aims to look beyond the obvious aspects of Latvia-Belarus economic relations in order to explain a seemingly flourishing business relationship over the last couple of years, despite the gloomy outlook for Belarus in the view of the Western community. Dynamic trade and investment volumes, as well as high-profile official visits from both countries, seem to indicate a new turning point in relations between Latvia and Belarus. Although there are more questions than answers, the overriding goal of this chapter is to examine and analyze Latvian companies involved in the economic relationship with Belarus, and *vice-versa*. Therefore, the first section will briefly highlight the following issues: general economic trends between Latvia and Belarus, and the characteristics of Latvian economic policy toward Belarus in the last few years. The second section will examine the activities of Latvian companies in Belarus, including an analysis of the major obstacles, risks and opportunities of doing business in Belarus. What are the main challenges for Latvian entrepreneurs and companies? What difficulties do the companies doing business in Belarus face? What are some of the success stories of Latvian companies in Belarus? The third section will focus on the presence of Belarusian investment in Latvia. In the conclusion, the main findings from each part will be summarized to shed light on the business-related questions that Latvia should pay special attention to. This study is designed to illuminate the important but sometimes neglected aspects of Latvia's foreign economic relations with Belarus.

1. Recent trends in Latvia-Belarus economic relations

For several years Latvia's official policy towards Belarus has been reactive and vigilant, and has largely been determined by EU policy. Although Latvia has consistently emphasized the observance of basic principles of democracy and human rights in Belarus since the renewal of independence, geographic proximity and economic profitability has suppressed a very tough stance toward Lukashenko and his regime. Up until now, Latvia has acted with circumspection and deliberation. Despite political difficulties between the EU and Belarus, Latvian-Belarusian economic cooperation has gone its own way. Cooperation

between both countries has become more intensive over the last five years. Indeed, entrepreneurs and business people, as the driving force of the market economy and sustainable growth, more frequently ask the question: What are the next steps toward scaling up bilateral economic ties? In fact, the growth dynamics of relations appear not only in economic cooperation, but also in political cooperation.

While the volume of Latvia's external trade with Belarus is relatively small, it has the potential to grow at a faster rate than before the economic crisis. In 2011, the volume of export goods from Latvia to Belarus was LVL 107.7 million, which is 7% higher than in 2010. From 2005 to 2011, the turnover of exports almost doubled. Despite the global financial crisis that started in 2008, the volume of commodity imports has increased considerably, reaching LVL 341.2 million in 2011 (see Table 1). The data presented here also shows a strong asymmetry in exports and imports, as well as an urgent need to expand Latvia's foreign economic relations with Belarus.

Table 1. The dynamics of commodity exports and imports (mln. LVL)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Exports	13.7	22.5	21.2	23.9	45.1	57.6	75.9	92.6	98.0	92.2	99.8	107.7
Growth, %		65	-6	13	89	28	32	22	6	-6	8	7
Imports	66.5	85.3	68.2	110.8	181.5	281.5	297.7	256.7	250.0	163.3	202.4	341.2
Growth, %		28	-20	62	64	55	6	-14	-3	-35	24	68
Saldo	-52.8	-62.8	-47.0	-86.8	-136.3	-223.9	-221.8	-164.1	-152.0	-71.1	-102.6	-233.5

Source: Central Statistical Bureau of Latvia. Annual Reports of Central Statistical Bureau; Monthly Bulletin of Latvian Statistics, Riga, February, 1(200)/2011.; Baltkrievija (Belarus) <http://www.liaa.gov.lv> (Investment and Development Agency of Latvia (LIAA); published 01.04.2012).

In 2011, Belarus ranked 12th among Latvia's export partners and 7th with regard to imports. The main export commodities to Belarus were machinery and mechanical appliances; electrical equipment (16%), transport vehicles (15%), products of the chemical and allied industries (14%), as well as textiles and textile articles (12%). In that same year, the main important commodities to Latvia were mineral products (58%)³²³ and base metals and articles of base metals (26%). As the data clearly shows, the export and import policy is tightly connected with the development of the transit, transport and logistics industries. At the beginning of 2011, Belarus started increasing the export of commodities to Latvia and its ports

³²³ Petroleum oils, other than crude, are the most important Belarusian export group to Latvia.

by 28.9% over the same period of the previous year.³²⁴ More recently, in January-February 2012, it has been announced that trade between Belarus and Latvia has increased more than three and a half times.³²⁵

Statistically, Latvia is one of the main trading partners of Belarus. In 2011, Latvia ranked 4th by volume for Belarusian exports, after Russia, the Netherlands and Ukraine (see Appendix: Tables 5-11 show the development of bilateral trade and its structure). In fact, these numbers can reveal much more than we think, especially if we consider the latest compromise among the EU 27 governments and the decision to expand economic sanctions against Belarus.³²⁶ In the next sections, this debate will be brought into the spotlight by situating the economic interests of Latvia within 'the ongoing EU-Belarus dialogue'.

In taking a closer look at bilateral economic relations, it is worth analyzing the key areas of cooperation. The question of transit policy is obtaining increasing importance in economic cooperation between Latvia and Belarus, especially opportunities to increase the cargo transit volumes through the ports and railway services of Latvia. Although an increase of activity in the promotion of transit traffic with Belarus has been observed in recent years, the potential for cooperation is far greater than at present.

The major ports of Latvia – Riga, Ventspils and Liepaja – have served as a gateway between East and West since their formation. Nowadays, Latvian ports, as a part of the united network of Baltic States' ports, are called "the gateway of the European Union to the Eastern markets," mainly associated with Russia.³²⁷ However, looking closer at this strategically important corridor of cooperation infrastructure, cargo routes are not confined only to Russia. For several years a significant level of development has been built up with Belarus, offering the neighboring country transit routes for export and import cargoes through the

³²⁴ Belarus's merchandise export to Latvia nearly 30% up in January-April. <http://news.belta.by> (Belarusian Telegraph Agency (BeITA); news published 02.06.2011).

³²⁵ Belarus-Latvia trade up more than 3.5 times in January-February. <http://news.belta.by> (Belarusian Telegraph Agency (BeITA); news published 29.03.2012).

³²⁶ On January 31, 2011, EU foreign ministers decided to impose asset freezes and visa bans on Belarusian President Alexander Lukashenko and 157 associates, in response to an opposition crackdown. A few months later, the EU extended sanctions by adding several more people on "the black list" as personae non gratae. In June, the EU introduced economic sanctions against three Belarusian companies supposedly linked to Alexander Lukashenko – "Beltechexport" (arms traffic), "BT Telecom" and the marketing company "Sportpari". Almost one year later the EU widened sanctions on Belarus. On March 23, 2012, the EU added 12 people and 29 companies to its sanctions against Belarus in reaction to what it called the deteriorating political situation in the country. Currently, over 200 people are facing such EU sanctions.

³²⁷ Freeport of Riga Development Programme 2009-2018 (Rīgas brīvostas attīstības programma 2009-2018). <http://www.rop.lv/lv/klientiem-un-investoriem/attistibas-programma.html> (Freeport of Riga Authority), p. 30.

territory of Latvia. The total transit capacity of Latvia consists of 10 ports connected to the roads and railway of the TEN-T net, as well as two oil and one transmission pipeline for oil products to Ventspils. Taking into account that approximately 90% of the cargo reloaded in the ports is transit cargo, there are attractive opportunities for the promotion of cooperation. The ports of Riga and Ventspils operate with the status of “free port”, and the port of Liepāja is a component of Liepāja Special Economic Zone (SEZ). Companies operating in the free ports and SEZ can get not only a tax rate of 0% of customs, excise and value-added taxes, but also up to an 80% discount on business income and property taxes.

Undeniably, Riga, as an important transport hub in the Baltic Sea region, has relatively successfully integrated into the transport network of EU, creating the opportunity to be one of the most convenient and attractive ports for cargo transport. Taking into account the geographically advantageous location of Riga, carriers can reduce significantly the cost and time of road and railway transport in highly competitive conditions. However, Riga – similarly to the ports of Ventspils and Liepāja, which mainly deal with the handling of transit cargo, shipping the majority of the transported transit cargo of Latvia – faces both internal and external risks. One of the factors affecting the size of consignments is political relations with neighboring countries and the development of transport infrastructure, such as the European railway network. Also indicative of the presence of potential risk is the following statement in the Riga Freeport Development program for 2008 to 2018, passed by Latvian Port Council: “the cargo turnover is affected most substantially by political decisions of the Latvian government, the EU, Russia and Belarus.”³²⁸ Looking back at recent history, it can be seen that disagreements of the prevailing domestic representatives may still be one of the main challenges and obstacles for successful Latvian ports and transit business development. But, of course, a great benefit for the long term would be the recurrent negotiations about the consolidation of all Latvian ports under one professional management body, offering a common strategic vision of development. This decision would have the benefit of attracting container cargo from Belarus.

An essential step in the promotion of transit traffic was made in 2009. Alongside Belarusian and Estonian railway companies, Latvia introduced a container train, “ZUBR”, created for the Minsk–Riga–Tallinn route. Currently the train, consisting of cars with universal and specialized containers, serves the route between Latvia and Belarus, and in the near future it will connect Latvia with the ports of Ukraine – Odessa and Ilyichevsk. The operator of “ZUBR” in Latvia is *LDz Cargo Ltd.*, a subsidiary

³²⁸ Freeport of Riga Development Programme 2009-2018 (Rīgas brīvostas attīstības programma 2009-2018). <http://www.rop.lv/lv/klientiem-un-investoriem/attistibas-programma.html> (Freeport of Riga Authority), p. 30.

company of the State Joint Stock Company *Latvian Railways (Latvijas dzelzceļš)*, while Belarus is represented by *Belintertrans* in this project. There are procedures for a simplified border and customs control within the framework of this cooperation project. The transit time on the Minsk–Riga route can hardly be reduced from two days to one in the foreseeable future, especially taking into account that traffic volumes with “ZUBR” are constantly increasing. There were 988 TEU transported with “ZUBR” in 2009, which in the year 2010 had increased to 2542, which is two and a half times more cargo. The “ZUBR” project – with its many benefits and advantages, such as rapid shipments, special rates for the delivery of goods and a simplification of customs control proceedings – has vast potential to grow further in the coming years.

In May 2011, as widely predicted, the port of Ventspils completely lost the Belarusian potassium salt cargo, which is now being handled in Lithuania at the Klaipėda port. In the first quarter of 2011 the Belarusian supplier of potassium salt, *Belaruskalij*, had not used the “Potassium Park” terminal in the port of Ventspils. The representatives of the company say that this was due to economic reasons – it is more profitable to carry the cargo in the direction of Klaipėda (cargo-reloading in the port of Ventspils is \$10-12 [4.74 to 5.69 lats] more expensive). On the other hand, at the beginning of the year the Chairman of the Board of SJSC *Latvian Railways* Uģis Magone gave another insight into the advantages of Klaipėda for Belarusian goods: as Magone pointed out, the cargo of Belarusian potassium salt is carried to the port of Klaipėda in Lithuania because Klaipėda is much closer to the Belarusian potassium salt factories, and thus the total traffic costs are lower. Although the “Potassium Park” and *Belaruskalij* concluded an agreement for three-years of cooperation in late 2009, this did not determine annual handling volumes. The Belarusian potassium salt supplier did not operate through the port of Ventspils in 2009, which was a result of the fall in exports during the economic recession. Although it may seem that the Belarusians have entirely gone from the port of Ventspils, “Potassium Park” is currently cooperating actively with Russian suppliers who use the port of Ventspils for potassium and also other fertilizers.³²⁹

Furthermore, there is active cooperation in the engineering industry and metal working sectors between Latvia and Belarus. These industries are included among the major sectors for interstate trade – accounting for 26.4% of Latvian exports to Belarus and 26.9% of Latvian imports in 2010. After a long break, in 2010 the JSC *Daugavpils Factory of Locomotive Repair* signed a new contract with the *Railway of Belarus* regarding capital repairs of the traction electric motor and the main generator for diesel locomotives. *Tractor Factory of Minsk MTZ* is the leading manufacturing company of tractor technology in Belarus.

³²⁹ Ventspils osta zaudējusi Baltkrievijas kālija sāls kravas (Ventspils Port has lost Belarus's potassium salt cargoes). *Business&Baltija*, 05.05.2011.

With the growing interest to foster and deepen mutually beneficial trade and economic cooperation between Latvia and Belarus, officials and citizens of both countries have increasingly tried to promote business dialogue and facilitate trade across borders. One indication of the intensification of relations was the establishment of the Latvian-Belarusian Business Cooperation Council in 2008. As one of the priorities of the Employer's Confederation of Latvia (LDDK) is strengthening Latvian foreign economic relations with other countries, this organization has been the initiator of the formation of the joint economic cooperation councils with employers' organizations in Belarus, Russia, Ukraine and Kazakhstan in the last three years. Encouraging every entrepreneur to engage actively in improving the work of these economic cooperation councils, the LDDK led the Latvian-Belarusian intergovernmental meeting on commercial-economic cooperation, which was held on the 29th and 30th of September, 2010, in Minsk. From the Latvian private enterprise perspective, two of the key issues discussed with the management of the Belarusian Confederation of Industrialists and Entrepreneurs were the measures taken toward Belarusian economic liberalization and planned privatization in the country. In its turn, the Belarussian delegation was interested in knowing more about the opportunity to expand their activities in Latvia by forming joint ventures for the production of innovative products, as well as applying for support options offered by EU structural funds.

Furthermore, since 2005 the "Latvian Society for the Promotion of Latvian-Belarusian Economic Relations" (*Latvijas un Baltkrievijas ekonomisko sakaru veicināšanas biedrība*) has been one of the most active players in facilitating business-to-business contacts. Today, the society encompasses 20 companies such as "Ventspils Tirdzniecības Osta", "M.T.Z.-Serviss", "SSF Logistic", "Kālija Parks", "Tehnobank" and "Belavia Riga".³³⁰ The companies' headquarters are mainly located in Riga and Ventspils, which are business activity centers. Thus, membership in the Latvian Society for the Promotion of Latvian-Belarusian Economic Relations provides a good platform to strengthen business contacts between Latvia and Belarus.³³¹ Moreover, it is also worth mentioning that the

330 All 20 companies are the following: "Greencarrier Latvia", "Nitraco", "Ventspils Tirdzniecības Osta", "GIGI", "M.T.Z.-Serviss", "SSF Logistic", "Ostas Flote", "Kālija Parks", "Mineral Trans Serviss", "Ventspils Grain Terminal", "Baltic Coal Terminal", "Tehnobank", "Baltic Oil Terminal", "Proventus Farm Pluss", "Indutek LV", "UHY Orients N", "DTLL", "Belavia Riga", "DLKD" and "VARUL".

331 Another good example is the "Diplomatic Economic Club", which held a meeting with Aleksandr Gerasimenko, Ambassador of the Republic of Belarus to Latvia, on March 31, 2011. As a guest speaker, the Ambassador received many questions about economic relations between Belarus and Latvia, and he emphasized two main directions for mutually beneficial co-operation. The first one is transit. According to Gerasimenko, Latvia is the major transit corridor for Belarus; up to 70% of Belarusian

Investment and Development Agency of Latvia (LIIA) is planning to open representative office in Minsk. In summary, Latvia-Belarus economic relations have great potential for further mutually beneficial cooperation. However, currently Latvia's external trade with Belarus is relatively small and is based too much on "a short-lived trend" as has rightly been pointed out Mihails Popkovs, Ambassador of the Republic of Latvia to Belarus.³³² For instance, between January and June 2011, cars were the main export commodity from Latvia to Belarus and amounted to \$20 million. According to the Ambassador, such a significant increase in turnover is not stable for long-term business, "which can be observed in Belarusian trade with other bordering countries – Lithuania and Poland".³³³ Nevertheless, Belarus's proximity to Latvia and strong people-to-people links are attractive for entrepreneurs. Thus, transit and state-of-the-art assembly plants that take raw materials or semi-finished goods and creates a finished product that is ready for sale have large potential in the long-lasting relationship between the two countries. But it is important to take a much closer look at the potential of these directions for growth, as well as highlight those sectors and industries where Latvian companies can enjoy more control over producing goods or providing services.

cargo is transported to third countries through Latvian ports. The second direction is the development of assembly plants in Latvia. Thus, for instance, Minsk Tractor Works (Мінскі трактарны завод), which is one of the largest manufacturers of agricultural machinery in the world. Nowadays, Belarusian tractors are assembled in Gulbene and near Jelgava. A few weeks later, the Ambassador restated the importance of these two economic segments and paid special attention to the Freeport of Riga, which is the shortest way to sea for Belarus. See: The guest in the Club, H.E. Mr. Aleksandr Gerasimenko, Ambassador of the Republic of Belarus to the Republic of Latvia. <http://www.dec.lv/> (Diplomatic Economic Club); Lecture 'Latvia-Belarus economic relations' by H.E. Mr. Aleksandr Gerasimenko, Ambassador of the Republic of Belarus to the Republic of Latvia. Faculty of Geography and Earth Sciences, University of Latvia. Riga, 11 May, 2011.

332 Structure of the Belarus-Latvia trade turnover puts everything in its place. <http://belarus.bel.biz/?p=1407> (the business-portal BEL.BIZ; expert opinion published 10.11.2011).

333 *Ibid.*

2. Boosting Latvian business in Belarus: from risks to captivating opportunities

For many years there has been a widespread belief among Western Europeans that there are many risks involved in doing business in Belarus, but overall there is only one main risk which determines the negative outcome of other factors. That risk, of course, lies in the unpredictability of the autocratic rule of Lukashenko. While some foreign companies have drawn attention to hazy regulations and time-consuming bureaucracy, many others have feared Lukashenko's unlimited authority: his power to re-impose administrative control over prices and currency exchange rates, and his power to expand the state's right to directly intervene in the management of private enterprises.³³⁴ As this critical belief has often been portrayed without an in-depth analysis, the purpose of this section is to not only consider the major risks and outline the largest Latvian business failures in the past, but also to shed light on the recent activities of Latvian entrepreneurs in Belarus. The overall aim is to balance an overly critical and *a priori* pessimistic outlook with the latest information about the sectors and individual Latvian companies in Belarus that develop despite Lukashenko's authoritarian regime.

According to *Doing Business 2011: Making a Difference for Entrepreneurs*, the eighth in a series of annual reports published by the World Bank and International Finance Corporation,³³⁵ Belarus is ranked 68 out of 183 economies. While it is relatively easy to start a business or register property in Belarus, considerably larger problems exist in paying taxes and protecting investors (see Table 2).

³³⁴ Bertelsmann Stiftung. *BTI 2010 - Belarus Country Report*. Gütersloh: Bertelsmann Stiftung, 2009. p. 16.

³³⁵ Launched in 2002, the *Doing Business* project offers objective measures of business regulations and their enforcement across 183 economies and selected cities at the sub-national and regional level. A set of regulations affecting nine stages of a business's life are measured: starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. The indicators are used to analyze economic outcomes and identify what reforms have worked, where, and why.

Table 2. Belarus's ranking in *Doing Business 2011*

Rank	Doing Business 2011
Ease of Doing Business	68
Starting a Business	7
Dealing with Construction Permits	44
Registering Property	6
Getting Credit	89
Protecting Investors	109
Paying Taxes	183
Trading Across Borders	128
Enforcing Contracts	12
Closing a Business	93

Source: The International Bank for Reconstruction and Development/The World Bank. *Doing Business 2011: Making a Difference for Entrepreneurs (Belarus)*. Washington, D.C.: The World Bank, 2011. p. 2.

Furthermore, a recently published analysis by Manfred Stamer highlights the following weaknesses for Belarus: a business-unfriendly Soviet-style political and economic system, international isolation, a lack of significant political and economic reforms, high economic dependence on Russia (especially on Russian energy), large current account deficits, inadequate foreign exchange reserves, a high exchange rate risk, a rapidly rising external debt burden, and a generally weak business environment.³³⁶ Similarly, Raita Karnite highlighted the following negative qualities: "state imposed administrative barriers, state meddling in private business with control and licenses, changeable laws and a lack of guarantees, and also corruption".³³⁷ Moreover, it is important to remember that "aside from announcing an overall liberalization of the economy, Belarus in practice has not pursued a true process of privatization".³³⁸ Despite loud rhetoric in support of the privatization of companies that previously belonged to the state, Lukashenko's regime prefers to borrow on the international market to get out of trouble rather than introducing structural reforms that would include the privatization of state enterprises.³³⁹ Nevertheless, being aware of the existing business constraints and

³³⁶ Stamer, M. Country Review: Belarus. Euler Hermes Kreditversicherungs-AG, 2 February, 2011, p. 2.

³³⁷ Karnite, R. Latvia-Belarus economic relations. In: *External economic relations of Belarus*. Ed. Liuhito, K. Turku: Pan-European Institute, 2007, p. 57.

³³⁸ Bertelsmann Stiftung. *BTI 2010 - Belarus Country Report*. Gütersloh: Bertelsmann Stiftung, 2009. p. 12.

³³⁹ Совет республики одобрил законопроект, которым разрешается ►

challenges in Belarus, Latvian companies continue to increase direct investment and export volumes to the country. In 2011, for instance, Latvia's investment amounted to \$118.5 million, half of which took the form of direct investments. All in all, investment over the past five years has reached \$700 million.

Over the past few years foreign companies in Belarus have clearly witnessed a policy of comprehensive state involvement in the economy, and Latvian entrepreneurs are no exception. Thus, for instance, the edition of Minsk *Your Country's Tomorrow* (*Завтра твоей страны*) published an article in November 2010 on the success of Latvian entrepreneurs in Belarus in recent years. Although Latvian businessmen once saw the Belarusian market as a "land of new opportunities and hopes", the publication indicates that something went wrong. Those who failed were well-known Latvian businessmen such as Kirovs Lipmans, Aivars Lembergs and Gunars Kirsons.³⁴⁰ According to the article, one of the richest men in Latvia, Kirovs Lipmans, suffered a failure in the planned acquisition of a controlling interest of a Borisov medical equipment factory in 2009.³⁴¹ Negotiations over the acquisition of shares hit a dead end after the Belarusians refused to sell a significant number of shares to Lipmans. Instead of buying shares of the Borisov factory, Lipmans bought the Slovak pharmaceutical company *HBM Pharma* in August. In fact, the article also mentions that Aivars Lembergs had great intentions with Belarus several years ago. In 2004 he was a co-owner of one of the biggest Latvian transit business holding companies, "LSF Holdings", and intended to give the Belarusians control over the terminal for loose cargo in Ventspils for free in order to ensure the reloading of Belarusian cargo – including potassium and oil products – in the port of Ventspils. The controlling interest of the terminal had to be given over to the company *Belaruskalij*. However, as a result of the "war of Ventspils" the transaction did not happen. Consequently, as the article points out, it was not only Lembergs that suffered, but the Latvian

приватизация Беларуси и магистральных нефтепроводов. (The Council of the Republic has approved a bill that allows the privatization of the main oil pipeline and Belaruskalij). <http://www.interfax.by/news/belarus/75256> (Интерфакс (Interfax); news published 30.06.2010); Приватизация осталась в условиях предоставления кредита Беларуси – Кудрин. (Privatization has remained in conditions of granting of the credit of Belarus – Kudrin). <http://www.interfax.by/news/belarus/93641> (Интерфакс (Interfax); news published 30.06.2010); Dambrauskaitė, Ž., Jurkonis, V., Kondratjeva, O., Narkevičiūtė, J., Pimpė, J., Gira, V.S. Belarusian Challenge to the New EU Policy: Ignorance equals legitimization. Eastern European Studies Centre: Analytical Review. 2010, no. 2 (1), pp. 21-24.

340 Некрашевич, Н. Почему у латвийских миллионеров не идут дела в Беларуси? (Why do Latvian millionaires fail to do business in Belarus?). (*Завтра твоей страны* (Tomorrow of Your State); article published 08.11.2010).

341 In October 2008, Grindeks confirmed that the negotiations with Borisov Medical Preparations Plant are proceeding as planned. The two companies were considering a joint investment project in Belarus, with the agreement potentially to be finalised in early 2009.

economy as well. Belarus now transports the potassium through the Lithuanian port of Klaipėda. The banker and businessman Vasily Melnik had already intended to set up a joint venture, *Ogre-Aļesja*, in 2004, whereby an Ogre knitwear factory would also operate and the large Minsk sewing factory *Aļesja*. This project also has failed because the Belarusian side did not want to part with the controlling interest of "Aļesja". Furthermore, the owner of *Lido*, Gunars Kirsons, had planned to expand his empire of restaurants in Minsk. He had even found a business partner in Belarus. As a result, there was a restaurant opened in Minsk which in both menu and appearance resembles the *Lido* restaurants Riga. However, Kirsons, facing huge problems in his homeland, had pulled out of the business in Minsk. The only Latvian millionaire who, according to the publication, has successfully operated in the market of Belarus is Leonids Esterkins, the major shareholder of *West Bank*. Esterkins developed the business in Belarus in 2001, when a branch of *West Bank* opened there. In 2008, the Latvian businessman bought the first batch of assets of Belarusian companies – a 50% share of the leasing company *WestLizing* (car leasing) and *Westtransinvest* (the leasing of construction, passenger and cargo transport, and road construction technology).³⁴² But, of course, over the last few years several other Latvian companies have developed successful businesses in Belarus.

For several years the export of machinery and mechanical appliances and electrical equipment to Belarus has been one of the most profitable businesses for Latvian companies. Latvian mechanical engineering and metalworking companies such as "BM Industrial", "Darba Spars", "Daugavpils Factory of Locomotive Repair", "Forma Machinery", "IRM", "Izotermis", "Jauda", "The Jelgava Engineering Plant Company", "Komforts", "Marmors", "Nook" and "Rigas Dizelis" have looked to Belarus as one of their major markets. Since 2005 "Preco" and "Rigamet" have also targeted Belarus as an export destination. Latvian companies are increasingly looking for cooperation partners in Belarus. The Latvian companies "Inos" and "Grandeg" are two good examples. "Inos", an industrial machinery and equipment supplier, along with its partners regularly sets up plants in Belarus. Other metalworking manufacturing companies have developed a cooperation scheme with two Minsk-based companies – FormanGroup and Inter Blaze. The export of electrical equipment and optical instruments and apparatuses to Belarus has also been stable for the last few years. As the production of electrical and optical equipment has developed rapidly in Latvia, more and more companies are establishing links with the Belarusian market. Companies such as "JAUDA", "Komforts" and "Z-Light" are good examples of

342 Некрашевич, Н. Почему у латвийских миллионеров не идут дела в Беларуси? (Why do Latvian millionaires fail to do business in Belarus?). (*Завтра твоей страны* (Your State's Tomorrow); article published 08.11.2010).

companies that are increasing their export volume to the neighboring country.

One of Latvia's most essential exports to Belarus is products from the chemical and allied industries, which makes up a large portion of Latvian trade with Belarus. Many Latvian pharmaceutical companies have launched businesses in Belarus. The Joint Stock Company "Grindeks"³⁴³ is one of the leading Latvian companies that is a well-known on the Belarusian market despite unsuccessful attempts by Kirovs Lipmanis to buy the Borisov medical equipment factory. In fact, as an export-oriented and growing company, "Grindeks" engages in the research, development, manufacture, and sale of original products and active pharmaceutical ingredients. The "Grindeks" group consists of four subsidiary companies in Latvia, Estonia and Russia, as well as representative offices in 10 countries, including Belarus since 2002. Products from the company are exported to 50 countries, and export comprises more than 95% of total turnover. As the leading pharmaceutical company in the Baltic States, "Grindeks" exports active pharmaceutical ingredients such as oxytonic, droperidol, desaminooxytonic and zopiclone to Belarus. The second largest Latvian medicine manufacturer, "Olainfarm", also exports to the neighboring country. Key components that allow for an increase in total sales in Belarus include the production of high quality niche products and prescription medicines with unique substances. It's not only the largest pharmaceutical enterprises in Latvia that export medical products to Belarus, but also small medicine manufacturing companies such as "LMP" Ltd. Until quite recently, the Latvian pharmaceutical company "Silvanols" also exported products to Belarus.

In fact, the size of the pharmaceutical market in Belarus last year totaled \$676.4 million, and more and more foreign companies are interested in creating pharmaceutical facilities in Belarus. In June, companies from the Czech Republic and Switzerland announced plans to manufacture pharmaceuticals in Belarus.³⁴⁴ Meanwhile, Vladimir Bryntsalov, one of Russia's richest businessman, and Belarus's Belbiopharm, a state concern, have announced the intention to invest up to \$120 million in the construction of the largest pharmaceutical plant in Belarus. The new plant is expected to be built in 2015 with the support of state pharmaceutical company Dialek.³⁴⁵ Despite the present economic difficulties and challenges, the government of Belarus is looking for ways to replace imported goods with domestically produced ones. While the majority of Latvian pharmaceutical

343 In the first three months of 2011 "Grindeks" worked with a profit of LVL 1.5 million, which has increased by 7.1% compared with the first quarter last year. The turnover of "Grindeks" was LVL 14 million – 4.1% more than in 2010. The output produced in the first quarter was exported for LVL 13.2 million in total.

344 The Czechs and Swiss plan to manufacture pharmaceuticals in Belarus. <http://news.belta.by> (Belarusian Telegraph Agency (BelTA); news published 07.07.2011).

345 Russian billionaire may construct largest pharma plant in Belarus. <http://www.thepharmaletter.com> (The Pharma Letter article).

companies feel relatively safe in exporting medical products to Belarus, the entrance of new local competitors may cause serious business headaches in the long run.

The field of information and communications technologies (ICT) is another perspective business niche for Latvian entrepreneurs in Belarus. In an increasingly globalized world, the role of ICT continues to become increasingly important. Countries are passing laws to facilitate the proliferation of ICT to foster a high-added value and innovation-driven economy. Belarus, despite being a so-called "isolated country", is not an exception. Over the past few years Belarus has declared the ICT sector to be one of the top-priority economic fields for development. In 2005, by decree of the President, the Belarus Hi-Tech Park was established to stimulate high-tech production development in the country. Unlike many parks in Europe that deal with engineering and software development, the Belarus Hi-Tech Park provides a special business environment for IT business. Thus, for instance, the resident companies in the Park are exempt from all corporate taxes, including value added tax (VAT) and profit tax.³⁴⁶ Over the next five years, according to Igor Voitov, Chairman of the State Committee on Science and Technology of Belarus, the country "is set to increase the export of innovation products more than 2.5 times to about \$7.9 billion".³⁴⁷ Moreover, Latvian IT companies are currently faced with a shortage of highly qualified specialists. Therefore, in order to address the growing need for specialists, IT outsourcing services in Belarus are becoming an attractive option. Recently, several Latvian companies have chosen to import qualified specialists from abroad. In 2011, the Office of Citizenship and Migration Affairs of Latvia issued 76 permits to work in the IT sphere. A large majority of foreign IT experts came from countries such as Ukraine, Russia and Belarus.³⁴⁸

346 Currently, almost 100 companies are registered as Hi-Tech Park residents and half of them are foreign companies and joint ventures - 45% from the USA and Canada, 30% from European countries, and only 20 % from Russia and CIS countries. Within the 2006-2010 period, Belarus Hi-Tech Park export made up \$452.3 million. According to Belarus's new innovation development program for 2011-2015, "the High-Tech Park will make up \$160 million in the export of high-tech goods in 2011 and \$430 million by 2015". See: Беларусь за пятилетку увеличит экспорт инновационной продукции более чем в 2,5 раза до \$7,9 млрд. (Belarus in five years to increase export of innovative products more than 2.5 times to \$ 7.9 billion). <http://www.government.by/ru/news-end-events/> (Совет Министров Республики Беларусь (Council of Ministers of the Republic of Belarus, news published 10.05.2011).

347 Беларусь за пятилетку увеличит экспорт инновационной продукции более чем в 2,5 раза до \$7,9 млрд. (Belarus in five years to increase export of innovative products more than 2.5 times to \$ 7.9 billion). <http://www.government.by/ru/news-end-events/> (Совет Министров Республики Беларусь (Council of Ministers of the Republic of Belarus, news published 10.05.2011).

348 Mendziņš, J. Apmēram 300 vakancu tukšas (Approximately 300 vacancies are empty). Diena, 11.06.2012, 8.-9. lpp.

In the long-term perspective, either the cooperation framework with the Hi-Tech Park or the opening of new branch office in Belarus could contribute to faster business growth and network expansion. It is worth mentioning that the Belarus Hi-Tech Park has already signed a cooperation memorandum with the Latvian IT association "Latvian IT Cluster". The agreement was signed during the Belarusian-Latvian Forum in Minsk on October 16, 2008. SIA DPA is one of the Latvian IT companies that has successfully opened a branch office in Belarus. The main trading products of the DPA are software licenses, software audits, IT consultancies, and IT infrastructure support consultancies. DPA has operated in Latvia since 1998, with branch offices in Lithuania, Belarus, and Ukraine. In 2010, DPA's foreign turnover reached EUR 2.29 million, which is more than a 25% increase compared to 2009. This major growth was achieved following the decision to open a new branch in Belarus.

In addition to the growing business activities of Latvian pharmaceutical and ICT enterprises in Belarus, textile manufacturers also play a major role in fostering exports. "Lauma Fabrics" is one of the success stories of Latvian companies in Belarus. As one of the leading manufacturers of lace, elastic knitted fabric and ribbons in Europe, *Lauma Fabrics* offers through the Belarusian company *Mila Vitsa* a wide range of high quality textile materials. According to Edijs Eglins, a board member of *Lauma Fabrics*, the company turnover exceeded LVL 19 million in 2010. Since the beginning of the year, "the company [has exported] approximately 80% of its products, [and] the best results in terms of sales increase are shown by Belarus, which accounts for 35% of exports".³⁴⁹ *New Rosme* is another leading company in corset production in the Belarusian market. In fact, *New Rosme* is one of the biggest women lingerie suppliers in the Baltic market. In 2010, the company's turnover reached LVL 6 million, more than a 17.7% increase compared to 2009. Along with the rise in sales, direct production deliveries from *New Rosme's* factory in Belarus to Russian partners also saw an increase. Thus, as the company's Board Chairman Edgars Stelmahers highlights, it was able to reduce production costs related to customs tariffs.³⁵⁰ Though *New Rosme*, due to the global financial crisis, has reorganized its structure by reducing the number of employees from 562 in 2006 down to 318 in 2011, the company is currently doubling its capacity in Belarus.³⁵¹ While some Latvian entrepreneurs are still seeking their

niche in the Belarusian market, well-developed companies such as "Larmet" and "STATS Serviss" continue to capture a market share in Belarus. But, of course, the threat of Belarus's financial instability is apparent to entrepreneurs. As the Board Chairman of *New Rosme* indicated in 2011, the existing difficulties surrounding the devaluation of the Belarusian ruble directly affect those Latvian companies that have invested and launched production units in the country.³⁵² Although three of the most heavily held currencies in the world (the euro, the US dollar and the British pound) are mainly used in transactions as the settlement currency between the Latvian companies and Belarusian business partners, the main risks faced by entrepreneurs are directly connected to domestic payments and financial transactions in Belarusian rubles. For instance, many Latvian construction workers are paid in rubles. Moreover, the problem with the ruble devaluation is that it deteriorates purchasing power. Thus, as DnB Nord Bank economic expert Peteris Strautins explains, the exports from Latvia to Belarus could decrease as a result of the devaluation because purchasing power could decrease in Belarus.³⁵³

Notwithstanding the risks and other hazards that may be present in the Belarusian business environment, Latvian companies continue to search for ways to expand their presence in the neighboring country. Strong people-to-people connections and Russian language skills play a notable role in strengthening Latvian businesses in Belarus. In fact, the main advantages of Belarus are that it has a relatively large domestic market, comparatively low production costs and good industrial capacity. Several Latvian companies continue to successfully develop their businesses despite the aforementioned risks. *Grindeks*, *Olainfarm*, *Lauma Fabrics*, *New Rosme*, *DPA*, *Larmet*, *STATS Serviss* and *Forma Machinery* are just a few of the many companies that are trying to expand their business in Belarus. Over the last couple of years, the ICT, pharmaceutical and textile industries have opened up new business opportunities for Latvian entrepreneurs. However, in the coming years we can expect that the structure of major export commodities to Belarus will stay the same. Thus, machinery and mechanical appliances and electrical equipment will continue to play a major role in export to the neighboring country.

349 SIA Lauma Fabric's sales figures increase. <http://www.laumafabrics.com/en/jaunumi> (Lauma Fabrics, news published 04.04.2011).

350 Lingerie producer New Rosme turnover – 6 million lats. <http://bnn-news.com/corsetry-producer-new-rosme-turnover-%E2%80%93-6-million-lats-23024> (Baltic News Network).

351 Central Europe and post-Soviet countries appreciate Latvian lingerie production. <http://bnn-news.com/central-europe-post-soviet-countries-latvian-lingerie-production-24305> (Baltic News Network); New Rosme: more turmoils to crash

Latvia. <http://bnn-news.com/new-rosme-turmoils-crash-latvia-23681> (Baltic News Network).

352 Stelmahers, E. Nāksies rēķināties ar ļoti lielu nestabilitāti Baltkrievijas ekonomikā. (Have to count on a very large instability in Belarusian economy). *Dienas bizness*, 02.09.2011, 3. lpp.

353 Baltkrievijas rubļa devalvācija Latviju neietekmēs. (The devaluation of the Belarusian ruble will not affect Latvia). http://www.financenet.lv/viedokli/378621-baltkrievijas_rubla_devalvacija_latviju_neietekmes (Financenet).

3. The presence of Belarusian investment in Latvia

Until quite recently, Latvia experienced the worst recession of the European Union countries. The Latvian economy is currently experiencing a slow recovery. At time when the revival of international trade makes it possible to increase exports, government officials and business executives are working together to find common ground. As in other countries, Latvian government officials and entrepreneurs are looking for common solutions to raise competitiveness and promote exports. In this context, the attraction of foreign capital is another way to contribute to the development of the national economy. Therefore, the main focus of this section will be on Belarusian investment and the largest investors in Latvia.

According to the level of fixed capital investment in businesses registered in Latvia, Belarus ranks in 28th place with the total amount of investment at 8.9 million LVL with 896 active businesses (see Table 3). For comparison, Estonia, with direct investment in the fixed capital of businesses totaling 803.546 million LVL, is the leader in terms of direct investment in the registered fixed capital of Latvian businesses, outpacing even the Scandinavian countries. Sweden is the second biggest investor in Latvia, with 527.290 million LVL and the Netherlands, with 403.324 million LVL of total investment. is in third place. The amount of direct investment in Latvia for regions such as Cyprus (LVL 279.483 million), Guernsey (LVL 57.620 million), and the British Virgin Islands (LVL 27.419 million) is much bigger than that of Belarus, despite the geographical proximity of Latvia and Belarus and the close economic and social ties that have existed since Soviet times.³⁵⁴ Of course, these figures suggest that investors from other countries are working through these small islands.³⁵⁵ Drawing attention to this fact, Nils Muiznieks, Director of the Advanced Social and Political Research Institute at the University of Latvia, emphasized that there was a possibility that “some Latvian tycoons might account for part of the capital flow”.³⁵⁶ When viewing the direct investment of

³⁵⁴ Ārvalstu tiešo investīciju sadalījums pa valstīm (The allocation of foreign direct investments by countries). <http://www.lursoft.lv/lursoft-statistika/> (Lursoft).

³⁵⁵ If it may still be theoretically assumed that investors from Belarus are much less active than the million inhabitants of Cyprus, then it is in practice difficult to understand how such a small country can become a much greater investor than Russia (LVL 27.419 million), the USA (LVL 147.662 million) or Germany (LVL 102.148 million). Until comparatively recently, Swedish researcher Tomas Malmlof highlighted that Cyprus, Switzerland, Luxembourg and Malta serve as significant capital flowing channel for Russian investment. See: Malmlof, T. Ryskt ekonomiskt inflytande i de baltiska staterna – säkerhetspolitiska konsekvenser. Stockholm: FOI, Swedish Defence Research Agency, 2010. p. 45.

³⁵⁶ Muiznieks, N. Latvian-Russian Relations: Dynamics since Latvia's Accession to the EU and NATO. Riga: University of Latvia Press, 2011. pp. 56-57.

Belarus in Latvia, as well as knowing that overall statistical data may not match the real situation, some may ask what the total volume of Belarusian capital in Latvia via other countries is. Unfortunately, it is difficult to track the true holders of investments. However, we can assume that Belarusian investors are less likely than Russians to have large financial capital invested through another country, due to the nature of the Belarusian economic system. The discussion about providing residence permits based on investment in the Latvian economy is a good sample for analysis.

Table 3. Belarusian direct investment in Latvia

Year	Increase in Investment (Cases)	Investment Growth, LVL	Number of Investors	Number of Enterprises	Balance
1991	19	1,169.00	19	13	1,169.00
1992	70	30,476.50	88	58	31,645.50
1993	77	706,299.00	159	104	737,944.50
1994	67	385,091.60	215	145	1,123,036.10
1995	17	461,173.00	215	150	1,584,209.10
1996	2	-935,189.29	211	156	649,019.81
1997	-27	81,373.60	182	150	730,393.41
1998	-26	82,977.70	154	134	813,371.11
1999	26	55,890.10	174	157	869,261.21
2000	29	-25,926.00	197	177	843,335.21
2001	17	69,771.00	207	189	913,106.21
2002	31	339,249.40	231	208	1,252,355.61
2003	29	302,828.89	254	232	1,555,184.50
2004	32	300.00	285	256	1,555,484.50
2005	34	371,329.00	311	284	1,926,813.50
2006	40	97,230.50	349	310	2,024,044.00
2007	-4	2,588,315.00	337	307	4,612,359.00
2008	71	2,685.00	396	352	4,615,044.00
2009	42	694,812.00	429	376	5,309,856.00
2010	137	1,609,577.00	541	489	6,919,413.00
2011	293	1,053,022.00	785	744	7,972,435.00
2012*	161	940,489.00	900	896	8,912,924.00

Source: Tiešo investīciju pamatkapitāla apjoma un to gadijumu skaita dinamika (The allocation of foreign direct investments and case dynamics). <http://www.lursoft.lv/lursoft-statistika/> (Lursoft).

*During the first half-year of 2012.

As of July 1, 2010, amendments to the Latvian Immigration Law came into force to provide a new possibility for receiving a residence permit in Latvia. According to the Immigration Law amendments, citizens of third countries are eligible to apply for a temporary residence permit for a period of up to five years, provided that they have invested a significant amount in the country and thereby contributed to Latvia's economic growth. As of today, foreign citizens are able to apply for residence permits in Latvia if they buy property worth at least LVL 100,000 in Riga or at least LVL 50,000 elsewhere in the country. Residence permits are also granted if LVL 25,000 has been invested in a Latvia-based enterprise and LVL 20,000 was paid in taxes in the first year of operation. A year later, in July 2011, the investigative news program "Nekā personīga" (Nothing personal) on TV3 reported that citizens of Russia and Belarus are especially interested using these amendments to obtain a residence permit in Latvia, with which they can move freely within the Schengen area.³⁵⁷ The reality of the situation is different. Up to now, the interest from Belarusians to obtain a residence permit is much smaller than the interest from Russians. According to the latest report and evaluation of the amendments to the Immigration Law, the breakdown of foreign investors by nationality is the following: Russia – 820 people, Ukraine – 87, Kazakhstan – 76, Uzbekistan – 33, Belarus – 22,³⁵⁸ Israel – 12, Azerbaijan – 7, USA – 7, and Kirgizstan – 4.³⁵⁹ Generally, investing in real estate has become increasingly popular over the last couple of years. The majority of investors have chosen to buy real estate instead of investing their capital in Latvia-based companies in order to get the permits. Belarusians, for instance, have not invested a single lats in local Latvian companies since July 1, 2010. Therefore, it is necessary to question the validity of these amendments and the long-term vision of policy makers.

Furthermore, over the past decade the number of joint Latvia-Belarus ventures has increased. Since 2000, the number of joint ventures has grown more than 4 times over – from 177 joint ventures in 2000 to 744 in 2011. The direct investment from the 20 largest Belarusian investors in the registered fixed capital

357 Nekā Personīga: Krievijas viduslānis arvien vairāk pārceļas uz Latviju. (Nothing personal: Middle class is increasingly moving to Latvia). <http://www.tv3.lv/content/view/13622/282/> (TV3).

358 12 Belarussian citizens have bought real estate in Latvia, whereas 10 other personas have invested their capital in credit institutions.

359 Ziņojums par Imigrācijas likuma 23. panta pirmās daļas 3., 28., 29. un 30. punktā paredzēto noteikumu īstenošanas gaitu un rezultātiem. (Report on the Immigration Law of the first subparagraph of article 23 - 3, 28, 29 and 30. The implementation of the provision contained in paragraph and the results. <http://www.mk.gov.lv/lv/mk/mksedes/saraksts/darbakartiba/?sede=543> (The Cabinet of Ministers of the Republic of Latvia – 20.09.2011).

of Latvian businesses totals 6.242 million LVL, or 80% of the total amount of Belarusian investment in Latvia. In just the last five years, the amount of Belarusian direct investment of fixed capital in Latvia has rapidly increased. The major Belarusian investors in Latvia are Valery Azamatov, Aksana Kalesnik and Liana Asnuovskaya. Belarusian resident Valery Azamatov, with LVL 1,531,135.00 million in investments in five companies, ranks in first place. The largest investments have been carried out in *Ostas skati* Ltd. (LVL 1,42,300.00), *Fora Group Ltd.* (LVL 61,000.00) and joint-stock company *RBSSKALS* (LVL 44,800.00). In turn, both Aksana Kalesnik, and Liana Asnuovskaya have invested in *BALTINTRADE* with an equal amount of fixed capital (LVL 813,300.00) (see Table 4.).

In general, the real estate sector, retail trade and legal services are the major interest for Belarusian investment in Latvia. While Belarusian export volumes are tightly connected with the transit business, several Latvia-based companies with Belarusian capital are boosting business between the two countries. For instance, *Baltkrievijas tirdzniecības centrs* and *Belwest Trade* have become Belarusian "Ambassadors" in Latvia, selling Belarusian clothes and knitted wear, electrical appliances, office supplies and other goods. Other well-known joint Latvia-Belarus ventures are *Ilguciems* and *Baltimex Trading*.

The fear of losing of profitable business with Belarussian companies has been one of the main concerns in Latvia for the last few months. Seeking to increase pressure on President Alexander Lukashenko's government, EU foreign ministers on March 23, 2012 placed an asset freeze and visa sanctions on 12 people and 29 companies.³⁶⁰ Yury Chyzh is one of the leading Belarus businessmen who has been included on the list of individuals. For many years he has provided financial support to the Lukashenko regime through his holding company, *LLC Triple*, which is active in numerous sectors of the Belarusian economy, including activities resulting from public funding and concessions from the authoritarian regime. However, due to consistent opposition from Latvian representatives, three petrochemicals firms from *Triple* holding were excluded from the sanctions. These are the *Triple Energo* company, *Belneftegaz* and *Neonafta*. In fact, *Neonafta* since 2008 has owned 80% of biofuel production plant Mamas-D, as well as 80% of the company *Latgales Alus D* in Daugavpils. Prior to the EU foreign ministers' meeting in Brussels and the decision to compromise on economic sanctions, Director General of the Employer's Confederation of Latvia (LDDK) Liga Mengelsone announced that the bloc's sanctions against Belarus could cause a loss of 480.9 million euros for Latvia.

360 Council Implementing Regulation (EU) No 265/2012 of 23 March 2012: implementing Article 8a(1) of Regulation (EC) No 765/2006 concerning restrictive measures in respect of Belarus. Official Journal of the European Union, 23 March, 2012.

Table 4. Largest Belarusian investors in Latvia

	Investors	Capital Investments, LVL	Enterprises	Intensity %	Location (city)
1.	Azamatov Valery	1,531,135.00	Ostas skati – 1,424,300.00 Fora Group – 61,000.00 RBSSKALS – 44,800.00 Īpašums A5 – 1,000.00 FriendSpotter – 35.00	49.62 50.00 32.00 50.00 35.00	Riga Riga Riga Riga Riga
2.	Kalesnik Aksana	813,300.00	BALTINTRADE – 813,300.00	50.00	Riga
3.	Asnuovskaya Liana	813,290.00	BALTINTRADE – 813,290.00	50.00	Riga
4.	Musikhin Vitali	576,000.00	LALANGAMENA – 576,000	100.00	Tiraine
5.	Timošenko Aleksandrs	460,384.00	Bootex – 460,384.00	95.00	Riga
6.	Belwest	334,000.00	Belwest Trade – 334,000.00	100.00	Riga
7.	Neonafta	264,000.00	Mamas-D – 136,000.00 Latgales Alus D – 128,000.00	80.00 80.00	Daugavpils Daugavpils
8.	Kupryienka Henadzi	207,088.00	Hidrolats – 197,888.00 Solo L – 8,000.00 Steel-M – 600.00 LAILA L – 600.00	32.00 33.33 30.00 30.00	Liepaja Liepaja Liepaja Liepaja
9.	Basenko Anatolijs	150,000.00	JAUNPAGASTS PLUS – 150,000.00	5.00	Jaunpagasts
10.	Staravoitau Uladzimir	135,000.00	AlenMed Promotion – 135,000.00	100.00	Riga
11.	Zaharovs Artjoms	110,000.00	Sudrabegles – 110,000.00	100.00	Riga
12.	Sadavojs Aliksandrs	104,500.00	Konkors – 104,500.00	50.00	Riga
13.	Tjutjunnik Andrei	103,210.00	RR Fish – 103,210.00	25.00	Riga
14.	Volkov Andrei	102,000.00	Zaļkrasti – 102,000.00	100.00	Salacgrīva
15.	Musikhin Vitali	100,000.00	Liberton – 100,000.00	100.00	Riga
16.	Zaļkevičs Sergejs	100,000.00	Nertons – 100,000.00	100.00	Riga
17.	Zaitsau Aliaksei	100,000.00	Tago Baltija – 100,000.00	98,04	Riga
18.	Gostevskis Aleksejs	90,000.00	-	-	-

19.	Filimonovs Staņislavs	77,000.00	ASO Timber – 77,000.00	100.00	Rezekne
20.	Velitchko Vadim	71,400.00	Baltimex Trading – 71,400.00	28.00	Riga
Total (20)		6,242,307.00			
Total (100)		7,712,722.00			

Source: Lielākie Baltkrievijas investori Latvijā (The allocation of foreign direct investments by countries). <http://www.lursoft.lv/lursoft-statistika/> (Lursoft).

A few days before the EU foreign ministers' meeting in Brussels, President of *Latvijas dzelzceļš* (Latvian Railways) Uģis Magone said that EU sanctions will severely reduce the company's cargo volumes. Considering that 33.8 million tons, making up 57% of the total amount of *Latvijas dzelzceļš* activity, were transported between Latvia and Belarus in 2011, the EU sanctions, as noted by Magone, could cause considerable losses in the hundreds of million of lats.³⁶¹ On March 26, in response to the EU tightening its sanctions against the neighboring country, LDDK said that sanctions are not in the interest of the Latvian national economy, and that they will cause a loss of over LVL 20 million for transport and logistics companies every year.³⁶² Despite the aforementioned concerns, it is not likely that the latest EU sanctions will cause significant losses for the Latvian economy as they have not been targeted at companies whose closest ties are with Latvia. In summary, Belarus is interested in increasing investment volumes in Latvia despite the EU pressure and sanctions against it (e.g., imposed travel bans on certain individuals responsible for the repression of the opposition and civil society in Belarus; an embargo on the export of arms to Belarus; asset freezes in relation to a number of key business figures [and companies controlled by them] associated with the regime). In the last three years, Belarusian investment in Latvia has rapidly increased from LVL 6.919 million in 2010 up to LVL 8.912 in the first half of 2012. In fact, the last six months have marked a new record of investment growth since 2007, at LVL 940,489.00. Along with the increased investment, Latvia is home to 896 joint ventures with Belarusian capital. In 2011 alone, this number rose by 255 joint ventures. Since 2009 the number of Belarusian-Latvian joint ventures has doubled.

³⁶¹ EU sanctions against Belarus could cause hundreds of millions in losses for Latvia (ES sankcijas pret Baltkrieviju rezultātā vasts var zaudēt simtiem miljonu latu). <http://www.nozare.lv> (Nozare.lv; news published 23.03.2012).

³⁶² Sanctions on Belarus to cause loss of LVL 20 million a year for transport companies (Sankcijas pret Baltkrieviju transporta uzņēmumiem gadā radīs 20 miljonu latu zaudējumus). <http://www.nozare.lv> (Nozare.lv; news published 26.03.2012).

Conclusions

Although it may seem difficult to identify what Belarus's interests are in economic cooperation with Latvia, an analysis of underlying patterns of business behavior demonstrates that Belarus has a large interest in expanding transit volumes via Latvian ports and increasing the development of assembly plants. The fields of transit and transport provide many opportunities, offering the neighboring country the chance to use Latvian ports. There is great growth potential in the relationship between the countries, with the potential to increase the cargo amount and introduce new cargoes, as well as the chance to attract opportunities for cargo transport-related services. In this respect, it is important to note the decision by the Riga Freeport board to open several missions abroad, including Belarus, which deal with promoting recognition in exporting countries. Transport with the container train "ZUBR" on the route between Riga and Minsk has been developed successfully since 2009, which opens new opportunities for cargo transport between entrepreneurs of both countries. Thus, taking into account the growing interest from Belarusian entrepreneurs in the promotion of market to and exporting to Western countries, it may be predicted that regardless of the development of the situation in this country or possible further EU sanctions and restrictions, the Belarusians will continue to be interested in developing transit corridors to Europe, inter alia via the Baltic Sea.

Considering the fact of asymmetric trade relations between the countries, the Latvian government and entrepreneurs must work together to further increase export turnover. Besides the areas of transit and shipment, the production and sale of pharmaceuticals, textiles, and information communications technology also open up great opportunities for Latvian private enterprises. Recently a number of Latvian companies have successfully expanded their business in Belarus. Thus, for instance, the joint-stock paper producer *Liepājas papīrs* has opened a new paper mill in Gomel, while *New Rosme* is doubling its capacity in Belarus. The findings also demonstrate that it is not fully true that only "large Latvian corporations have been rather successful in Belarus".³⁶³ Actually, a number of small and medium-sized businesses such as *Larmet* and *STATS Serviss* have fruitfully operated in the Belarusian market. In fact, one of the key components of doing business wisely in the long term in Belarus is exporting niche raw materials. These supplies are far less dependent on the effects of economic fluctuations than exporting end products. Unlike other medicine manufacturers, for instance, *Olainfarm* successfully exports prescription medicine with unique substances.

³⁶³ Liuhito, K. (ed.). *External economic relations of Belarus*. Turku: Pan-European Institute, 2007, p. 14.

In other words, the state of trade and economic relations between the countries provides reasonable confidence that Belarusian-Latvian business-to-business contacts will remain close despite the present difficult state of EU-Belarus relations and future challenges. Professional ties and mutual trust will continue to play much bigger role than EU sanctions or restrictive measures. Regular business forums and visits organized by stakeholders such as the Investment and Development Agency of Latvia, the Latvian-Belarusian Business Cooperation Council and the Republican Confederation of Entrepreneurship (Belarus) will encourage businesspeople from the two countries to make an even stronger working relationship. But, of course, the fact that a reiterative devaluation of the Belarusian ruble may lead to a reduced purchasing capacity of Belarusian citizens and cause further economic instability is a risk that must be considered.

Latvian entrepreneurs must still be aware of comprehensive Belarusian state involvement in the economy. As Raita Karnite correctly pointed out several years ago, "Latvian entrepreneurs are hopeful about cooperation with Belarus, although they note some problems with investing there. Businesses consider that in Belarus the views of the state authorities must be taken into account and it is forbidden to make negative reports about the country".³⁶⁴ Besides, the recent devaluation of the Belarusian ruble and the shortage of foreign currency, as well as a rapid deterioration of living standards, have made everything much more difficult and risky.

Lately, the big headache for Latvia has been caused by the choice of a tactical foreign policy that balances EU sanctions against Belarus and long-term national interests. In contrast with other EU countries that are not bound by geographic proximity with Belarus, as well as historical and economic ties, Latvia may be directly affected by hasty decisions that extend the amount of sanctions against Belarus. The most short-sighted of these would be the creation of economic sanctions for Belarus, making the country strongly dependent on Russia. ceptically minded EU member countries that demand economic sanctions could regret their decision over a longer time period. In fact, this is not just about political and economic relations and scenarios for the development of ties between Latvia and Belarus, the EU and the Lukashenko authoritarian regime, but it is also about national security and stability in Belarus, which Russia could take a significant role in. This scenario would affect the overall situation in the region in a relatively short time period. For this reason, the expansion of EU sanctions against Belarus in the long term could contribute to an increase of vulnerability in the country and lead to unpredictable scenarios of development

³⁶⁴ Karnite, R. Latvia-Belarus economic relations. In: *External economic relations of Belarus*. Ed. Liuhito, K. Turku: Pan-European Institute, 2007, p. 58.

in future. Although EU political leaders have been waiting for a decline of the authoritative regime and the implementation of democracy principles in Belarus since Lukashenko gained access to power, broad-based sanctions will be unlikely provide the expected result. In fact, the latest analysis by Julia Korosteleva, Lecturer in Business Economics at University College London, also demonstrates that a broader sanction approach to Belarus – which implies targeting key state-owned companies with a high export potential (chemical and petrochemical industry) and contribution to the economy, or the imposition of restrictions on capital flows – may potentially cause much higher economic damage for the economy as a whole, thus directly affecting vulnerable populations. Moreover, it would be inefficient in facilitating a Lukashenko regime change. In turn, as Korosteleva points out, “this may lead to further political and economic isolation for Belarus in the international arena and to the intensification of economic ties with Russia”.³⁶⁵

Despite the attitude of the EU toward Belarus, which is often full of bravado and certainly justifiably negative, Latvian entrepreneurs and representatives of the government should involve themselves more actively in discussions with their Western colleagues and cooperation partners on the situation in the neighboring country. Although some Latvian entrepreneurs and politicians are interested in developing economic cooperation with the help of nostalgia in former Soviet bloc countries, Latvia must base itself on the cultural relations and values of European businesses.

The events of recent months in Belarus and the sharp EU position have shown some decisiveness in bringing increased pressure and sanctions on Belarusian President Alexander Lukashenko and his inner circle, as well as prompted Latvia to formulate its foreign policy toward Belarus much more clearly. But, of course, bearing in mind the existing situation in Belarus, one cannot repudiate that numerous economic issues may change on relatively short notice. While Belarus's future is shrouded in uncertainty and vagueness, Latvia must swiftly define for itself a clear vision and long-term policy toward the neighboring country. Alongside economic experts and regional specialists, the Latvian government must turn the spotlight to questions that arise either on the Belarus-EU or the Latvia-Belarus agenda. Currently, it would be thoughtless to assert that the development of the economic and political situation of Belarus may be predicted for the next couple of years. Considering the development of the Latvian economy and the strengthening of national security, it is important to be prepared for potential risks and opportunities.

³⁶⁵ Korosteleva, J. Impact of Targeted Sanctions on Belarus. Directorate-General for External Policies of the Union. Directorate B, Policy Department. EXPO/B/AFET/ FWC/2009-01/Lot1/36/May; PE 433.697, 8 May, 2012.

Notwithstanding the challenges facing the Belarus, a flourishing bilateral economic and trade relationship with Belarus is of interest to Latvian entrepreneurs because of Belarus's proximity to Latvia and because of the strong people-to-people links. In fact, it is of strategic interest for the EU as a whole to have a prosperous and democratic Belarus as a neighboring country. Therefore, following the latest trends in the country, the question is not whether there will be changes in Belarus, but how these changes will be made. At a time when most EU member states are politically disassociating themselves from Belarus, new opportunities are arising for Latvia, both at the governmental and the business community level. This is the right time to replace a temporary policy with a smart and proactive policy. The policy of waiting watchfully must change to a long-term, consistent and active surveillance approach toward Belarus. While ensuring national interests and upholding the country's economic interests, it is important for Latvia to oppose any broad-based sanctions against Belarus, especially economic sanctions. Simultaneously, it is in Latvia's interest to support thorough political, economic and social reforms in Belarus, as well as to urge the country to push ahead with privatization. Latvia, together with Lithuania and Poland, must become leading countries in the EU in pushing for faster reforms in Belarus. Contrary to previous efforts, all three countries must synchronize their existing approaches and take 'Belarus reform debate' to a new level. They have to speak with one voice. Overall, in the long term perspective, Belarus must become one of the Latvia's foreign policy priorities in pursuit of national economic interests.

Appendix

Table 5. Foreign trade in goods of the Republic of Belarus (mln. USD)

	2000	2005	2009	2010	2011
Volume of foreign trade in goods	15972	32687	49873	60168	86041
exports of goods	7326	15979	21304	25284	40294
imports of goods	8646	16708	28569	34884	45747
balance	-1320	-729	-7265	-9600	-5453
with CIS countries*	10469	18202	27540	34172	47590
exports of goods	4399	7060	9316	13636	19503
imports of goods	6070	11142	18224	20536	28087
balance	-1671	-4082	-8908	-6900	-8584
of which with Russia	9315	15834	23444	28035	38608
exports of goods	3710	5716	6718	9954	13685
imports of goods	5605	10118	16726	18081	24923
balance	-1895	-4402	-10008	-8127	-11238
with non-CIS countries**	5503	14485	22333	25996	38451
exports of goods	2927	8919	11988	11648	29791
imports of goods	2576	5566	10345	14348	17660
balance	351	3353	1643	-2700	3131

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Belarus in Figures 2011 (Беларусь в цифрах, 2011)*. Minsk: National Statistical Committee of the Republic of Belarus, 2011, pp. 89-90.; National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Belarus in Figures 2012 (Беларусь в цифрах, 2012)*. Minsk: National Statistical Committee of the Republic of Belarus, 2012, pp. 82-83.

* Since 2009, excluding Georgia.

** Since 2009, including Georgia.

Table 6. Foreign trade of the Republic of Belarus with selected countries (mln. USD)

Exports of goods				
	2000	2005	2010	2011
Latvia	467,3	322,6	929,5	3150,8
Poland	276,8	847,3	885,8	1123,2
Ukraine	559,7	907,8	2560,1	4157,1
Russia	3710,1	5715,8	9953,6	13685,0
Netherlands	130,3	2408,3	2845,6	6157,9
Germany	231,7	708,5	460,8	1826,3
China	136,2	430,9	475,8	637,1
United Kingdom	95,9	1120,4	935,2	406,9
Italy	76,1	159,7	195,4	553,3
Venezuela	1,9	15,6	302,4	198,8
Total	7326,4	15979,3	25283,5	40294,0

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Belarus in Figures 2011 (Беларусь в цифрах, 2011)*. Minsk: National Statistical Committee of the Republic of Belarus, 2011, p. 91.; National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Belarus in Figures 2012 (Беларусь в цифрах, 2012)*. Minsk: National Statistical Committee of the Republic of Belarus, 2012, p. 85.

Table 7. Foreign trade of the Republic of Belarus with selected countries (mln. USD)

Imports of goods				
	2000	2005	2010	2011
Latvia	29,7	90,6	95,8	115,8
Poland	223,8	578,9	1079,8	1289,2
Ukraine	340,6	893,9	1879,3	2034,8
Russia	5604,7	10118,2	18080,6	24922,6
Netherlands	79,5	161,3	316,3	400,4
Germany	587,9	1121,1	2385,3	2556,2
China	47,4	284,1	1684,1	2193,7
United Kingdom	106,3	144,1	313,4	356,1
Italy	162,6	393,5	772,4	967,8
Venezuela	0,2	0,0	1152,3	1129,8
Total	8646,2	16708,1	34884,4	45747,1

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Belarus in Figures 2011 (Беларусь в цифрах, 2011)*. Minsk: National Statistical Committee of the Republic of Belarus, 2011, p. 92.; National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Belarus in Figures 2012 (Беларусь в цифрах, 2012)*. Minsk: National Statistical Committee of the Republic of Belarus, 2012, p. 86.

Table 8. Commodity exports by main trading partner countries

	2006		2007		2008		2009		2010	
	mln. USD	%*	mln. USD	%	mln. USD	%	mln. USD	%	mln. USD	%
Total	19733,7	100	24275,3	100	32570,8	100	21304,2	100	25225,9	100
CIS countries	8608,8	43,62	11221,4	46,23	14360,2	44,09	9316,3	43,73	13499,3	53,51
Countries of Eurasian Economic Community	7192,5	36,45	9383,9	38,66	11130,5	34,17	7238,6	33,98	10502,2	41,63
Non-CIS countries	11124,9	56,38	13053,9	53,77	18210,6	55,91	11987,9	56,27	11726,6	46,49
European Union	9087,6	46,05	10612,0	43,72	14168,8	43,50	9301,1	43,66	7603,8	30,14
Latvia	462,0	2,34	990,2	4,08	2141,0	6,57	1655,8	7,77	930,6	3,69
Lithuania	432,7	2,19	564,5	2,33	619,2	1,90	362,3	1,70	450,9	1,79
Estonia	94,5	0,48	226,5	0,93	329,2	1,01	119,8	0,56	150,1	0,59
Russia	6845,3	34,69	8878,6	36,57	10551,9	32,40	6718,5	31,54	9816,1	38,91
Ukraine	1234,0	6,25	1469,8	6,05	2777,9	8,53	1691,5	7,94	2562,3	10,16
Poland	1032,8	5,23	1226,2	5,05	1798,4	5,52	823,2	3,86	886,3	3,51
Netherlands	3494,5	17,71	4277,3	17,62	5408,2	16,60	3698,0	17,36	2773,3	10,99
Germany	752,8	3,81	731,1	3,01	812,0	2,49	987,4	4,63	461,0	1,83
Brazil	207,4	1,05	371,1	1,53	1073,7	3,30	444,8	2,09	705,5	2,80
Venezuela	6,0	0,03	42,7	0,18	173,1	0,53	230,6	1,08	302,3	1,20
India	112,9	0,57	102,0	0,42	313,8	0,96	487,8	2,29	331,0	1,31
Kazakhstan	259,4	1,31	361,4	1,49	365,2	1,12	313,4	1,47	463,5	1,84
China	398,7	2,02	484,5	2,00	613,4	1,88	174,0	0,82	474,0	1,88
United Kingdom	1474,9	7,47	1528,9	6,30	1415,5	4,35	803,7	3,77	984,0	3,90

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Foreign Trade of the Republic of Belarus: Statistical Book (Внешняя торговля Республики Беларусь: Статистический сборник)*. Minsk: Republican Unitary Enterprise „Information and Computer Center of National statistical committee of the Republic of Belarus”, 2010- 2011, pp. 32-36.

* As per cent of total exports.

Table 9. Commodity imports by main trading partner countries

	2006		2007		2008		2009		2010	
	mln. USD	%*	mln. USD	%	mln. USD	%	mln. USD	%	mln. USD	%
Total	22351,2	100	28693,1	100	39381,3	100	28569,0	100	34868,2	100
CIS countries	14511,7	64,93	19015,7	66,27	25957,2	65,91	18224,5	63,79	20510,2	58,82
Countries of Eurasian Economic Community	13195,6	59,04	17387,2	60,60	23725,4	60,25	16838,6	58,94	18534,0	53,15
Non-CIS countries	7839,5	35,07	9677,4	33,73	13424,1	34,09	10344,5	36,21	14358,0	41,18
European Union	5039,8	22,55	6242,0	21,75	8541,9	21,69	6545,9	22,91	7547,1	21,64
Latvia	111,9	0,50	127,5	0,44	138,0	0,35	116,6	0,41	95,8	0,27
Lithuania	170,3	0,76	180,1	0,63	233,6	0,59	195,2	0,68	247,9	0,71
Estonia	37,7	0,17	43,3	0,15	61,8	0,16	58,8	0,21	70,1	0,20
Russia	13099,1	58,61	17204,9	59,96	23507,4	59,69	16726,3	58,55	18058,2	51,79
Ukraine	1223,7	5,47	1534,3	5,35	2115,1	5,37	1290,0	4,52	1877,6	5,38
Poland	765,9	3,43	819,1	2,85	1154,9	2,93	786,6	2,75	1077,4	3,09
Netherlands	220,0	0,98	250,3	0,87	364,0	0,92	232,3	0,81	318,4	0,91
Germany	1672,0	7,48	2171,4	7,57	2791,7	7,09	2211,1	7,74	2388,1	6,85
Brazil	210,0	0,94	105,9	0,37	155,1	0,39	118,0	0,41	157,1	0,45
Venezuela	-	-	0,9	0,00	0,1	0,00	0,0	0,00	1152,3	3,30
India	58,6	0,26	81,1	0,28	116,8	0,30	115,9	0,41	151,8	0,44
Kazakhstan	74,4	0,33	151,7	0,53	171,8	0,44	74,9	0,26	403,7	1,16
China	553,6	2,48	815,8	2,84	1414,8	3,59	1080,1	3,78	1683,4	4,83
United Kingdom	184,8	0,83								

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Foreign Trade of the Republic of Belarus: Statistical Book (Внешняя торговля Республики Беларусь: Статистический сборник)*. Minsk: Republican Unitary Enterprise „Information and Computer Center of National statistical committee of the Republic of Belarus”, 2010- 2011, pp. 37-41.

* As per cent of total exports.

Table 10. Belarus's exports of goods to Latvia

Commodity	2008		2009		2010	
	quantity	value, thsd. USD	quantity	value, thsd. USD	quantity	value, t hsd. USD
Total		2 140 993		1 655 847		930 557
Rape seeds, thsd.t	-	-	133,3	40899	5,1	1750
Rape oil, thsd.t	1,4	1737	7,1	5227	9,9	8248
Beer, mln.l	0,1	51	2,4	1026	3,7	1355
Spirits, liqueurs and other spirituos beverages, thsd.l, alc. 100 %	500,5	1720	589,6	1849	611,6	1907
Salt, thsd.t	58,2	2295	42,7	1656	64,6	2198
Products of the distillation of coal tar, thsd.t	21,4	16 125	12,1	6960	44,5	28990
Petroleum oils, other than crude, thsd.t	1908,8	1600993	2028,8	935386	853,1	537921
Petroleum coke, petroleum bitumen, thsd.t	15,2	6503	15,5	4524	8,1	3586
Nitrile-function compounds, thsd.t	21,3	21578	21,2	18103	13,7	11960
Fertilisers, potassic, thsd.t K ₂ O	6,5	6149	-	-	1,9	1107
Mineral fertilisers, mixed, thsd.t	2,4	1498	11,7	3573	25,3	7629
Polymers of ethylene, t	1970	3055	1026	918	730	1026
Fuel wood, thsd.t	14,1	1159	37,2	4661	44,5	5227
Wood in the rough, thsd.m ³	136,6	7183	97,4	2962	132,8	5768
Wood sawn or chipped lengthwise, thsd. m ³	30,2	6075	25,6	3408	67,1	9126
Builders' joinery of wood, t	1857	5309	782	2065	918	2413
Syntetic filament yarn, t	526	1698	406	1092	490	1412
Men's overcoats of textile materials, thsd.pcs	59,1	1936	33,3	1199	30,0	819
Corsetry, thsd.pcs	739,4	3405	244,5	969	185,5	642
Footwear with uppers of leather, thsd.pairs	93,5	2772	51,7	1387	83,5	2330
Slag wool, thsd.t	33,3	2334	31,0	1863	25,0	1540

Semi-finished products of non-alloy steel, thsd.t	116,6	74048	194,5	66687	185,9	90683
Other bars and rods of non-alloy steel, hot-rolled, thsd.t	21,4	17908	2,6	1078	7,5	4137
Wire of non-alloy steel, t	2840	2550	955	426	3684	2142
Tractors and trucks, pcs	399	7403	124	2306	408	6646
Parts and accessories of motor vehicles and tractors, t	293	2685	137	626	236	949

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Foreign Trade of the Republic of Belarus: Statistical Book (Внешняя торговля Республики Беларусь: Статистический сборник)*. Minsk: Republican Unitary Enterprise „Information and Computer Center of National statistical committee of the Republic of Belarus”, 2011, pp. 169-170.

Table 11. Belarus's imports of goods from Latvia

Commodity	2008		2009		2010	
	quantity	value, thsd. USD	quantity	value, thsd. USD	quantity	value, thsd. USD
Total		137 994		116 622		95 833
Fish, frozen, thsd.t	23,4	11341	20,1	9325	16,9	6597
Prepared of preserved fish; caviar, t	2132	5900	1269	3684	589	1838
Flours, meals and pellets, of meat or meat offal, of fish, t	2640	3167	1440	1750	625	779
Preparations of a kind used in animal feeding, thsd.t	6,9	7563	2,5	2331	0,9	1791
Gypsum, anhydrite; plasters of gypsum, thsd.t	14,2	3589	10,7	2256	12,3	2477
Cements, thsd.t	3,7	704	2,6	204	102,2	6824
Electrical energy, mln.kWh	70,3	3425	58,1	2469	-	-
Medicaments put up in forms or packings for retail sale, t	62	7736	45	7593	27	6455
Putties and mastics, thsd.t	3,1	2600	2,1	2050	2,1	1973
Prepared binders, t	1813	2131	5442	5703	1646	1705
Narrow woven fabrics, t	251	5943	190	4122	175	3683

Knitted or crocheted fabrics, of a width not exceeding 30 cm, containing elastomeric yarn, t	227	4880	173	3569	168	3462
Warp knit fabrics, t	169	2878	126	2113	125	1983
Worn clothing, t	273	1152	298	1356	468	2143
Structures of iron or steel, thsd.t	2,7	6605	1,5	3816	1,0	2236
Boards, panels, desks for electrical apparatus, t	536	3275	210	1589	111	963

Source: National Statistical Committee of the Republic of Belarus (Национальный статистический комитет Республики Беларусь). *Foreign Trade of the Republic of Belarus: Statistical Book (Внешняя торговля Республики Беларусь: Статистический сборник)*. Minsk: Republican Unitary Enterprise „Information and Computer Center of National statistical committee of the Republic of Belarus”, 2011, pp. 320-322.

THE POLITICAL IMPLICATIONS OF LATVIA'S ECONOMIC RELATIONS WITH RUSSIA AND BELARUS

Gatis Pelnēns, Diāna Potjomkina

When analyzing economic relations between countries, one should not look only at “purely economic” determinants; the political context should be considered as well. The issue is all the more relevant when at least one of the parties involved does not adhere to liberal external economic policies, so that it is official institutions, not so much the logic of the market, that determine who the foreign business partners are. This is exactly the case with Russia and Belarus. Latvia, like so many other countries, is willing and ready to use political tools to get into closed or semi-closed foreign markets. Thus, the political implications of Latvia's economic relations with Russia and Belarus must be assessed carefully and in a balanced way – whether there are significant implications and what they might be. Such is the aim of this chapter.

The authors distinguish between the implications that economic relations with Russia and Belarus have for both Latvia's external relations and Latvia's domestic politics and society. Accordingly, both subchapters are structured into two main sections – one on external and one on internal consequences (which is not to deny that the internal and external dimensions are closely linked in practice). The first section of each subchapter addresses the main trends and priorities – and changes therein, if any – in Latvia's relations with, respectively, Russia and Belarus. Furthermore, it also analyzes Latvian-Russian and Latvian-Belarusian relations in a wider context, such as Latvia's adherence to common European/Western policies, if any, regarding these two countries. The term “Latvia's foreign policy”, of course, does not presuppose that the state has a unitary and indivisible foreign policy. The second section of each subchapter looks at the preferences of main domestic players – the political elite as well as entrepreneurs and broader society. Attention is devoted in particular to the “values-interests” debate that is so characteristic of Latvia's foreign policy-making as well as the domestic milieu. (“Values” is a cliché widely used in Latvia representing the liberal-democratic, free market values supposedly linking Latvia to the Euro -Atlantic community, while “interests”/“pragmatism” are understood as concerning material – especially economic – interests. When discussing relations with such non-democratic countries as Russia and Belarus, the two are often taken to be incompatible.) Sometimes these preferences are determined by economic rationale, but

sometimes other priorities dominate. They are related to the overall political culture and are used in – and cause – even domestic debates not directly related to the foreign policy sphere. The final section highlights similarities and differences between the two cases, followed by recommendations for Latvia's policy makers. An analysis of the political implications of economic relations poses numerous conceptual, methodological, and practical challenges. What determines whether a Latvian actor "gives in" to economic pressure and enticement? What are the general interests of a country, and what could be the instruments to influence them? How is it possible to assess any political implications when not all the players admit openly their economic preference for Belarus and Russia, and lobbying economic ties with non-democratic regimes can be a sensitive issue both domestically and internationally? The aim of the authors is to provide as broad an analysis as possible, not limited or foreclosed by any strict conceptual limitations. It is accepted that the players involved can have both ideational and strictly material goals and needs, the exact content and balance of which varies in each case and over time; some can be likely to succumb to external pressure, others to resist it. The players, in this case, are many and various; (foreign) policy-making in Latvia, like in any democratic country, involves not only different groups within the national elite but also international organizations, local entrepreneurs, diasporas (in this case Russian and Belarusian), human rights activists, and more. At the same time, understanding the complexity of the given task, we do not claim to provide an overall list of evidence of the ramifications of economic ties, but rather to clarify and illustrate general trends.

1. Latvia's economic relations with Russia

The complexity of Latvia's relations with Russia gives the impression that there is a lot of disagreement and only a little of common interest to both countries. Indeed, political discussions on the nature of relations between Latvia and Russia often come down to issues like compatriots, human rights, democracy, or historical legacies, which raise serious tension in the mutual relationship. However, this is just the surface of relations and there is still a lot of common ground for both countries. For Latvia, Russia presents a security challenge and an opportunity at the same time. Regarding Russia, "...it can neither isolate itself from [the post – Soviet space], nor dominate it to secure its interests there..."³⁶⁶

³⁶⁶ Arbatov, G. A., Hartelius, D. *Russia and the world: A new deal*. New York: EastWest institute, 1999. p. 7.

Economic cooperation is one of the major directions of mutual interest and it has been influenced by the political climate between the states. As noted by Žaneta Ozoliņa and Airis Rikveilis: "While expanding, economic cooperation between Latvia and Russia has been seriously impeded by political constraints."³⁶⁷ It has also been argued by Latvian entrepreneurs and government officials in both countries that political issues between the countries are hampering the intensity of economic cooperation. Economic cooperation, however, is not just greatly influenced by the nature of political environment, but also is a factor that impacts the political environment. In this respect, we are talking about the potential implications of economic cooperation, both positive and negative.

There is political disagreement on how to further develop relations with Russia in economic matters. Calls for increasing cooperation have been made by particular political parties, local governments and businesses, and a notable portion of the economic elite. Intensifying economic cooperation is, therefore, regarded as a goal in itself (where economic gains from cooperation with Russia are regarded as a part of overall economic development) and a means to improve political relations. Those who favor limiting economic cooperation with Russia are nationalist political parties and particular government officials. Russia and its intentions are securitized by arguing for the necessity to reduce Russia's presence in Latvia's economy as a matter of great importance to national security. The possible threat of Russian influence is the key feature of arguments on limiting economic cooperation. Distrust is based on negative perceptions of Russia's potential influence on Latvia's domestic policy and position on a bilateral level, where economic interaction may serve as a tool of political influence. Russia's "great power" aspirations, together with the notion of "privileged interests"³⁶⁸ in post-Soviet countries, close relations between the political administration and business elites, and particular events³⁶⁹ make countries around Russia cautious and distrustful of its intentions and actions. Therefore, Russia's presence in any way is regarded as a security issue and thus perceived as dangerous.

Various actors are involved in the discussion on economic cooperation with Russia – political parties, elites, institutions, businesses, and even society in general are all part of these discussions. Thus, it is not only important where the implications stem from, but also for whom and at what level of policy.

³⁶⁷ Ozolina, Ž., Rikveilis, A. *Latvian and Russian Foreign Policy: Bound by a Post-Soviet Heritage* In Muižnieks, N., ed. (2006), *Latvian-Russian Relations: Domestic and International Dimensions*. Riga: LU Akadēmiskais apgāds, p. 92.

³⁶⁸ Medvedev outlines five main points of future foreign policy. RIANOVOSTI, 31/08/2008. <http://en.rian.ru/world/20080831/116422749.html>, accessed on 01.07.2011.

³⁶⁹ Namely, Ukraine Gas crisis, war with Georgia and rather offensive political tone toward the West.

1.1. Economic relations with Russia: implications for Latvia's foreign policy

Economic cooperation with Russia has implications for Latvia's foreign policy in two ways – bilateral relations between Latvia and Russia and the broader context of Latvia's relations with other partners. This section focuses on the role of economic cooperation in the development of bilateral relations with Russia, as well as the impact of economic cooperation on Latvia's foreign policy in a multilateral context.

1.1.1. Bilateral relations

The goal of political cooperation on a bilateral level is to improve relations with Russia on the basis of a pragmatic approach and discussion over practical issues of mutual interest and unresolved political issues.³⁷⁰ Economic cooperation plays a role in boosting economic performance through support for businesses and also improving political relations between the countries. Respectively, despite political tensions between Latvia and Russia throughout recent history and particular tensions on the economic matters, economic interaction between the countries has continued to grow after the economic crisis in 1998.³⁷¹

When dealing with Russia on a bilateral level, it is of great importance to understand that Russian political elites play an important – one may even say decisive – role in issues of economic cooperation. Russia is rated as “mostly unfree” by the Index of Economic Freedom – Russia ranks 143rd out of 179 countries, with the most problematic areas being business freedom and trade freedom.³⁷² In this context, doing business with Russia seems difficult if there is no backing from the political elites. As noted by Karlis Bukovskis in this volume: “Russian businesses [...] take into account official state policy and statements made by the highest officials [...] [therefore the]...improvement of political relations is now becoming an expectation for increasing investments and an intensification of economic cooperation in general.”³⁷³ For Latvia, tensions of political character

usually mean restraints on exports of some goods to Russia, or “slowing down” transit flows at border checkpoints. In fact, the economic implications of political tensions between the countries affect mainly Latvia.

Russian entrepreneurs are involved in different kinds of business in Latvia, however, on the official level Latvian-Russian economic relations are mainly about a few major issues – transit, gas, the banking sector, tourism, and infrastructure. The reason for this is the need for the Latvian government to oversee the sectors that are most profitable or “strategic”. At the same time, the development of “on the ground” economic relations with Latvia is still in the hands of the economic elites, which “... mostly pursue their business interests... [and]... are not interested in long-term political destabilization, if or once economic interests are ensured.”

³⁷⁴ The Russian business elite is not interested in political tensions as these can also harm business – therefore, the more Russian businesses in Latvia, the more interested the Russian business elite will be in promoting a good relationship between the countries. Therefore, the presence of Russian business represents not only economic benefit, but also a political advantage: attracting more Russian investment and businesses could actually serve as a trigger to improve the political relationship. In this regard both entrepreneurs and governments have a common agenda to intensify bilateral cooperation, which could lead to fewer restrictions for doing business.

However, there is a challenge with having the improvement of the relationship as an ultimate goal of bilateral relations. Namely, Latvia should not easily give up its position on other matters for the sake of putting economic relations first.³⁷⁵ It is rather hard to imagine that the improvement of political relations with Russia for the sake of “pragmatic” interests will be enough to intensify economic interaction. Pragmatism in relations with Russia could also mean granting political support to issues important for Russia for the sake of “good political and economic relations”. Therefore, it should not be taken for granted that “pragmatism” in relations with Russia will always work on both sides.

After some recent developments, bilateral relations between Latvia and Russia have intensified and gained some degree of stability. One of the major events favoring the development in relations was the official visit by then President of Latvia Valdis Zatlers at the end of 2010. The visit did not cause an immediate trade or investment boom, but it created a good basis for more active

370 Latvijas ārpolitikas vadlinijas 2006.-2010. gadam. (Latvia's Foreign Policy guidelines 2006.-2010.), p. 10. Available at <http://www.mfa.gov.lv/lv/Arpolitika/pamatnostadnes/>, accessed on 12.06.2011.

371 See chapter by Andrejs Jakobsons.

372 Miller, T., Holmes, K., et.al. 2011 Index of Economic Freedom. Washington DC: The Heritage Foundation and Dow Jones & Company, Inc. pp. 29-52. (available at http://www.heritage.org/Index/pdf/2011/Index2011_Full.pdf, accessed on 01.07.2011).

373 See chapter by Karlis Bukovskis.

374 Moshes, A. Russian Policy Towards Ukraine, Belarus, and the Baltic States in the Putin Era Baltic States in the Putin Era. PONARS Policy Memo 123, Institute of Europe. April 2000. Available at http://www.gwu.edu/~ieresgwu/assets/docs/ponars/pm_0123.pdf, p. 6, accessed on 01.07.2011.

375 See chapter by Karlis Bukovskis.

government involvement in economic cooperation. The agreements reached on important economic issues (taxation, investment, tourism) do add confidence in the governments' willingness to improve political relations. The other event that demonstrated a turn to a more "pragmatic" approach in bilateral relations was the debate on the referendum on the status of the Russian language in Latvia. Despite some political criticism from Russian officials,³⁷⁶ there was no serious political debate in Russia on the potential negative implications in relations between the countries. In the same way, the results of the presidential elections in Russia were anticipated with no great worry for sudden negative changes in mutual relations or the intensity of economic cooperation.³⁷⁷

1.1.2 Foreign policy – multilateral context

"Reintegration" into the "West" and moving further away from Russia was the general line of Latvia's foreign policy at the beginning of 1990s. To a large extent, this also defined bilateral relations with Russia for Latvia's foreign policy agenda – starting with the pull out of Russian troops and continuing with the perception of insecurity regarding Russia's intentions. After the accession to the EU and NATO, relations with Russia still remain a high priority on the foreign policy agenda, however, most of the effort of Latvia's foreign policy now is directed toward further integration into the EU – namely, being fully involved in the development of the EU's policies as much as possible and joining the euro-zone. Russia in this matter is also important for Latvia as a part of the EU's policies. Taking into account the plurality of attitudes toward Russia and the common stance of EU members on a partnership with Russia, it can be argued that the EU acts as a de-securitizing force in political relations between Latvia and Russia. In this context, the interests of each individual EU member states in putting forward their own interests regarding economic cooperation with Russia should not be ignored.

The EU has noted on numerous occasions that Russia is an important economic partner and that a good relationship with Russia – both bilaterally and on a multilateral level – is necessary for the further development of a partnership. The signing of a border agreement between Latvia and Russia is but one example of the presence of the "EU factor" in Latvia's policy toward Russia. Namely, the

³⁷⁶ See, for example „Latvian referendum ‘a spit’ at European Rights Court”. 20 February, 2012. <http://rt.com/politics/referendum-language-latvia-kosachev-747/>, accessed on 01.07.2011.

³⁷⁷ „Eksperti: Putina kļūšana par Krievijas prezidentu Latvijas ekonomikā neko nemainīs.” 2011. gada 24. septembris. <http://www.diena.lv/latvija/zinas/eksperti-putina-klausana-par-krievijas-prezidentu-latvijas-ekonomika-neko-nemainis-13905334>, accessed on 01.07.2011.

EU insisted on closing negotiations on a border agreement with Russia as soon as possible and put it as a precondition for Latvia to join the Schengen zone. Therefore, if the EU has applied certain pressure toward Latvia to secure its interests regarding Russia in the past, this may also be present in the future. In this case, Latvia stepped down on a domestically sensitive issue (giving up the Abrene district) while relying on the economic benefits of the move. As it was stated in *Declaration of intended actions of the Ivars Godmanis government*: "...with the border agreement, the preconditions are made for a significant development of economic relations."³⁷⁸ We may assume that such statements on potential economic benefits are related to the willingness of the Latvian government to improve bilateral relations with Russia. However, the presence of the EU's "incentive" in the dialogue allows for talk about the more complex nature of the issue.

Creating a visa free regime is emphasized by Russia as an important step toward a Common Economic Space. Vladimir Putin stated that the current visa regime creates barriers for small and medium sized businesses and innovation companies.³⁷⁹ Political discussions on a visa free regime between Russia and the EU are still ongoing, and Latvia has officially declared its support for the idea, but also looks at the issue with a long-term perspective.³⁸⁰ In this respect, there has been a change of attitude toward a visa free regime for Russia – from rejecting the idea³⁸¹ to recent trends of more support for a visa free regime.³⁸² Such changes can

³⁷⁸ Deklarācija par Ivara Godmaņa vadītā Ministru kabineta iecerēto darbību, 2008. Available at <http://www.mk.gov.lv/mk/vesture/godmana-valdiba-2/godmana-valdibas-deklaracija/?print>.

³⁷⁹ Article of Vladimir Putin in newspaper „Deutsche Zeitungen” ‘Rossija i Evropa: otosmislenija urokov krizisa – k novoj povestke patnjorstva’, republished in Russian on the official site of Prime ministre of Russian Federation, <http://premier.gov.ru/events/news/13088/>, accessed on 01.07.2011

³⁸⁰ Latvian Prime Minister Valdis Dombrovskis referred to the complicated process of the implementation of a visa free regime that does not give prospects for a visa free regime in foreseeable future. See Dombrovskis: bezvīzu režīms ar Krieviju nebūs tuvākās nākotnes jautājums. 2011. gada 8. marts. <http://www.db.lv/citas-zinas/dombrovskis-bezvizu-rezims-ar-krieviju-nebus-tuvakas-nakotnes-jautajums-236270>, accessed on 01.07.2011.

³⁸¹ In 2009, then the Minister of foreign affairs of Latvia Maris Riekstins noted that the debate on a visa free regime should not be exceptionally about Russia, but should also include Belarus and Ukraine. He raised concerns about the possible risks of illegal migration that could be caused by the cancellation of the visa regime. See ‘Latvija tozhe ne v vostorge ot ideji otmeni viz mezhdue ES i Rossijej’ 22.12.2009. <http://www.newsru.com/world/22dec2009/latviavise.html>, accessed on 01.07.2011.

³⁸² President of the Republic of Latvia Andris Bērziņš has expressed his support for a visa free regime between the EU and Russia, arguing that this could bring economic benefits. Jaunais Latvijas prezidents atbalsta bezvīzu režīmu ar Krieviju. Pirmdienā, 11. jūlijs 2011. <http://www.apollo.lv/portal/news/articles/243557>, accessed on 01.07.2011.

be explained by a willingness to improve the mutual relationship, however, the EU's position also seems to have impact on the matter. Latvia wants to be involved in the EU's policies (including the ones concerning Russia), therefore opposing a visa free regime would be contrary to the positive attitude for that within the EU.

Finally, the external dimension of Russian–Latvian economic relations should be viewed in the context of the Baltic States. Despite an orientation of foreign economic relations toward the West, Russia still remains an important partner, and internal competition between developing trade with and attracting investments from Russia is inevitable. Russia's economic activities have contributed to a certain unity of the Baltic States. Sharing similar fears of Russia's influence has led to a common position regarding the necessity to diversify the energy supply and regional cooperation in the field. Building the LNG terminal and a nuclear power plant in the Baltics are examples of this cooperation. However, both of these projects have become stuck due to political disagreement among the Baltic countries, and Russia adds pressure to the negotiations by proposing an alternative to the Visagina power plant³⁸³ and participating in discussions on the LNG.³⁸⁴

Economic cooperation with Russia has various implications for Latvia's foreign policy – both from exerting direct influence to change the position of Latvia on particular issues and also the in-direct ways of pursuing greater involvement in the political dialogue with Russia within a multilateral context. The EU plays an important role in shaping Latvia's policies toward Russia by de-securitizing the issue and promoting closer cooperation. When looking from a “values-interests” perspective, the foreign policy of Latvia seems more guided by pragmatic (interest) assumptions than values. There is no doubt that such a conclusion depends on the issue discussed, and in this case the domestic political environment is of great importance. For example, Latvia's position on the Russian–Georgian conflict did not change despite the efforts of influential politicians. The example of the Georgian–Russian conflict emphasizes persistent values in Latvia's foreign policy, which were not outbid by abstract visions of economic benefits.

383 Russia announced plans to build a nuclear power plant in Kaliningrad, which undermines the necessity of the other power plant that Baltic States are planning to build in Visagina, Lithuania. (see Antonovič, M. The Baltic Nuclear Power Plant in Kaliningrad district – dim prospects without export markets. <http://www.geopolitika.lt/?artc=4813>).

384 *Gazprom* and its partner companies are not interested in the development of an LNG plant in Baltics if it bypasses *Gazprom* as a partner. Therefore, speculation on price of the gas and the usage of Inčukalns underground gas storage has been brought to the forefront. (see Sašķidrinātais dabasgāzes terminālis sadārdzināšot gāzes cenu, 20. Oktobris 2011. http://www.financenet.lv/viedokli/396346-saskidrinatais_dabaszgazes_terminalis_sadardzinashot_gazes_cenu).

Therefore, the main question is how far and at what cost Latvia is willing to make its political decisions for the sake of economic benefits.

1.2. Russia's factor in domestic politics of Latvia

The implications of economic cooperation on a domestic level can affect different areas and vary in their expressions and sources. Security and the stability of the state, the interests of particular groups (businesses, political parties, local governments, etc.), or society as a whole can be subjected to such implications. Implications at a domestic level are related to the domestic political environment and the issue of Russia's influence in Latvia. One such channel of political influence is through political parties. The pro-Russian “Harmony Center”³⁸⁵ is regarded as a potential channel of influence for Russia's interests. Taking into account the party's significant representation in parliament after the last elections and its connections with Russian political elites, one should not ignore the potential risk of Russia's influence. It should be noted that there is no clear evidence of the party's direct involvement in promoting Russia's interests. However, “Harmony Center's” position on issues such as joining the euro-zone or a revision of terms of the bailout agreement with IMF and EU³⁸⁶ could strain relations between Latvia and its Western partners, and that would match the interests of Russia in Latvia. Due to unclear evidence, assumptions about “Harmony Center's” connections to Russian interests should be regarded as a risk rather than threat.

Economic groupings within Latvia are another way to get support for Russian interests in Latvia – especially if they are related to political parties. Before the last elections there were three parties directly related to the so called oligarchs. According to press reports, they may have personal business interests with Russia or Russian businesses in Latvia.³⁸⁷ Political influence for private business interests by itself is an indication of grounds for potential political corruption. If political

385 “Harmony Center” emerged as a party bloc of several political parties and is regarded as pro-Russian because of connections with Russian political elites and the statements of some of its members. Although officially the major issues on the agenda of “Harmony center” are related to social problems, its attention is mainly focused on the protection of the rights of minorities in Latvia – with great emphasis on rights and interests of the Russian-speaking minority.

386 Latvia's pro-Russian leader urges euro referendum. 19 September 2011 <http://www.eubusiness.com/news-eu/latvia-vote-euro.cap>, accessed on 01.07.2011.

387 Wikileaks materials indicate that Andris Skele is involved in business with Russia concerning the energy sector; Ainars Slesers and Aivars Lembergs are involved in transit business, which has strong ties with Russia. See “WikiLeaks: Godmanis ir izņēmums Latvijas politiskajā elite.” <http://www.db.lv/citas-zinas/wikileaks-godmanis-ir-iznemums-latvijas-politiskaja-elite-232471>, accessed on 01.07.2011.

influence is used to back Russian (or its businesses') interests for the sake of personal business interests, this should be regarded as a security concern or even threat to the country. In practice, this could lead to decisions to grant a special position to businesses from Russia, which could ease access to Latvian markets and enterprises or foster deals where political issues would become a part of a bargain on economic cooperation. Intensifying economic cooperation with Russia could be used as an argument for such political decisions. In this context, securitization of Russia works as a countermeasure for having too much Russian influence and puts pressure on decision-makers to have greater control over Russia's activities in Latvia. The close link between politicians and economic elites allows a bypassing of safeguards and restrictions on an institutional level, thus weakening the role of institutions in economic interaction and intensifying the risk of corruption.

As noted by Kārlis Bukovskis, "personal relations were unanimously considered to be the most important factor in the promotion of economic relations between Latvia and Russia."³⁸⁸ If we combine the significance of personal relations with the links of Latvia's business elite to Russia, it is possible to assume that attempts at political influence through these elites is inevitable. Special attention in this case should also be brought to the possibility that the presence of Russian businesses is much greater than what is shown in official data, because investment coming through offshore companies links Latvian political and economic elites to Russian business.³⁸⁹ There is no doubt that business communication through direct channels takes less time and may prove to be more effective, but such practices should not be embraced because of the possible risk of corruption. Direct business contacts block state institutions from exerting sufficient oversight and control over the economic affairs of the state. At least for now, the Latvian government has not allowed the sale of relevant companies to Russian buyers, to a large extent out of national security considerations.³⁹⁰ The last elections have

³⁸⁸ See chapter by Kārlis Bukovskis.

³⁸⁹ The media has stressed the business interests of A. Šķēle, A. Lembergs and A. Šlesers in Russia and the possible attempts to influence Latvia's position concerning the Russian-Georgian war (see Wikileaks: ASV uzteic Godmani, kritizē Zatleru. Krievijas vēstnieks meklē Šlesera un Šķēles atbalstu. 30.novembris 2010. <http://www.kasjauns.lv/lv/zinas/34185/wikileaks-asv-uzteic-godmani-tacu-kritize-zatleru-krievija-vestnieks-mekle-slesera-un-skeles-atbalstu>) as well as dinner of former prime minister A. Kalvītis with V. Putin (see Kalvītis ticies ar Putinu. Diena.lv, 2009. gada 30. septembris <http://www.diena.lv/sabiedriba/politika/kalvitis-ticies-ar-putinu-691744>) and potential relation with Kalvītis included in board of Latvijas Balzams (see Kalvītis trīs stundas vakariņo ar Putinu un iegūst krēslu Latvijas Balzamā. 2009. gada 5. oktobris. <http://www.db.lv/citas-zinas/kalvitis-tris-stundas-vakarino-ar-putinu-un-iegust-kreslu-latvijas-balzama-176827>).

³⁹⁰ Ozolina, Ž., Rikveilis, A. Latvian and Russian Foreign Policy: Bound by a Post-Soviet Heritage In Muižnieks, N., ed. (2006), *Latvian-Russian Relations: Domestic and International Dimensions*. Riga: LU Akadēmiskais apgāds, p. 93.

significantly changed the layout of the political environment in Latvia, however, influence through personal contacts may remain a part of Latvia's political landscape and create a basis for potential political corruption.

Interaction with Russia and a perception of its harmful intents are also transferred to public attitudes, not only on particular issues such as economic cooperation, but also regarding Russia in general. The rationale behind such opinions is related to the assumption that economic assets in Latvia can potentially be used to gain a certain political influence. Therefore, a fear is planted within Latvian society about having less control over economic activities within the country and about the growing influence of Russia through control over economic assets in Latvia. In this context, economic cooperation with Russia is perceived as dangerous and even threatening as it urges Russia to be more involved in one of the key spheres of the country.

To sum up, the implications on a domestic level are more related to potential risks than opportunities (as in the case of external relations). On the one hand, these risks are related to suspicion about Russia's intents and the securitization of Russia in the domestic environment. On the other hand, risks such as corruption and political lobbying for the benefit of self-interests are more general problems that Latvia's domestic political landscape is facing. Therefore, the role of Russia in these problems should not be overestimated. Economic cooperation with Russia can contribute to corruption because of a business culture of "private contacts" and could be a part of issues surrounding domestic stability, but should not be seen as a cause of either consequence.

2. Economic relations with Belarus

2.1. Implications for Latvia's foreign policy

Along the lines already set for this chapter, this section is concerned with direct and indirect ramifications which economic ties with Belarus have left on Latvia's external relations. For most of the time, foreign policy debates in Latvia on relations with the A.Lukashenka regime have not achieved similar intensity as those on policy towards Russia. One might even say this issue has been deliberately kept in shadow by some players. At the same time, the variety of opinions on Belarus is notable in Latvia, with clashing economic, cultural, geopolitical and other interests. As the Western stance on Belarus is more united than that on Russia, implications for Latvia's multilateral relations have also been more visible in this case.

2.1.1. Bilateral relations

Belarusian economic policy has different ramifications on Latvia's foreign policy, both in a bilateral context and in a broader multilateral context. The Belarusian economy is closely controlled by the state, the economic milieu is generally unfriendly toward foreign businesses, and Belarus can afford to choose whether to cooperate with Latvia or not. Therefore, in order to support Latvian entrepreneurs in the neighboring country and to attract Belarusian investors/transit/trade etc., (pro)active support and dialogue would be needed from Latvian foreign policy-makers.³⁹¹ Whether, why and how this support manifested in Latvia's foreign policy is the topic of this section.

Let us first turn to the "normative" approach in Latvia's foreign policy, which judges Belarus primarily by its system of governance. According to these players, cooperation with A.Lukashenka's regime could be interpreted as tacit support for his authoritarian policies, which pose many dangers to Latvia. In the opinion of proponents of this approach, Belarus is currently a satellite of the threatening Russia,³⁹² and Latvian entrepreneurs would be better off if the regime changed.³⁹³ Also, they have quoted the policies of the European Union, the U.S., the OSCE, the Council of Europe and other Western partners, all of whom had severed virtually all links with Belarus. Thus, "normativists" have (long) disfavored political dialogue and also securitized economic relations with Belarus. There have been a few such groups in Latvia, including political forces (primarily "Unity" and the National Alliance All For Latvia-For Fatherland and Freedom/LNNK, with some inconsistencies) and also players outside of the political elite. Their activity and relative prominence had increased during the crises (e.g., because of non-democratic elections in Belarus) but weakened in the meantime. It must also be admitted that Belarus, although a neighbor, has not played nearly as prominent a role in Latvia's foreign policy or academic and public debates as Russia has.

391 See e.g. Jermaks M. Latvijas dialogs ar Baltkrieviju: vērtības vai intereses?: Divpusējo attiecību pieredze (1998-2004) un perspektīvas Latvijas ekonomisko un politisko interešu kontekstā. No: *Latvijas ārpolitika un „robežu paplašināšana”*. Zin.red. Ž. Ozoliņa. Rīga: Zinātne, 2006.

392 As one representative of the "normative" stream noted, "each state which chooses democracy and cooperation with the EU, diminishes Russia's empire." See Aldis Kušķis (then "New Era"), quoted in Cālite A. Darbs Eiroparlamentā nav sprinta skrējienis. *Latvijas Avīze*, 22.07.2005. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.). See also e.g. Kalniete S. [then "Civic Union", MEP] Krievijas un Eiropas uzskatu sadursmes. *Latvijas Avīze*, 14.11.2009. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.).

393 See also e.g. article by Kalniete S. [then "New Era"]: Kalniete S. Pārsteidz, bet ne Baltkrievija. *Diena*, 03.08.2006. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.).

Against this background of (heavier and lighter) criticism toward cooperation with official Belarus, one can assess the political implications that have appeared. In spite of generally insufficient interest in Belarus, as well as both objective and subjective obstacles, quite a few players have stood for cooperation with the A.Lukashenka regime and are ready to negotiate smaller or larger political compromises (the intensity of "pragmatism" has also fluctuated). The main "pragmatists" have been entrepreneurs working/interested in the Belarusian direction, the Belarusian diaspora in Latvia, and certain political forces. Economic rationale has evidently been the main reason for cooperating with the regime.

Predictably, business representatives from both the private and state sectors have been the main group supporting official cooperation with Belarus regardless of its regime, voicing their concerns very explicitly and publicly. For instance, a few days after the rigged elections and referendum in Belarus in 2004, the Director General of state railway company "Latvijas Dzelzceļš", Andris Zorgevics, was quoted as warning the prime minister that Latvia's criticism of Lukashenka could have unwelcome business repercussions: officials in Belarus might react by cutting transit through Latvian territory.³⁹⁴ There have been quite a few such calls, even after the last presidential elections, and these notably intensified when the EU for the first time introduced (small-scale) economic sanctions against enterprises linked to the regime.³⁹⁵ Another example could be the March 2011 call to support A.Lukashenko, issued by representatives of the Belarusian national minority organizations in Belarus's neighboring countries (including the Latvian Union of Belarusians). In this case, the EU and the Council of Europe were called upon to stop "external pressure" on Belarus.³⁹⁶ The Latvian Union of Belarusians was also opposed to economic sanctions on Belarus, quoting Latvia's interest in economic cooperation.³⁹⁷

394 Космачев К. Торговать или бороться? *Телеграф*, 22.10.2004. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.). Another example would be the Director General of Latvian Chamber of Commerce and Industry Jānis Leja asking Latvian politicians not to criticize Belarus after its 2006 presidential elections, as "[e] very critical action finds expression in the mode of Lat, Dollar, Euro or Belarusian rubel." See Barkāns E. Biznesmeņi nevēlas naidoties ar Lukašenko. *Nedēļa*, 27.03.2006. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.).

395 E.g. Alfrēds Čepānis (politician, former MP and entrepreneur, who currently chairs the board of the "Association of favouring economic relations between Latvia and Belarus"), see Čepānis quoted in Аюпова И. Белорусский транзит обойдет нас стороной. 18.04.2011. <http://www.telegraf.lv/news/beloruskii-tranzit-oboidet-nas-storonoi> (Telegraf.lv news portal; accessed on 20.08.2011.).

396 Piskunova V. et al. „[To] Heads of Member States of the European Union and the Council of Europe, Members of the European Parliament.” 12.03.2011. http://www.belchas.com/index.php?option=com_content&view=article&id=115:heads-of-member-states-of-the-european-union&catid=37:2010-07-25-05-27-48&Itemid=55 (Belchas.com; accessed on 20.08.2011.).

397 Латвийские белорусы призывают отменить санкции. 13.03.2011. <http://baltijal.lv/news/read/15631> (Информационный портал русской общины Латвии; accessed on 20.08.2011.).

At one point or another, these arguments have resonated with a large part of the political elite. The traditionally “pragmatic” forces, such as “Harmony Center” and the currently abolished parties LPP/LC and People’s Party (the latter had fluctuated between “values” and “interests”), have also asked to “depoliticize” relations with Belarus so that economic relations would not suffer. In the words of Jānis Lāčplēsis, then mayor of the near-border city of Daugavpils and a member of LPP/LC, “politics – this is one thing. One shouldn’t meddle in the system that Belarusians themselves have chosen. However, the fact that before both ‘Latvijas Dzēlceļš’ and its Daugavpils unit have earned very much from Belarusian orders was and is very important.”³⁹⁸

However, interestingly, economic rationale has not been ignored by “normative” political forces as well. Even “Unity” and “National Alliance” notably softened their positions around 2008. As the last economic crisis posed real problems for Latvia’s security, economic benefits from cooperation with A.Lukashenka must have outweighed other concerns. Also, at that time economic relations had already reached a greater degree of institutionalization. Such a policy on Latvia’s side, of course, was enabled by the *détente* in relations between Belarus and Latvia’s Western partners, which also started at that time. In any case, from approximately 2008 until late 2010, practically the entire Latvian political spectrum engaged in actively building official contacts with Belarus at the highest level. To a lesser extent, this policy continued afterward (see below).

What can be considered as economically motivated political decisions? One aspect might be seen in continuous bilateral political relations, which mostly concern practical issues. High-level dialogue (at the governmental and parliamentary levels) went on in the 1990s, even after authoritarianism consolidated in Belarus and Western countries limited contact with the regime. Around the year 2000, coinciding with Latvia starting its accession negotiations with the EU, dialogue came to a halt, but lower-level official cooperation continued,³⁹⁹ as did cooperation at the level of municipalities. New bilateral agreements were still concluded,⁴⁰⁰ and until 2004 (at least) economics was the

main issue in interstate negotiations.⁴⁰¹ After Latvia’s accession into the EU and NATO in 2004, which was contemporaneous with new waves of repressions in Belarus, interstate relations suffered additional setbacks, and at times the official stance from Riga was markedly critical and “securitizing”. Nonetheless, the overall attitude remained moderate: “[...] cooperation with Belarus is developed, finding a balance between democratic values and economic interests, because a great part of Belarusian transit cargoes are transported through Latvian territory.”⁴⁰² Looking at development cooperation projects with Belarus in this period, the record is rather mixed, whereby some projects are oriented toward civil society while others seem to be directly or indirectly strengthening economic links.⁴⁰³ Cooperation intensified in 2008, when the EU partially “unfroze” relations with Belarus, and since then the influence of economic reasoning has been much more visible. A whole series of meetings soon followed, involving *inter alia* prime ministers, presidents, and parliamentarians from both Latvia and Belarus (though a meeting between presidents didn’t take place). According to official announcements, the main issues discussed by the officials were not democracy and human rights in Belarus but rather practical, particularly economic, cooperation – namely, those issues that are of interest to Latvian businesses. Belarusian state enterprises also got involved. Thus, the rapid growth in Latvian-Belarusian economic relations has been a cause and consequence of the improved political climate.

Bilaterally, various other political decisions could be linked to economic imperatives. Some are rather obvious, such as the support for entrepreneurs provided by the Latvian MFA and the Latvian Embassy, or the decision to open an economic representation for Latvia in Belarus.⁴⁰⁴ Others are less obvious and

398 Quoted in Līcītis E. „Rīga varai vienmēr būt tuvāk nekā Daugavpils...” Vai tiešām? *Latvijas Avīze*, 28.10.2009. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.).

399 On IGC see Jermaks M. Latvijas dialogs ar Baltkrieviju: vērtības vai intereses?: Divpusējo attiecību pieredze (1998-2004) un perspektīvas Latvijas ekonomisko un politisko interešu kontekstā. No: *Latvijas ārpolitika un „robežu paplašināšana.”* Zin.red. Ž. Ozoliņa. Rīga: Zinātne, 2006. http://www.president.lv/images/modules/items/PDF/item_501_latvijas_arpolitika.pdf (President of the Republic of Latvia; accessed on 27.09.2011.).

400 Divpusējo līgumu datubāze: Latvijas Republikas divpusējie līgumi, kas noslēgti kopš 1990. gada 4. maija: Baltkrievijas Republika. <http://www.mfa.gov.lv/lv/Arpolitika/bil>

ateral/?mode=out&state=BLR&title=&branch=0&day1=dd%2Fmm%2Fyyyy&day2=dd%2Fmm%2Fyyyy&status=0&day3=dd%2Fmm%2Fyyyy&signer= (Ministry of Foreign Affairs of the Republic of Latvia; accessed on 28.08.2011.).

401 Jermaks M. Latvijas dialogs ar Baltkrieviju: vērtības vai intereses?: Divpusējo attiecību pieredze (1998-2004) un perspektīvas Latvijas ekonomisko un politisko interešu kontekstā. No: *Latvijas ārpolitika un „robežu paplašināšana.”* Zin.red. Ž. Ozoliņa. Rīga: Zinātne, 2006. http://www.president.lv/images/modules/items/PDF/item_501_latvijas_arpolitika.pdf (President of the Republic of Latvia; accessed on 27.09.2011.).

402 Artis Pabriks, then foreign minister: Pabriks A. Uz deputātu jautājumiem rakstiski iesniegtās atbildes. *Latvijas Vēstnesis*, 05.10.2006.. <http://www.latvijasvestnesis.lv/index.php?menu=doc&id=145009> (Latvijas Vēstnesis; accessed on 28.08.2011.).

403 Palīdzība Baltkrievijai. <http://www.mfa.gov.lv/lv/Attistibas-sadarbiba/valstis/Baltkrievija/> (Ministry of Foreign Affairs of the Republic of Latvia; accessed on 28.08.2011.).

404 It is due to start operation in 2012. See Latvijas Republikas Ministru Kabinets. Latvijas ārējo ekonomisko pārstāvniecību tīkla turpmākās attīstības rīcības plāns (apstiprināts ar rīkojumu Nr. 399 no 19.06.2009.) <http://polsis.mk.gov.lv/view.do?id=3049> (Politikas plānošanas dokumentu datu bāze; accessed on 27.09.2011.).

could be considered apolitical or even serving the needs of Belarusian civil society – e.g., education partnerships, or cooperation between municipalities. However, it is doubtful whether these spheres of interstate relations would be developed so intensively if Latvia was not interested in closer economic links. For instance, in 2010 travel was simplified for inhabitants of the border territories, including *inter alia* the city of Daugavpils, which is closely interested in cooperation with Belarus.⁴⁰⁵ One of the aims of the travel permitted by the agreement is maintaining economic contacts.⁴⁰⁶

Finally, as has been mentioned, Latvia has evidently tried to preserve good economic relations even after the Belarusian presidential elections on December 19, 2010, and the ensuing events. The “ghost” of the economy is well seen in some announcements from then foreign minister Ģirts Valdis Kristovskis (“Unity”): “With our political attitude [toward Belarus] we are not interested in limiting business opportunities for our entrepreneurs. When formulating a political stance toward the political governance of another state, one should watch out so that business would not suffer.”⁴⁰⁷ This was uttered against a background of overall international condemnation.⁴⁰⁸ Even if Latvian officials later joined the critics, cooperation on economic and other practical issues has still been going on, albeit at a lower level, such as in economic fora. The abovementioned “economized” changes in attitudes and policies are perhaps not very tangible. Still, economic relations with Belarus have somewhat intensified thanks to the improved political climate. The wish to improve the economic ties has also been a test for the coherence, certainty, and balance of Latvia’s foreign policy.

405 Latvijas Republikas un Baltkrievijas Republikas pierobežas teritoriju administratīvi teritoriālo vienību saraksts. 10.08.2010. <http://www.mfa.gov.lv/lv/jaunumi/PazinojumiPresei/2010/Augusts/10-01/latvijas-baltkrievijas-teritorealo-vienibu-saraksts/> (Ministry of Foreign Affairs of the Republic of Latvia; accessed on 03.06.2011.).

406 Latvijas Republikas valdības un Baltkrievijas Republikas valdības vienošanās par Latvijas Republikas un Baltkrievijas Republikas pierobežas teritoriju iedzīvotāju savstarpējo braucienu vienkāršošanu. 10.08.2010. <http://www.mfa.gov.lv/lv/jaunumi/PazinojumiPresei/2010/Augusts/10-01/vienosanas-projekts/> (Ministry of Foreign Affairs of the Republic of Latvia; accessed on 03.06.2011.).

407 Quote from Melkīš D. Neesam ieinteresēti skriet ratiem pa priekšu. *Diena*, 10.01.2011. <http://news.lv/> (Lursoft periodics library; accessed on 01.07.2011.). See also e.g. Ģirts Valdis Kristovskis, quoted in: Ārlietuministrs Ģ.V. Kristovskis: aicinām Baltkrievijas pusī rast ātru un demokrātisku risinājumu saistībā ar 19.decembra notikumiem. 22.12.2010. <http://www.mfa.gov.lv/lv/jaunumi/PazinojumiPresei/2010/decembris/22-2/> (Ministry of Foreign Affairs of the Republic of Latvia; accessed on 26.06.2011.).

408 See e.g. Council of the European Union. Council conclusions on Belarus. 3101st Foreign Affairs Council meeting, Luxembourg, 20 June 2011. p. 2. http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/122926.pdf (Council of the European Union; accessed on 14.07.2011.).

2.1.2. Foreign policy – multilateral context

Belarus’s economic appeal has affected not only Latvia’s foreign policy toward Belarus itself, but also its relations with and policies toward other countries and international organizations. Unlike in the case with Russia, politically or even legally binding international norms have been a major factor in limiting cooperation between Latvia and Belarus. The EU, for instance, took a binding decision back in 1997 to limit ministerial contact and technical assistance to Belarus, conditional on its compliance with human rights norms and democratic principles.⁴⁰⁹ The EU, in the words of Sabine Fischer, chose a “regime change” policy and accepted the (self)isolation of the Belarusian government while supporting civil society there.⁴¹⁰ This policy continued until 2008 with no fundamental changes, and a similar or even stricter stance was taken by another “strategic partner” of Latvia, the United States. In 2008, the EU began to unfreeze relations – its new policy of “incremental regime evolution” was an attempt to achieve changes through limited cooperation with the regime.⁴¹¹ Arguably, there have been some “pragmatic” reasons for this turnaround on the part of some member states and perhaps even the Union as a whole. Europe is interested in stable transit through Belarus, combating cross-border crime, and also in a few other kinds of practical cooperation.⁴¹² Notwithstanding this, Belarus is a much less important partner for the EU than Russia is, and A.Lukashenka’s attitude toward “the West” is an additional disincentive for the EU. The democratization of Belarus has remained the primary goal of the Union and many other influential players.

In this context, it can be seen that for Latvia the so-called “values-interests” dilemma in fact also represents a dilemma between international partners’ norms and some players’ own narrow interests, such as immediate business gains (of

409 The Council Conclusions stipulated *inter alia* that the EU will not conclude the comprehensive Partnership and Cooperation Agreement (like those with other East European countries) and that bilateral technical assistance between Belarus and the EU and its Member States will be halted unless it is related to democratization or humanitarian needs. See 2027th Council meeting General Affairs Brussels, 15 September 1997. PRES/97/269. Belarus: Council Conclusions. <http://europa.eu/rapid/pressReleasesAction.do?reference=PRES/97/269&format=HTML&aged=1&language=EN&guiLanguage=en> (Europa Press Releases RAPID; accessed on 29.08.2011.).

410 Fischer S. Executive Summary. In: Balmaceda M.M. et al. *Back From the Cold? The EU and Belarus in 2009*. Ed. S. Fischer. Chaillot Paper No. 119. Paris: European Union Institute for Security Studies, November 2009, pp. 12-4. <http://www.iss.europa.eu/> (European Union Institute for Security Studies; accessed on 03.01.2010.).

411 *Ibid.*

412 See e.g. Bosse G. Challenges for EU Governance through Neighbourhood Policy and Eastern Partnership: The Values/Security Nexus in EU–Belarus Relations. *Contemporary Politics*. 2009, Vol. 15, No. 2, pp. 215-227. <http://search.ebscohost.com/> (EBSCO; accessed on 05.02.2011.).

course, one could discuss whether a hard-line “regime change” policy is the best, whether all Western partners adhere to the norms they declare, etc. However, with regard to Belarus, the pursuit of economic interests *per se* is hardly consistent with liberal and democratic values). Throughout different periods of time, this dilemma has been solved in different ways by different players. “Normative” forces did much in the past to put the Belarus issue higher on the international agenda – for instance, the MEPs from such parties intensively worked for the European Parliament and also the U.S. congress to condemn the Belarusian regime.⁴¹³ However, Latvian decision-makers have also interpreted, evaded, and even shaped these international norms to suit their other interests and needs, among which economic cooperation with Belarus has played a key role. Western norms have often been quoted in public while developing very “pragmatic” and economized cooperation on the ground;⁴¹⁴ some players have even protested openly against such “external limitations.”⁴¹⁵

To illustrate, it should be noted that Latvia never officially supported economic sanctions against Belarus, and in 2011-2012, when discussions regarding the issue reappeared on the agenda, asked the EU to “take into account” Belarusian-Latvian economic links⁴¹⁶ (in the end, however, the Council of the EU imposed a series of sanctions on Belarus, among them freeze of the assets of some companies linked

to the regime – the number now amounts to 32 –,⁴¹⁷ which provoked wide-ranged criticism from various actors as detrimental to Latvia’s economic interests⁴¹⁸). At the same time, “pragmatists” have been eager to use opportunities provided by the EU in relations with Belarus – here, it is interesting to see a consensus at the highest level to use EU’s cross-border cooperation programs more actively.⁴¹⁹ The country welcomed the warming in EU-Belarus relations and Belarus’s inclusion in the Eastern partnership (of course, Latvia has also called on Belarus to comply with Western requirements and to take steps to start a dialogue, which is another way of rectifying inconsistencies⁴²⁰). Hence, the desire to strengthen economic ties must have been the main reason for Latvia’s attempts to change and/or circumvent the general Western position. Again, these changes in policy might not have left an immediate tangible impact on Latvia’s situation, and, to the author’s knowledge, Latvia has not been accused of violating international norms. Nevertheless, in the long term this “economization” of foreign policy is significant.

Certain repercussions have evidently also appeared in Latvia’s relations with the other Baltic States, its crucial partners. Lithuania – among others – is interested in attracting Belarusian business and strengthening its position in the relatively unexplored Belarusian market. The competition for oil transit from Venezuela to Belarus, as well as for the transit of Belarusian potassium salt and oil products, has been only one example of this. Under such circumstances, Belarus has the possibility to choose partners, to demand concessions and even to pitch the players against each other, basically using the “divide and conquer” strategy. Latvia and Lithuania in particular are competing among themselves – although in the long term cooperation would have been more desirable. This is just another example how, for Latvian foreign-policy makers, different priorities can clash among themselves.

413 See e.g. Klich B.A., Kušķis A., Posselt B. and Duka-Zólyomi Á. on behalf of the EPP-ED Group. Motion for a Resolution, B6-0193/2005, 07.03.2005. <http://www.europarl.europa.eu/sides/getDoc.do?type=MOTION&reference=B6-2005-0193&language=EN> (European Parliament; accessed on 30.08.2011.); Szymański K., Bielan A., Roszkowski W., Zapałowski A.T., Czarnecki R. un Vaidere I. on behalf of the UEN Group. Motion for a Resolution, “European Parliament resolution on the situation in Belarus after the parliamentary election of 28 September 2008,” B6 0534/2008, 03.10.2008, <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+MOTION+B6-2008-0534+0+DOC+XML+V0//EN> (European Parliament; accessed on 30.08.2011.); Aldis Kušķis: Eiropas Parlamenta deputātu un ASV kongresmeņu vienotā nostāja ir politisks spiediens, lai atturētu Lukašenko no asinsizliešanas. 16.03.2006. <http://lv.lv/index.php?menu=doc&sub=&id=130540> (Latvijas Vēstnesis; accessed on 30.08.2011.), etc.

414 On Latvia’s adherence to international norms when developing relations with Belarus, see Potjomkina D., *Eiropēizācija Latvijas ārpolitikā attiecībā uz Baltkrieviju (2004-2010)*. Bachelor’s Thesis (unpublished). Thesis Advisor: Sprūds A. Rīga: Rīgas Stradiņa universitāte, 2010.

415 For instance, after the last presidential elections in Belarus the Latvian Confederation of Employers called on the government not to support the EU’s economic sanctions against the neighboring country. See Latvijas Darba devēju konfederācija [LDDK]. „Uzņēmēji ieinteresēti stiprināt kaimiņattiecības ar Baltkrieviju.” 26.05.2011. <http://www.ddd.lv/index.php?main=84&lang=1&p=1566> (LDDK; accessed on 08.01.2011.).

416 Luksemburgā ārlietu ministrs Ģ.V.Kristovskis piedalījās diskusijā par Eiropas Savienības kaimiņu reģioniem. 13.04.2011. <http://www.mfa.gov.lv/lv/Jaunami/Pazinojumi/Presei/2011/aprilis/13-3/> (Ministry of Foreign Affairs of the Republic of Latvia; accessed on 03.06.2011.).

417 See e.g. Council of the European Union. Council conclusions on Belarus. 3101st Foreign Affairs Council meeting, Luxembourg, 20 June 2011. p. 2. http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/-EN/foraff/122926.pdf (Council of the European Union, accessed on 08.01.2012.); „The EU and Belarus: A Factsheet”. 23.03.2012. http://www.eu-un.europa.eu/articles/en/article_12009_en.htm (European Union @ United Nations, accessed on 25.08.2012.).

418 Cf. Kariņš K. [MEP from Latvia, „Unity”]. „Krišjānis Kariņš: Eiropas sankciju politika Baltkrievijā.” 22.03.2012. <http://www.delfi.lv/news/comment/comment/krisjanis-karins-eiropas-sankciju-politika-baltkrievija.d?id=42226320> (Delfi portal, accessed on 17.06.2012.); Naudiņš R. [MP, „National Alliance”]. „Naudiņš: Ekonomiskās sankcijas pret Baltkrieviju ir nepieņemamas.” 02.03.2012. <http://www.diena.lv/latvija/viedokli/naudins-ekonomiskas-sankcijas-pret-baltkrieviju-ir-nepienemamas-13934737>

419 Valsts kanceleja. Ministru prezidents tikās ar Baltkrievijas premjerministru Sergeju Sidorski. 12.11.2008. <http://www.mk.gov.lv/lv/aktuali/zinas/2008gads/11/12112008/> (Cabinet of Ministers of the Republic of Latvia; accessed on 30.08.2011.).

420 See e.g. Алексеев Н. „Минск – Рига: договор подписан.” Час, 03.03.2008. http://www.chas.lv/win/2008/03/03/l_030.html?r=30& (Час web page, accessed on 30.08.2011.).

2.2. Economic relations with Belarus: implications for Latvia's domestic politics

The impact that economic relations with Belarus have left on Latvia's domestic politics is even more difficult to describe than the foreign policy consequences. Challenges include its indirect and/or obscure nature, as well as the generally low salience that Belarus – and foreign policy in general – has in Latvia's domestic debates. Nonetheless, some aspects are worth mentioning even though they are not related very directly to economic relations between the countries.

One of these seems to be the impact of the Belarusian example on public attitudes towards politics – including Latvian politics. In the Latvian press one can occasionally find references to the success of the Belarusian economic model, implying that this could justify authoritarian governance. Those who are discontent with Latvia's (real or assumed) neo-liberal and Western-oriented economic path often praise the egalitarian social system, the continued existence of large enterprises, and other aspects of the Belarusian economy⁴²¹ (although the recent economic hardships in Belarus will probably weaken this position). Belarus is seen as an alternative to the current political system in Latvia, as a country resisting Western pressure and preserving its sovereignty – the “mistakes” for which these “pragmatists” criticize Latvia. As a result, a well known Latvian newspaper even ran an article entitled “Latvia Needs Lukashenka!...”⁴²² Arguments along these same lines have been voiced by some “pragmatic” political forces, who point out that the Lukashenka regime has (seemingly) guaranteed high levels of social protection and economic development, and at the same time they deny any infringements of human rights in the country.⁴²³ The policies in Belarus have also given additional ground to the “normative” current of Latvian political and societal thought. At times, the country has been construed as a threat, albeit much less so than Russia and the influential local Russian minority. Another related aspect, therefore, has been the use of Belarus in inter-party debates, criticizing the other side of, for example, worsening Latvia's image in the EU by

defending Belarus,⁴²⁴ or the opposite, a lack of “pragmatism”. Finally, like in the case with Russia, a related implication could be the impact on Latvia's political culture regarding obscure links between entrepreneurs and the political elite. The necessity to “open” the economic system of Belarus through political contacts gives an incentive for non-transparent decision making, which serves neither democracy nor the economic interests of Latvia's society as a whole.

To conclude, the economic policy of Belarus has left a visible and multifaceted impact on Latvia's foreign policy and domestic politics. Of course, this effect should not be exaggerated. Liberal-democratic values and international norms, as well as geopolitical hard security considerations, have played an important part in hampering cooperation. The necessity of negotiating with Russia has arguably contributed more to “pragmatism” in Latvia than Belarus ever did. Also, a direct link cannot in all cases be proven to exist between economic interests and certain political decisions. However, over long term broad tendencies can be identified in Latvia's foreign policy toward Belarus, and here “pragmatism” plays a key role. One can identify a constellation of certain influential private and public economic interests and members of the political elite who are interested in economic cooperation over other considerations, and are ready for appropriate political measures. This position also resonates with part of society in general.

As a consequence, both bilaterally and in relations with international partners such as the EU, many political decisions were taken on closer economic cooperation with Belarus, without necessarily adhering to “values”. The economic crisis has shown that most of the political elite are potentially ready for such a compromise. The immediate impact might not be very marked, but on a more general level the very necessity of solving this dilemma has contributed to internal political disagreements and the lack of overall principles that is so characteristic of Latvia's foreign policy. To a certain extent, this also must have inhibited the ability to identify with other European/Western partners. In an apt description by Dovilē Jakniūnaitē, for the Baltic States “Europe” is still an “other”, even if it is a “positive other.”⁴²⁵ There is not much readiness to sacrifice short-term personal gains for the sake of, for instance, a more coherent EU foreign policy in the long term. Thus, when “Western” values, principles, and regulations are thought to be compatible with “national interests” (security with regards to Russia, the wish to “open up” the economies of partner countries, positioning Latvia as a

421 For a positive assessment of the situation in Belarus, see Kaņepe M. Ceļojums laikā bez bailu sajūtas. *Druva*, 29.12.2007. (Lursoft periodics library; accessed on 01.07.2011.); Krauze A. Trīs dienas Minskā. *Neatkarīgā Rīta Avīze*, 08.12.2006. (Lursoft periodics library; accessed on 01.07.2011.).

422 Харланова И. „Латвии нужен Лукашенко!..” *Час*, 01.07.2011. <http://www.chas.lv/culture/theme/interview/9928-2011-07-01-g005.html> (Час; accessed on 08.01.2012.).

423 See e.g. parliamentary debates on condemning Belarus's repressions against the civil society, Latvijas Republikas 8. Saeimas ziēmas sesijas astotā sēde, 02.03.2006. (Saeima; accessed on 08.01.2012.).

424 Jurķis R. Vai tiešām „batjka” var darīt, kā grib? *Diena*, 01.08.2006. (Lursoft periodics library; accessed on 01.07.2011.).

425 Jakniūnaitē D. Neighbourhood Politics of Baltic States: Between the EU and Russia. In: *Identity and Foreign Policy: Baltic-Russian Relations and European Integration*. Farnham, England; Burlington, VT: Ashgate, 2009, p. 119.

successful reformer, etc.), in practice no inconveniences arise. However, when “values” and “interests” clash, the former often prevail. This poses a challenge for Latvian policy-makers, since the country maintains very close relations with both Western partners and Belarus (and often discusses one side with the other).

3. Russia's and Belarus's influence: a comparison and recommendations

3.1. Comparison and conclusions

According to the previous sections on Latvian-Russian and Latvian-Belarusian relations, it is possible to identify certain similarities and differences between both cases. Russia and Belarus have similar interests regarding cooperation with Latvia and the EU, they both are regarded as non-democratic with similar problems regarding freedom of the economy, and both countries call for pragmatism in economic relations while still paying attention to the political context. Russia and Belarus have different political, economic, and normative weight, and they have different goals with regard to Latvia and different strategies for the achievement of those goals. Nevertheless, Russia and Belarus remain partners – notwithstanding many internal arguments – and have commonalities in their policy that allow for a meaningful comparison and highlight some interesting trends regarding Latvia's foreign policy and domestic political environment.

Both countries are interested in economic cooperation with Latvia as an integral part of the EU. For Belarus, cooperation with Latvia is an opportunity to be more involved in economic interaction and political dialogue with the EU, which could potentially lessen criticism of its lack of democracy. For Russia, cooperation with Latvia is a potential opportunity to influence the EU's policies. For both it is also a possibility to ‘step into’ the European internal market – a “pragmatic” goal on their side.

Russia and Belarus are regarded as non-democratic and, despite certain differences, they both share similarities in their strong control over the political, social, and economic activities of their citizens. The economic systems of Russia and Belarus are defined as “not free” and are relatively closed regarding foreign trade and investments. Therefore, the backing of political elite is necessary for doing business in both countries. In this respect, we can also see similarities in how both countries have used economic benefits as an incentive to influence political decisions in Latvia. Ironically, Russia and Belarus have often reproached Latvia

for an alleged lack of pragmatism and undue “politization” of relations, while the countries themselves stick to anti-democratic and anti-Western rhetoric.

Russia's influence is more comprehensive thanks to both its larger economic capacity and volume of interaction, as well as to its political position. In the case of Belarus, the leverages are primarily economic. At the same time, Russia's activities are perceived as much more threatening than those of Belarus, due to both historical reasons and to its current policies. Relations with Belarus have been securitized much less than with Russia. The influence of both (Russia and Belarus) is sustained through the presence of interested players in Latvia who are ready to put explicit public pressure on the Latvian foreign policy-making process. The current economic crisis has especially tilted most political forces toward greater “pragmatism”. At the same time, opposing “normative” currents in Latvia's foreign policy have developed historically and persist to this day. These domestic factors make Latvia vulnerable to external influence and internal disagreements, and also make it harder to develop a unified and consistent foreign policy toward Russia and Belarus. Relations with Russia in particular has been a polarizing issue, while Belarus has received scant attention in public debates.

The policies of both Russia and Belarus have in many cases served as a disincentive for Latvia to develop a common policy with its Western partners (in cases where “pragmatic” political forces took the lead). In fact, Western partners themselves do not have a clear and united foreign policy towards Russia even though they declare adherence to the same values, which makes it somewhat easier for Latvian players to be “pragmatic”. There are particular cases where Latvia has followed a policy of supporting the “EU's interests” regarding Russia, and these are mostly related to prospects of long term economic gains. In the case of Belarus, there has generally existed a remarkable unity among Latvia's major Western partners, with obvious resultant limitations on Latvia's foreign policy. However, even in this case short-term economic interests have at times prompted Latvian decision-makers to depart from Western “values”. Yet not all the implications of this have been negative for Latvia. Attempts by Russia and Belarus to influence Latvia's foreign policy have already provoked discussions on the principles of Latvia's foreign policy, and on the risks and benefits of cooperation with these countries. This work must be continued, as is noted in the next subsection.

Finally, there is a difference in how the “values – interest” debate is expressed regarding cooperation with Russia and Belarus. Namely, in the case of Belarus the “values” dimension is more of a concern in Latvia's external relations. Latvian policy-makers have to make decisions taking into account the [“values”] agenda of democratization (which has been of great importance to Western partners)

and the [“pragmatic”] agenda of economic interests on the domestic level. In the case of Russia, the situation is different because pressure on the “values” dimension comes from the domestic political environment, while the “interests” agenda is backed by the EU. In fact, it is rather difficult to observe a dichotomy between “values” and “interests” regarding cooperation with Russia because of increasing support for the “pragmatic” approach in domestic politics and the nature of “values” that have largely been promoted as the narrow political interests of nationalist parties, rather than the overall “values” dimension of the political environment. To sum up, we can see that economic interaction with Russia and Belarus may differ in scope, value, or their capabilities to influence Latvia. However, the main goals of their policies are rather similar. From this perspective, it is important to assess possible options for cooperation in general and more specific implications.

3.2. Recommendations

Latvia lacks comprehensive long and medium-term policies on Russia and Belarus that would guide our position on issues of common interest. Therefore, it is not only dialogue that is necessary in relations with Belarus and Russia, but also a clear strategy toward both countries. In 2011 and 2012, debates on foreign policy were held in the parliament; however, these have not resulted in clear guidelines for policy. In general, the debates were too vague, lacking a clear direction and no general conclusions were achieved. Strategic guidelines on relations with Russia and Belarus need to be adopted in order to develop a more stable policy, and Latvia’s position needs to be clear for all the parties involved. The discussion on such guidelines should be transparent and accessible to entrepreneurs, interest groups, academics, and society at large, to both avoid narrow interests dominating the debate and to reduce Latvia’s vulnerability wherever possible.

An analysis of the current situation in Belarus and Russia must be made to reveal the most problematic issues and the issues that have room for compromise. Since perceptions on Russia and Belarus are related to certain negative beliefs and stereotypes, analysis could also reveal new options for Latvia’s foreign policy toward these countries. How possible would regime change in Belarus be, and what could be some alternatives to A. Lukashenka? What are the best options for reform in the country? How could business interests be influenced by political instability in Russia or Belarus? All these questions await consideration and could

provide new options for decision-makers. Some of these may be considered along with Latvia’s other partners.

Multilateral solutions should be embraced to a greater extent if we opt for sustainable, long-term guidelines in relations to Russia and Belarus. Latvia’s position as a member of the EU allows for direct participation in developing the EU’s policies toward Russia and Belarus. A common position with the other Baltic States and the other countries in Central and Eastern Europe within the framework of the EU would prevent Russia and Belarus from pursuing a “divide and conquer” policy. Russia and Belarus have choices regarding preferred partners, but they are also heavily dependent on the EU: this leverage should be exercised more effectively.

There is a possibility that the economically and politically weak A. Lukashenka regime could turn to Russia for assistance. Nonetheless, relations between Russia and the Belarusian government have deteriorated in recent years, while Russia objectively has many common interests with the EU in such spheres as energy transit through Belarusian territory, stability in the country, etc. Thus, Russia could – and should – also be considered a partner in achieving sustainable reforms in Belarus. A geopolitical approach on Latvia’s side, which would involve trying to get Belarus into its “sphere of influence”, would only exacerbate the existing situation.

Latvia should retain its position on the necessity of serious reforms in both Russia and Belarus. However, a moderately critical policy toward Belarus still seems to be an appropriate choice. This means allowing not only involvement with society but also limited, low-key cooperation with officials in order to achieve reforms. Reforms are necessary to prevent the country from turning into a failed state. So Latvia and other partners should work on promoting pro-democratic sentiments in the population (and also parts of the elite) and refrain from weakening them.⁴²⁶ If Western partners decide to widen economic sanctions toward Belarus, the targets must be selected very carefully so that the long-term prospects for the general economic development of Belarus are not harmed. Therefore, the “values-interests dilemma” might be reconciled in the long run, since a democratic and stable Belarus would also become a desirable economic partner. The situation is more difficult regarding reforms in Russia because it reacts much more harshly to criticism and argues that there is a lack of democracy in Latvia itself. Therefore, Latvia should not be at the forefront of pursuing a democratic transition and a liberalization of the economic system

⁴²⁶ Decisions by Latvia to abolish document processing fees for Belarusians wishing to obtain long-term visas and to support easing EU’s visa rules for Belarusian citizens are very welcome in this context.

– we should side up with other players on a multilateral level, as this is a more effective way to change Russia than criticism from Latvia on its own.⁴²⁷ At the same time, care must be taken so that this moderately critical policy is not hijacked by narrow interests.

State institutions have limited control over the economic activities of Russian businesses in Latvia, not because of incapacity or ineffectiveness, but because of limited access to political decision-making and business decisions “on the ground”. In fact, the institutions are stuck in between the economic policy of government and the economic activities of the business elite. The role of these institutions must be strengthened to lessen the risk of political corruption and to sustain continuous oversight of economic activities.

Entrepreneurs in Latvia are calling for better political relations, as this could help in doing business with Russia and Belarus. They have expressed concern regarding tensions between the countries, criticizing the official position of the Latvian government and arguing for “business before politics”. At the same time, it seems that politics are a part of Russia’s and Belarus’s economic actions, and the fact that Russian and Belarusian entrepreneurs are constrained by political decisions in their countries is of little concern to Latvian entrepreneurs. As a result, Latvia is criticized for being unfriendly to business interests, while the situation in the neighboring countries is regarded as an axiom that simply must be accepted. As was noted before – “pragmatism” in relations with Russia and Belarus should work in both directions. Therefore, requests to step down on some positions for the sake of compromise should not be utilized only by Russia or Belarus, but Latvia could also call for more pragmatism in relations.

Despite sometimes passionate expressions of political tension between Latvia and Russia, economic relations between the countries have remained relatively stable. With the exception of particular “loud” issues, trade and investment flows between countries have not decreased. Also, there is no doubt that improving relations with Russia and Belarus has the potential for economic benefits, but up to now the improvement of political relations has led to no considerable gains. This means that Latvia as a whole should not be particularly afraid of voicing criticism toward Russia and Belarus, and it should not always succumb to narrow interests. Pursuing a long-term balanced policy is possible.

⁴²⁷ For example, Russia’s accession into the WTO, finally completed in August 2012, should bring positive results regarding the liberalization of its economy – and also better opportunities for Latvian-Belarusian economic relations as well, as new rules would apply to the entire Customs Union between Russia, Belarus and Kazakhstan..

LITHUANIAN ECONOMIC RELATIONS WITH RUSSIA AND BELARUS

Liudas Zdanavičius, Vadim Volovoj

This article provides a broad overview of the current state of Lithuanian economic interaction with Russia and Belarus. In the first part, a short overview of Lithuania’s economic relations (foreign trade, direct investment, and transit) with Russia and Belarus is given. In the second part, Lithuania’s national and local government relations with Russia and Belarus (the institutional framework, main agreements, and agenda) in the economic field are analyzed. In the third part, the most important sectors (such as energy, manufacturing, finances, and transport) of bilateral economic cooperation are analyzed. The most attention here is given to the main actors involved and the identification of their major interests. The final part is devoted to the assessment of Russian and Belarusian economic influence on the Lithuanian political system. This article is based on official statistical data, scientific publications, information from the mass of media of Lithuania and other countries, and interviews with representatives of businesses and associations.

1. Lithuanian economic relations with Russia and Belarus

After regaining independence, the Lithuanian economy was badly hit by the collapse of the USSR and the destruction of former economic links. Until the financial crisis in Russia in 1998, Lithuanian businesses still heavily relied on exports to Russia and other CIS countries, and only after this crisis were they forced to put more emphasis on the diversification of exports toward Western countries and other markets. In 2011, the share held by Russia and Belarus in Lithuanian exports was 1.5-2 times smaller than in 1997, though it was much higher in absolute terms⁴²⁸. Despite that, Russia and Belarus still play a significant role in Lithuanian foreign economic relations.

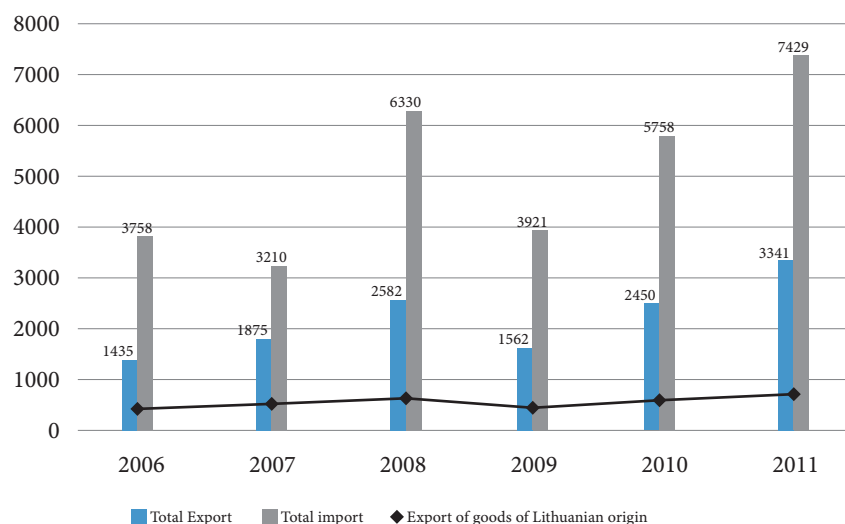
1.1. Trade with Russia and Belarus

Russia is the one of Lithuania’s most important trade partners. In 2011, exports to Russia accounted for 16.6% of total Lithuanian exports, while at the

⁴²⁸ Lietuvos statistikos departamentas, Svarbiausi užsienio partneriai, <http://www.stat.gov.lt/lt/news/view/?id=10097>

same time imports from Russia made up 32.8% of total imports. Lithuanian exports to and imports from Russia have been constantly growing since 2000. The only considerable exemption was crisis of 2009, when exports and imports decreased almost 1.5 times compared to 2008. However, in 2011 both Lithuanian exports and imports were higher than in 2008. Lithuanian trade with Russia is largely dependent on the price of oil. Lithuanian exports depend on the economic performance of Russia (consumption and import), which in turn directly depends on oil prices. For example, in 2009 oil prices temporarily dropped more than 3 times over from the record highs registered in July 2008, and Russian GDP fell by 7.8%. In 2010-2011, oil prices returned to near record heights and Russian GDP growth averaged 4-4.5%⁴²⁹. In 2011, total Russian imports grew by 29%. The dominant share of Lithuanian imports from Russia consist of energy resources, the price of which directly depends on world oil prices.

Chart 1. Lithuanian trade with Russia in 2006-2011 mln. EUR

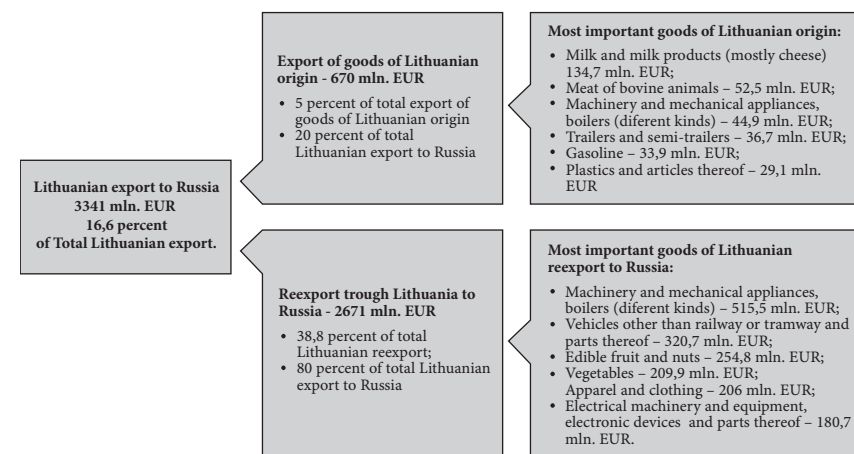


Source: Lithuanian department of Statistics.

One of the most important characteristics of trade with Russia is the considerable share of reexport. In 2011, only 20% of the Lithuanian goods exported to Russia were of the Lithuanian origin, while 80% of total exports to

Russia were reexported from third countries. From 2006-2011, reexports grew much faster than the export of Lithuanian goods. Russia, Belarus and other CIS countries differ in this regard from other Lithuanian export partners. By comparison, goods of Lithuanian origin account for 75-100% of total exports to most other export markets. This situation could be easily explained by the fact that Lithuania is an important transit hub of goods between the EU and Russia.

Chart 2. Lithuanian export and reexport to Russia in 2011



Source: Lithuanian department of Statistics.

An analysis of Lithuanian exports to Russia shows that the importance of this market for Lithuanian producers is not dominant, because only 5% of the Lithuanian-origin goods export goes to this market. At the same time, there are some sectors for which the Russian market would currently be very difficult or impossible to replace. For example, in 2011, exports to Russia constituted 43.3% of exports of pharmaceutical products of Lithuanian origin, 38.1% of meat and meat products, 29% of vehicles other than railway and tramway cars, 28.7% of dairy products (in the case of cheese, the situation is even more illustrative – in 2010, 75% of all locally produced fermented cheeses went to Russia). For some producers, the Russian market is much more attractive than Western markets because there is the possibility to obtain much higher profit margins (for example, by selling products under their own brand instead of selling products for supermarket generic brands). By contrast, for the biggest Lithuanian export

⁴²⁹ International Monetary Fund, Country statistics. Russia, <http://Imf.org>.

categories – such as oil products, plastics, fertilizers, furniture, and wood products – the Russian market is not important (the share of export to Russia is between 1 and 2.5%). But it is worth mentioning that some of these export sectors rely heavily on raw materials and energy imports from Russia.

Russia is the biggest market for Lithuanian services exports. In 2011, compared to 2010, these increased by almost 40% and constituted 779 million euros⁴³⁰ (20.1% of total Lithuanian services exports) and was bigger than the export to Russia of goods of Lithuanian origin. The export of transport services constituted 541.7 million euros (24.4% of total Lithuanian transport services exports), tourism services reached 204.3 million euros (21.1%), and building was 9 million euros (10.1%). The main problem of Lithuanian trade with Russia is the huge deficit (Lithuanian exports to Russia are more than 2 times smaller than imports), which constituted 13.3% of the Lithuanian GDP in 2011. The main explanation for this fact is the heavy dependency of the Lithuanian economy on energy supplies from Russia. After the closure of the Ignalina nuclear power plant in the beginning of 2010, Lithuania's dependency on energy imports grew from 48% to almost 80% of total energy consumption. (the EU average is around 50%)⁴³¹. Most of these resources come from Russia.

The dominant place in the import sector is occupied by crude oil (72.3% of total Lithuanian imports from Russia) that is sold to the refinery *Mažeikių nafta*⁴³². Another important part is deliveries of the natural gas (13.1% of total imports).

Table 1. Lithuanian energy resources import from Russia

	2005	2006	2007	2008	2009	2010
Amount, mln. EUR						
Crude oil	2668	2775	1650	4357	2797	4169
Natural gas	213	305	491	878	571	731
Electricity	11	27	28	54	14	178
Quantity (2005 - 100%)						
Crude oil	100%	80.3%	48.2%	92.7%	86.1%	91.5%
Natural gas	100%	102.8%	116.5%	108.4%	86.5%	98.9%
Electricity	100%	214.6%	189.7%	249.3%	73.6%	833.5%

⁴³⁰ Paslaugų eksporto apžvalga 2011, http://www.versli Lietuva.lt/uploads/file/PASLAUGU_eksporto_tendencijos_2011.pdf.

⁴³¹ Lietuvos statistikos departamentas, Energetikos statistika: 2010 m. keitėsi šalies kuro ir energijos sąnaudų struktūra, 2011-06-15, <http://www.stat.gov.lt/lt/news/view/?id=9044>.

⁴³² It is important to note that Lithuania, in contrast to Latvia and Estonia, does not import oil products from Russian refineries.

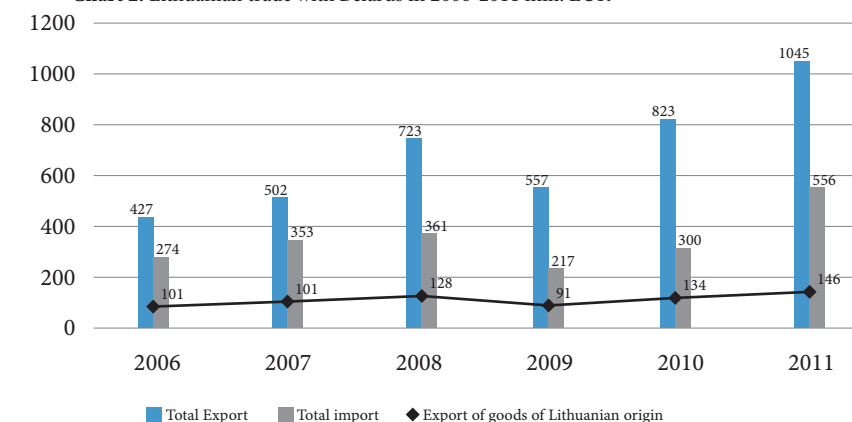
Prices						
Oil price per Ton, EUR	273.7	354.6	351.2	482.4	333.4	467.4
Price per GJ, EUR	2.1	2.9	4.1	8.0	6.5	7.3
Price per kWh, EUR	0.019	0.021	0.024	0.035	0.031	0.035

Source: Lithuanian department of statistics.

As was mentioned earlier, the main reason for the rapid growth of Russian imports to Lithuania was the rise of the price of energy resources. Hence, the sharp fall of Russian imports in 2009 could easily be explained by the sharp drop in oil prices in the world market. In the case of electricity, there was an 8 fold increase in imports in 2010. Lithuania was forced to substitute electricity, which was previously produced at the Ignalina nuclear plant, with the import of electricity and natural gas (for the local production of electricity) from Russia. Lithuania, which was a former net exporter of electricity (imports in previous years were due to the technical needs of the joint electricity system of former USSR countries), in 2010 became a net importer.

Lithuanian trade with Belarus from 2006-2011 grew at a dynamic pace. In 2011, Belarus was Lithuania's seventh largest export partner (at 5.2% of total export) after Russia, Latvia, Germany and Poland, but was only the 10th largest import partner (at 2.5%)⁴³³.

Chart 2. Lithuanian trade with Belarus in 2006-2011 mln. EUR



Source: Lithuanian department of Statistics.

⁴³³ Lietuvos statistikos departamentas, Užsienio prekyba, 2011-08-09, <http://www.stat.gov.lt/lt/news/view/?id=8837>.

The rapid growth of Lithuanian exports to Belarus from 2010-2011 was in fact only a temporary phenomena. At first glance it seems strange that during a harsh economic crisis in Belarus (with a devaluation of the currency, rapid inflation, etc.) Lithuania managed to sustain a rapid growth of exports, but the explanation is very simple – growth was induced by a temporary boom of second hand vehicle imports in Belarus. From July 1, 2011, import customs tariffs for second hand vehicles in Belarus were seriously increased due to the accession of the country into the Customs Union, and in the first half of 2011 the import of used vehicles amounted 370 million euros (two times higher than in all of 2010). It is clear that in 2012 Lithuanian exports to Belarus will return to 2009-2010 level. Similarly to the case of Russia, reexports to Belarus are growing much faster than the export of goods of Lithuanian origin. Additionally, in the case of Belarus a significant part of imports are not consumed in Lithuania, but are rather reexported to third countries. Lithuanian exports to and imports from Belarus are very diversified. the main export categories of Lithuanian goods to Belarus in 2011 were machinery and mechanical appliances and parts thereof (11.7%), plastics and articles thereof (10.1%), and articles of stone and similar materials (7.1%). The main goods for reexport through Lithuania were vehicles other than railway or tramway rolling stock (49.6%, mostly second hand), machinery and mechanical appliances and parts thereof (13.9%), and electrical machinery and equipment and parts thereof (4.5%). The main import goods from Belarus were mineral fuels and other oil products (42.2%, mostly transit trough *Klaipėdos nafta* oil terminal, with an almost three fold increase compared to 2010), metal products (12.3%), fertilizers (7.8%), and wood and articles of wood (6.3%).

Belarus is also a very important market for the Lithuanian export of services. In 2011 it constituted for 426.9 million euros (11.4% of the total Lithuanian export of services). The main categories for the export of services were transport services at 209 million euros (9.4% of the total export of transport services), tourism at 201 million euros (20.8%) and construction at 40 million euros (13.1%).

Investments

In October 2011, Russia was fifth in terms of the amount of foreign direct investment (at 674 million euros, 6.3% of the total FDI). The biggest investors to the Lithuanian economy were Sweden (1540 million euros, 14.3% of total FDI), Poland (1397 million euros, 13%), Germany (1059 million euros, 9.9%) and the Netherlands (920 million euros, 8.6%). However, it is difficult to evaluate precisely

the real size of the presence of Russian capital. The biggest problem with the estimation of Russian investments into Lithuania, as is the case for the other Baltic states, is the identification of the real country of origin of foreign investments. Russian capital not only comes directly, but also through offshore companies, foreign branches and even through Lithuanian companies that couldn't be identified as Russian. Investment from the United States, Switzerland, Netherlands, Cyprus, British Virgin Islands and other countries could possibly be of Russian origin.

Table 2. Accumulated foreign direct investment (FDI) to Lithuanian economy (in millions of euros)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total	2704,3	3087,9	3818,3	3967,6	4689,7	6920,7	8377,1	10282,6	9279,6	9759	10165,5
Russia											
Amount of FDI	27.2	48.4	199.1	230.6	395.7	704.2	522.5	1004.1	487.2	622.7	843.3
Share in total FDI	1.0%	1.6%	5.2%	5.8%	8.4%	10.2%	6.2%	9.8%	5.3%	6.4%	8.3%
Number of companies	115	110	125	135	149	157	144	157	167	178	179
Belarus											
Amount of FDI	1.1	0.9	0.5	1.8	5.1	6	7.5	37.1	42.6	36	36.8
Share in total FDI	0.04 %	0.03 %	0.01 %	0.05 %	0.11 %	0.09 %	0.09 %	0.36 %	0.46 %	0.37 %	0.36 %
Number of companies	16	24	33	34	37	40	38	45	59	84	96

Source: Lithuanian department of Statistics.

The table above shows that from 2000 to 2011, the accumulated amount of FDI from Russia to the Lithuanian economy increased 31 times over (the share of Russian investment in total FDI grew from 1% to 8.3%). Most remarkable Russian investments into Lithuania came in the 2002-2004 period (*Lietuvos dujos, Lifosa*). The rapid inflow of Russian investment during that period could be explained by the fact that at the same time in Russia a stable recovery began following the 1998 financial crisis, and the financial situation of Russian companies improved. During that period Lithuania was on the verge of accession to the European Union and this fact seriously enhanced the attractiveness of Lithuania as a target for the investment of Russian companies. It is worth mentioning that in the last 4-5 years, with some remarkable exceptions, there was no active arrival of new official Russian investment into Lithuania. The total size of investment is still growing, but mostly because value of already owned companies is rising. The largest share of identifiable Russian direct investment went to the energy sector (42% of total FDI), manufacturing (32.6%) and private acquisitions of real estate (4.6%).

Other important sectors in which the presence of Russian capital presence could be identified are transit, mass media and financial mediation sectors.

Investments from Belarus, despite a 30 fold increase during the last 10 years, are minimal. This could be explained by the obvious fact that the Belarusian economy is small and that most of the biggest companies are owned by the government. The government of Belarus is much more interested in the attraction of the FDI to Belarusian economy, than it is in its companies investing abroad.

Table 3. Lithuania FDI to Russia and Belarus (in millions of euros)

		2005	2006	2007	2008	2009	2010
Belarus	Number of companies	31	43	44	57	71	75
	Size of investment (cumulative)	7.1	10.7	15.6	20.0	44.2	59.6
Russia	Number of companies	43	49	48	62	72	65
	Size of investment (cumulative)	19.1	55.7	67.5	92.1	97.2	63.3
Kaliningrad oblast	Number of companies	25	27	25	27	25	23
	Size of investment (cumulative)	67.0	69.2	68.6	80.2	55.2	53.7

Source: Lietuvos statistikos departamentas, Statistinių rodiklių duomenų bazė.

Lithuania is a quite active investor into the Russian and Belarusian economies. It is clear that the real size of Lithuanian investments is higher than official figures suggest because some companies tend to avoid unnecessary attention from the media and from government officials of both countries. For example, official Belarus data shows that cumulative Lithuanian investment in Belarus at the end of the 2010 was \$150 million and that there were 410 companies with Lithuanian capital⁴³⁴.

Transit

Lithuanian relations with Russia and Belarus in the transport sector are quite diverse, and as was mentioned earlier these countries are the most important markets for the export of Lithuanian transportation services. The transit of Russian goods to Kaliningrad and Klaipėda ports is the most profitable part of the state company *Lithuanian railroads*. In 2011, transit to Kaliningrad totaled 13.1 million tons (of a total 52.2 million tons of cargo turnover). The turnover of Russian goods in the Klaipėda port, due to an unfavorable Russian government transit tariff policy for Baltic ports, sharply declined and in 2011 was approximately two times smaller

⁴³⁴ Посольство Республики Беларусь в Литве, Торгово-экономическое сотрудничество, http://www.lithuania.belembassy.org/rus/new_page_80/trade/.

than in 2000. At the same time, it can be seen that the transit of the Belarusian goods increased two times and thus compensated for the loss of Russian goods. The most important Belarusian transit goods are fertilizers (7.1 million tons, a 34.1% increase compared to 2010) and oil products (2.5 million tons, a 2.5 fold increase compared with 2010). Lithuanian road carriers are also active in the Russian market. The share of Lithuanian road carriers in the transportation of goods between the EU and Russia increased from 7% in 2005⁴³⁵ to 12% in 2010.

Table 4. Transit turnover of the Port of Klaipėda

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total cargo turnover	mln. Tons	19.4	17.2	19.7	21.1	20.3	21.8	23.6	27.4	29.9	279	31.3	36.6
	share	35.1%	16.3%	11.2%	9.5%	3.9%	4.6%	7.2%	13.1%	13.0%	11.8%	11.5%	10.5%
Russia	mln. Tons	6.8	2.8	2.2	2	0.8	1.0	1.7	3.6	3.9	3.3	3.6	3.8
	share	35.1%	16.3%	11.2%	9.5%	3.9%	4.6%	7.2%	13.1%	13.0%	11.8%	11.5%	10.5%
Belarus	mln. Tons	4.2	3.9	5	4.7	3.9	3.5	4.5	6.3	6.6	6.6	8.1	11.5
	share	21.6%	22.7%	25.4%	22.3%	19.2%	16.1%	19.1%	23.0%	22.1%	23.7%	25.9%	31.4%

Source: Port of Klaipėda⁴³⁶

2. National and local government in economic interaction with Russia and Belarus

2.1. Central government relations with Russia and Belarus

An analysis of Lithuanian–Russian relations in the field of the economy shows that contacts on the highest level they are very limited, while at the same time on lower levels relations are much more lively. Indicatively, Valdas Adamkus's visit to Moscow in 2001 was the last official meeting of Lithuanian and Russian presidents⁴³⁷. This could be explained by the cold atmosphere of bilateral relations in general, which is

⁴³⁵ За “круглым столом” АСМАП, http://www.map.asmap.ru/3%2867%29_06/kr_stol.htm.

⁴³⁶ Port of Klaipėda, Report on cargo handling in Klaipėda State Seaport in the year 2011, <http://www.portofklaipeda.lt>.

⁴³⁷ In August 2009, newly elected Lithuanian president Dalia Grybauskaitė made a telephone call to her Russian colleague D. Medvedev to discuss the difficulties that Lithuanian road carriers have with Russian customs and the problems for Lithuanian milk producers in the Russian market. In February 2010, Dalia Grybauskaitė had a short meeting with Russian Prime Minister V. Putin. In the end of March 2010, Lithuanian Prime Minister A. Kubilius visited Moscow on a working visit and met with Russian colleague V. Putin. This was the first meeting of the Prime Ministers after the visit of Prime Minister Algirdas Brazauskas to Moscow in 2003.

greatly damaged by question of the interpretation of the historical past – Lithuanian demands for compensation for the Soviet occupation, Lithuania's support for Georgia and Ukraine's NATO aspirations, the Druzhba oil pipeline affair, problems related to *Lietuvos dujos*, and a few other conflicts. It is clear that for an official visit of the president there should be a positive agenda (such as the signing of agreements, etc.). Despite the strained bilateral relations on the highest level, relations between Lithuanian and Russian ministries (for example, the ministries of Agriculture, Transport, Economy, etc.) could be described as operational with the tendency to become more active over the last 2-3 years. In an analysis of the functioning of the central Lithuanian institutions in economic relations with Russia and Belarus, it is clear that the Ministry of Foreign Affairs is working as the umbrella organization, taking active part in the organization of visits, meetings, conferences and business meetings and, most importantly, is playing one of the leading roles (along with the president's office) in defining the position on various foreign policy issues⁴³⁸.

The main format for bilateral negotiations is the Lithuanian-Russian Intergovernmental Commission for economic, scientific-technical, and cultural cooperation, which was founded in 1996. The commission has seven working groups: economy and trade, culture, science and education, energy, transport, social issues, the property of diplomatic representations, and the regulation of the financial questions⁴³⁹. There have been seven meetings of the Commission and nine meetings of the heads of the Commission. The last was held in October 2011 in Klaipėda. At the last session, the Commission signed an agreement on the construction of a new bridge across the River Nemunas (Neman), between Panemunė and the Sovetsk region⁴⁴⁰. Lithuania is actively pursuing the question of the renewal of operations of the "Druzhba" oil pipeline, the building of a Baltic nuclear plant in the Kaliningrad oblast, and questions about the conditions for Lithuanian exporters and investors in the Russian market. A very important aspect of Lithuania's position in this case is their support for Russia's accession to the WTO, which could eventually eliminate some discrimination against Lithuanian exporters and the transport sector (for example, Russia could be forced to equalize rail transportation tariffs on the Kaliningrad and Klaipėda routes).

Lithuania has signed many bilateral agreements with Russia (many of them related to the economy), but most of these were signed in 1990s. The

438 Vyriausybės siūloma apsvaistyti V. Uspaskicho ir K. Prunskienės veiksmus. ELTA. 2005-03-23

439 Lietuvos Respublikos užsienio reikalų ministerija, Lietuvos Respublikos ryšiai su Rusijos Federacija, <http://www.urm.lt/index.php?1201833357>.

440 Ministry of Foreign Affairs Of the Republic Of Lithuania, Lithuanian - Russian Intergovernmental Commission signs the Agreement, discusses topical issues of bilateral agenda, 2011-10-04.

2000s brought only two agreements. In a December 2010 interview, Lithuanian minister of foreign affairs A. Azubalis stated that Lithuania agreed with Russia on the readings of five new bilateral agreements. Negotiations on the other 12 were still on their way. One of the agreements, the text of which was agreed upon, is on cooperation in the area of the standardization of metrology and certification. This will ease the entrance of Lithuanian goods onto the Russian market⁴⁴¹.

Lithuania has developed the long standing strategy of so-called pragmatic selective co-operation with Belarus. In reality, this means that Minsk is rewarded with political attention and advocacy from the Lithuania in the EU if some democratic trends are strengthened. This policy, which is constantly modified, consists of a number of aspects. Only limited contact on the highest level has taken place. For example, for 12 years there was no meeting between the Lithuanian and Belarus presidents. Meetings of the prime ministers are also extremely rare (particularly considering the fact that Belarus is a close neighbor). The visit of A. Lukashenko to Vilnius in October 2009, and D. Grybauskaitė to Minsk in 2010, were only temporary exceptions to this trend. It is clear that after the last Belarusian presidential elections, it is difficult to predict the intensification of Lithuanian-Belarus contact at the highest level. Most official contact between Lithuania and Belarus go through the ministers of foreign affairs and the vice-ministers of the foreign affairs.

Concerning the main institutional format for cooperation between Lithuania and Belarus, in contrast to Lithuanian-Russian relations there is no umbrella Intergovernmental commission between Lithuania and Belarus. In the economic field there is the Bilateral Lithuanian – Belarusian Commission on Trade and Economic Cooperation. The heads of the commission from the both sides are the ministers of economy. The commission, which was formed in 1994, has annual meetings. The most attention during meetings of the Commission is given to questions of transit, bilateral transport projects (such as the "Viking" container shuttle train, or the fast train between Minsk and Vilnius), the business climate in Belarus for Lithuanian businessmen, and other questions.

There are also two state public entities, which were created and are owned by the Lithuanian state and function as *de facto* subsidiaries of the Ministry of Economy, that are important for the development of Lithuania's foreign economic relations: *Enterprise Lithuania* (one of the main responsibilities of this is the promotion of the export of the Lithuanian goods and services) and *Invest Lithuania* (the promotion of foreign investment into the Lithuanian economy and the attraction of tourists). An analysis of the activities of *Invest Lithuania*

441 Lietuva ir Rusija susitarė dėl penkių sutarčių, dar derasi dėl 12. BNS. 2010-12-30.

shows that the organization is not very active in the attraction of FDI from Russia. Most of its attention is concentrated on Western Europe and other countries.

Lithuania currently has two commercial attaches in Russia – one in Moscow and one Saint Petersburg, and one commercial attache in Belarus (Minsk). Commercial attaches have a diplomatic rank, but are subordinate to the Ministry of Economy (through *Enterprise Lithuania*). They work in embassies and consulates parallel to the economic diplomats from the Lithuanian MFA. Commercial attaches are more specialized in their support of Lithuanian companies, market research, trade fairs and the organization of missions. Economic diplomats work with more general questions about bilateral economic relations. Sometimes this division is not very clear, as representatives from both institutions are working on similar goals. Lithuania also has two specialized attaches in Moscow: in transport and in agriculture, which are subordinate to the Ministry of Communications and the Ministry of Agriculture, respectively. Currently there are no specialized (economic) attaches in Belarus. Compared to some other countries, Lithuania's economic diplomacy efforts (both in general and more specifically in Russia and Belarus) are very weak. For example, the Czech Republic has more than 400 economic diplomats⁴⁴². The Lithuanian confederation of industrialists is constantly asking the government to increase Lithuania's economic diplomatic presence in Russia by sending additional commercial attaches (at least in for the Ural and Siberia regions).

At the same time, Russia has a much bigger presence of economic diplomats in Lithuania. The most important institution from the Russian side is the Trade Representation (the only one in the Baltic countries) in Vilnius, which has an office separate from the embassy and is a subsidiary of the Russian Ministry of Economic Development. Officials from the Trade Representation have diplomatic status. The main goals of the Trade Representation are the development of Lithuanian-Russian economic relations, the promotion of Russian exports to Lithuania, and the defense of the interests of Russian investors. The Trade Representation and the Russian embassy take active part in the economic part of the Intergovernmental Commission.

2.2. Lithuanian local governments relations with Russia and Belarus

Economic relations at the level of local administration between Russian (and Belarusian) and Lithuanian regions are minimal. The existing cooperation

⁴⁴² Laura Gvozdaite, Pasiskiepyti nuo Rusijos kerų, <http://prekyba.eversus.lt/naujienos/638>.

agreements between the regions are just formal declarations of good intentions⁴⁴³. There are a number of reasons for this:

- Limited interest from the regional administrations of both sides;
- Very limited resources (particularly qualified personnel) from the Lithuanian side;
- The lack of a real agenda for such relations. The only real exception, in this case, are the border regions, where there is the possibility to jointly attract European funds for bilateral or trilateral projects. This is a good example of a situation where the European Union is much more interested in regional cooperation than in the regions by themselves;
- Lithuanian businesses are usually not very interested in help from the heads of their regions because they get support from the central government institutions, which help deal with the administrations of the Russian regions;
- The difference in size between Russian and Lithuanian regions. The decision of the Lithuanian government to disband county administrations has worsened the situation and had a serious negative impact on border cooperation because a serious part of such cooperation went on in the counties, not at the municipality level.

A very important aspect of Lithuanian-Russian economic relations is the Kaliningrad region. Lithuania states that it is very interested in the successful social and economic development of the Kaliningrad region. This region is a significant export market for Lithuanian production and Lithuanian companies are leaders in terms of the size of foreign direct investment in the region (Lithuania is one of the three biggest investors in the region). At the same time, the Kaliningrad oblast is highly dependent on Lithuanian policy in such areas as transit tariffs and the conditions for both passengers and goods, and the visa regime. Lithuanian-Kaliningrad trans-border cooperation is quite active. On both the national and local government levels there is a considerable list of projects being developed. Currently, the most important framework for this cooperation is the "Lithuania-Poland-Russia Programme" (a joint fund of 180 million euros for co-financing trans-border cooperation projects [for example, this could be used for the creation of joint tourism routes, the expansion of border check posts {currently these are serious bottlenecks for trade and transportation}, and the improvement of infrastructure and other joint projects]).

On the national government level, the most important institutional framework is the Council for Long Term Cooperation Between the Regions of

⁴⁴³ Most Lithuanian counties, which also were smaller than many of the Russian regions which currently are de facto disbanded, had cooperation agreements with the Russian regions, most of which were signed in 1999-2001.

the Lithuanian Republic and the Kaliningrad Region of the Russian Federation (formed in 2000)⁴⁴⁴, though the activities of this are limited. Also, the agreement between the Government of the Republic of Lithuania and the Government of the Russian Federation on long term cooperation between the regions of the Republic of Lithuania and the Kaliningrad Region of the Russian Federation (signed in 1999) has a provision about the organization of periodic Days for Lithuanian-Kaliningrad Cooperation. These are organized once every two years. Such events, besides a cultural component, have strong political and economic importance. Usually during these events a high level delegation led by the governor of the region arrives to Lithuania. At the same time, there are business forums in which leading businessmen from Lithuania and Kaliningrad take part alongside politicians and high level officials.

There are also intensifying relations between the Moscow and Vilnius city administrations. It is clear that this activity is encouraged by business projects – both regions are developing business projects in each others' territory. In 2005, the municipalities of the Vilnius and Moscow regions agreed to exchange land plots in order to build multifunctional centers for representation (a Moscow house⁴⁴⁵ in Vilnius and *vice versa*⁴⁴⁶).

3. Business groups in Lithuania's external economic relations with Russia and Belarus

3.1. Business organizations

The most active and influential Lithuanian business organization is the Lithuanian Confederation of Industrialists, which acts as an umbrella organization for the 32 branches and eight regional associations, which have more than 2,700 corporate members⁴⁴⁷. Inside the Confederation, the Lithuanian Business Council on Trade and Economic Cooperation with the Russian Federation was created in 2008 by the 13 leading Lithuanian companies from manufacturing, logistics, tourism, and other sectors (*Achemos grupė*, *UBIG*, *VICI*, *BEGA*, *Lithuanian railroads*, and others), and the Lithuanian Association of Road Carriers "Linava". The main aim of the Council is the organization of

conferences, business missions, and analyzing Lithuanian-Russian economic and trade relations. The council actively works with Lithuanian public institutions and diplomatic missions to discuss and analyze the difficulties of and possibilities for economic relations with Russia. The members of the council take part in a working group on economic and trade cooperation within the Lithuanian-Russian Intergovernmental Commission.

The confederation, the Business Council on Trade and Economic Cooperation, and the Lithuanian embassy in Russia regularly organize business missions for Lithuanian companies to Russia and Russian companies to Lithuania. If possible, included in the agenda of such missions are meetings with the heads or other high officials of the relevant Russian regions. The greatest amount of attention is currently given not to Moscow or Saint Petersburg, in which Lithuanian businessmen are already actively working and where it is more difficult to get the attention of officials, but instead to the smaller regions, where such attention is more easily attainable and Lithuanian investments are more important for local government. For example, in 2010 the governor of the Vladimir region and a group of officials and businessmen visited Lithuania. In May 2011, the Vladimir region was visited by a Lithuanian business delegation⁴⁴⁸ by invitation. From the Russian side there is a similar organization called the Russian-Lithuanian Business Council, which was created in 2008 within the Moscow Chamber of trade and commerce. The head of the council is the vice president of *Mechel*, which is one of the biggest Russian investors in the Lithuanian manufacturing sector, V. Tregubko.

Under the umbrella of the Lithuanian Confederation of Industrialists there is also the actively working Lithuanian Business Council for Economic and Trade Cooperation with Belarus. This currently works as the association of Lithuanian businesses. Its operations are very similar to the Lithuanian-Russian business council. In 2005, the Lithuanian Confederation of Industrialists, alongside the Belarusian embassy in Lithuania and the Belarusian Confederation of Industrialists and Entrepreneurs (Employers), in 2005 launched the annual Lithuanian-Belarus business forums. The most attention at these events is given to cooperation in the field of transit, foreign direct investment, the attraction of the EU funds, and other questions.

The Lithuanian Association of Road Carriers "Linava" is also actively involved in Lithuanian-Russian and Lithuanian-Belarusian economic relations because largest share of its members are involved in cargo transportation between the EU

444 Торговое Представительство Российской Федерации в Литовской Республике, Обзор о развитии торгово-экономических связей субъектов Российской Федерации с Литовской Республикой, http://rustrade.lt/?page_id=281.

445 „Maskvos namų“ statybos dėl lėšų stokos sustabdytos, BNS, 2011-08-12.

446 Kada pagaliau prasidės Vilniaus namų Maskvoje statybos?, Diena.lt, <http://www.diena.lt/naujienos/miestas/kada-pagaliau-prasides-vilniaus-namu-maskvoje-statybos-266199>

447 Lithuanian confederation of industrialists, About us, <http://www.lpk.lt/en/>.

448 It is important to note that not all business missions are organized with the Lithuanian Confederation of Industrialists. For example, the Lithuanian embassy together with *Enterprise Lithuania* organized business missions to the Irkutsk region (in 2010) and Moscow (in October, 2011).

and Russia. The association's members are very susceptible to regulations imposed by Russia (and Belarus). *Linava* actively communicates with Lithuanian, Russian and Belarusian government institutions (the transport ministries, customs, veterinary authorities, and other institutions). Other very important partners for *Linava* are the Russian and Belarusian road carriers associations. *Linava* organizes various business missions (through its representative in Moscow), usually in the regions that are closest and most interesting for Lithuanian road carriers (such as the Pskov region).

Other Lithuanian business organizations, such as the business confederation *ICC Lietuva*, the Lithuanian Confederation of Entrepreneurs, and the chambers of commerce and trade, are considerably less active in the organization of business missions or meetings with Russian and Belarusian representatives. The representatives of these organizations and their members sometimes take part in missions organized by the Confederation of Industrialists and Lithuanian governmental institutions. Lithuanian businessmen working in Russia and Belarus with the support of Lithuanian embassies created so-called "business clubs". There are currently three such clubs (in Moscow, Saint Petersburg, and Minsk), which serve as a format for information exchange, supporting new businessmen, organizing events, and communicating with Lithuanian and Russian officials.

3.2. Russian business investments and presence in Lithuania

3.2.1. Russian factor in the Lithuanian oil sector

The privatization of the Lithuanian oil refinery *Mažeikių nafta* has been one of the central and most indicative cases of Lithuania's official position regarding Russia's presence in the country's energy sector. In the second part of the 1990s, the Lithuanian government decided that it is too dangerous to rely on Russian supplies of oil. This was based on the memory of the Soviet economic blockade of 1990. The first part of the strategy to achieve greater independence from Russia in the oil sector was the decision to build an oil import–export terminal in Būtingė (the terminal was finally built and began operations in 1999). The second was the privatization of *Mažeikių nafta* to a "strategic investor". The Lithuanian government in October 1999 sold a 33% share of the *Mažeikių nafta* oil refinery and the rights to operate the refinery to US company *Williams international*. Despite unfavorable privatization contract terms for Lithuania, it was expected that the big U.S. company would manage to modernize the refinery and reach

agreements with Russian companies on a stable supply of crude oil. For *Lukoil*, which was also actively seeking the acquisition of the refinery, the Lithuanian government only offered the role of a junior partner responsible for the delivery of crude oil. *Williams International* managed to begin the modernization of the factory, but failed to reach agreements on a stable oil supply. For that reason the refinery registered heavy losses. It is clear that at least partly this was the result of a strategy by Russian companies to push the American investor out of the *Mažeikių nafta* refinery. In 2002, *Williams International* secretly sold its shares and control rights to a subsidiary of the Russian oil company *Yukos*, registered in Netherlands. Despite initial fears, *Yukos's* presence in *Mažeikių nafta* was one of the best examples of positive Russian investments in the Lithuanian economy. *Yukos* not only began a stable supply of crude oil to the factory, but also used the full capacity of the Būtingė export terminal. In 2003 the refinery already registered 106 million euros of profit, compared with a 43 million euro losses in 2002⁴⁴⁹.

This "golden age" ended when *Yukos* faced accusations of tax evasion in Russia. The *Mažeikių nafta* refinery was saved by the fact that it was operated through the *Yukos* Dutch subsidiary *Yukos finance BV*. In 2005, *Yukos BV* decided to sell its share in *Mažeikių nafta*. Officially, the Lithuanian government did not take part in the negotiations, but in reality it took an active part in the sale process. The companies in the open competition included *Lukoil*, Kazakhstan state gas company *Kazmunaigaz*, and the Polish company *PKN Orlen*. Moscow was indirectly pushing the Kazakhstani side to withdraw its bid. For example, In November 2005 the head of *Transneft* S. Vainshtok declared that his company decided not to sign an agreement with *KazMunayGaz* (KMG) on the transportation of crude oil to *Mažeikių nafta* and the Būtingė terminal through Russian territory⁴⁵⁰.

In 2006 the refinery was sold to the Polish company *PKN Orlen*, which offered the highest price for the shares. After sale of *Mažeikių nafta* to *PKN Orlen*, Lithuanian Minister of Foreign Affairs A. Valionis proclaimed that the "sale of the refinery to Poland is a fact of exceptional geopolitical importance, not only as a commercial project, but as an element of the geopolitical battle, which will have great outcomes for us"⁴⁵¹. Russia's answer to the decision was fierce. In 2007, the state company *Transneft* ceased the transportation of oil through the "Druzhba"

449 AB „Mažeikių nafta“ valdyba patvirtino 2003 metų finansinius rezultatus bei Modernizavimo programos išlaidas 2004 metais. 2004-03-26. <http://www.orlenlietuva.lt/lt/main/news/news?id=3558>.

450 Казахская нефть пробивает дорогу в Литву, Газета "Коммерсантъ", №218/П (3302), 21.11.2005.

451 A. Valionis: „Mažeikių naftos“ pardavimas Lenkijai - geopolitinės reikšmės faktas, BNS, 2006-09-05.

pipeline to *Mažeikių nafta*. This decision was officially explained by the poor state of the pipeline⁴⁵². It is clear, however, that this decision was not technical, but just a tool for exerting pressure, because the Russian side constantly ignores the Polish company's proposals to pay for the repair work⁴⁵³.

After the cessation of operations of the "Druzhba" pipeline in 2007, the owner of *Mažeikių nafta*, PKN Orlen, was forced to begin importing crude oil using the Būtingė oil terminal. This had three interconnected negative impacts on the financial results of *Mažeikių nafta*:

- Import capacity of the Būtingė terminal was lower than the oil pipeline's capacity and it is more susceptible to weather conditions. *Mažeikių nafta* imports crude oil from Russia (from the Primorsk port), but the price of oil increased because sea transportation is more expensive. For example, in 2007 this difference was \$1.5 per barrel⁴⁵⁴.
- In the period when the factory was owned by *Yukos*, the terminal was used for the export of crude oil transported through the Druzhba pipeline from Russia. For example, in 2005 exports through the Būtingė terminal constituted 6.1 million tons of crude oil⁴⁵⁵. Thus *Mažeikių nafta* lost considerable income from crude oil transit.
- To sum up, the strategies and tactics of both sides (Lithuania and *Lukoil*) in the Mazeikiai refinery case are questionable:
- In the actions of the Lithuanian government, geopolitical considerations prevailed over economic logic. The result of the privatization shows that Lithuania is still highly dependent on Russian oil deliveries and has no effective tools to change Russia's position. Despite the fact that Lithuania managed to get EU support in this case (the "Druzhba" question was included in the negotiations mandate for the new EU-Russia partnership and cooperation treaty⁴⁵⁶), this had no positive effect on the

renewal of operations of the pipeline. *Lukoil* (and, possibly, the Russian government through the state company *Transneft*) is using direct pressure on the Lithuanian government and the owners of the refinery, which could be hardly characterized as civilized business relations.

It is difficult to assess what would happen if *Mažeikių nafta* in 1999 or 2006 would have been sold to *Lukoil*. On the one hand, if the company would have operated the refinery in a similar way to *Yukos* it would be very profitable for the Lithuanian economy. In support of this argument, *Lukoil's* operations in the Lithuanian retail fuel market (it operates the largest operating network of gas stations in Lithuania [in 2011 there were 118 stations]) shows that the company could act as a normal economic player. On the other hand, pressure over the privatization deal exerted by the company proved that the fears of the Lithuanian government could have some ground.

3.2.2. Main players in the natural gas sector

Russia dominates the Lithuanian natural gas sector. In 2011, Lithuania imported 3.4 billion cubic meters of natural gas (9.7% more than in 2010). Additionally, transit through Lithuania to the Kaliningrad region was 2.0 billion cubic meters (47.3% more than in 2010). The main importers were *Lietuvos dujos* (selling gas to companies and private customers, with 39.6% of total imports), the intermediary company *Dujotekana* (selling gas only to companies, 14.9% percent of total imports), fertilizer producer *Achema* (purchasing gas directly from *Gazprom* for its own needs, 38% of total imports; in 2011 imports grew by 81.7% compared to 2010), and the Kaunas heat and power plant (owned by *Gazprom*, 7.0% of total imports).⁴⁵⁷

From beginning of the 2000s, *Gazprom* was very actively pushing the Lithuanian government to gain control of Lithuanian national gas company *Lietuvos dujos* (the distribution network and the core gas pipelines). In 2004, a 37.1% share of *Lietuvos dujos* was acquired by *Gazprom*. A total of 38.7% of the company is owned by the German company *E.ON Ruhrgas International* (which was supposed to balance *Gazprom's* influence in the company, but in fact currently acts as a silent supporter of the *Gazprom* position) and 17.7% is still in the hands of the Lithuanian government. The selling price of the shares was only 28 million

452 Interesting fact, that this poor state of the pipeline was important only to deliveries to Mazeikiai, refineries in Belarus were receiving Russian oil without interruptions.

453 In October, 2008 owner of the "Mažeikių nafta" oil refinery „PKN Orlen“ proposed to the owner of the "Druzhba" pipeline "Transneft" to take part of the financial burden of the pipeline repair. Russian company ignored this proposal. Lithuanian delegation led by the vice-minister of the economy in August, 2011 once again raised this question during the meeting with the Russian officials. The Moscow's answer was that "Druzhba" pipeline capacity is limited and there is no way to improve it even in case of repair. Marius Jokūbaitis, Maskva naftos čiaupų neatsuka ir už pinigų. Netrukus paleidę naują naftotiekį rusai tikisi pamokyti ir nesukalbamus lietuvius, ir baltarusius, Lietuvos rytas, 2011-08-17.

454 Naftos importas per Būtingę mažina "Mažeikių naftos" pelną. BNS, 2007-12-14.

455 Mažeikių nafta. Metinė ataskaita. 2005. P. 66.

456 A. Januška: valstybė gal ir laiminga, bet daugumai piliečių jau nusispjauti į šitokią laimę, www.delfi.lt, 2010-01-13.

457 Valstybinė kainų ir energetikos kontrolės komisija. Gamtinių dujų rinkos stebėsenos ataskaita už 2011 metus. Vilnius, 2012.

euros, which was at least three times less than the market price at that moment⁴⁵⁸. Such a low price at the time was explained by the fact that *Gazprom* will provide Lithuania with a stable supply of cheap gas. From 2004-2007, natural gas prices were considerably lower than those of natural gas exported to Western European markets. From 2008, natural gas prices were increased so that they reached (and even became higher than) average European values (by the new formula, active from 2008, the price was pegged to the price of mazut and diesel).

One of the major tasks for the Lithuanian government in the energy sphere is to get rid of the full dependency of the natural gas supply from *Gazprom*.

Two main steps to take in this case are:

- Building the LNG terminal in Klaipėda. After the “shale gas revolution”, LNG became an economically feasible alternative to gas sold by *Gazprom*. The terminal is planned to be built by 2014-2015. The success of the project will give Lithuania an alternative source of gas and *Gazprom* will be forced to become more flexible. The current gas prices, which are higher than in many European countries, are mostly based on the fact that Lithuania has no alternative provider.
- A separation of the distribution and import of natural gas, effectively splitting *Lietuvos dujos* in order to increase competition and create more favorable conditions for LNG terminal operations. In June 2011, Seimas passed the new edition of the Natural gas law, which imposes the most strict (and thus uncomfortable for *Gazprom*) possible implementation of the Third EU Energy Package.

In the 2009-2012 period, relations between *Gazprom* and the Lithuanian government have had two contradicting components. On the one hand, the Lithuanian government reported that it is negotiating with *Gazprom* on the question of decreasing natural gas prices for Lithuania. But there is only very limited information on how these negotiations proceed⁴⁵⁹. On the other hand, there is an open confrontation both on informational and judicial fronts (regarding cases in the Lithuanian courts and the Stockholm arbitration court). The confrontation aspects are much more visible and dominate the agenda. *Gazprom*, through *Lietuvos dujos* in both public and non-public ways, tries to influence the decisions of the Lithuanian government and parliament. For

example, when the vote in Seimas on the interpellation of Minister of Energy A. Sekmokas was held in March 2011, Prime Minister A. Kubilius made a public statement before that vote that decision of the Seimas will indicate the extent of influence of the Russian natural gas company *Gazprom*⁴⁶⁰.

The Lithuanian government is unhappy with many aspects of the *Gazprom* policy:

- Currently, *Gazprom* is selling natural gas to Lithuania for one of the highest prices in Europe. In January and February 2011, Lithuania paid for natural gas nearly \$367 per 1000 cubic meters, while Estonia at the same time paid \$309, Latvia \$310, Poland \$311 and the EU average was \$350⁴⁶¹. This means higher prices for gas and heating for Lithuanian customers and less competitiveness for Lithuanian businesses.
- The Lithuanian government states that *Gazprom* violates privatization agreement because the high natural gas price is politically motivated. In 2008, it was seen as revenge for the introduction of regulation on the profits of the gas importers. In 2010 came the revenge of *Gazprom*, which gave discounts for Latvia and Estonia but not for Lithuania because of Vilnius's plans to implement the strictest version of the Third EU Energy Package. In Lithuania's opinion, this version was supported by the public statements of the head of the board of *Gazprom*, V. Golubev, and the press secretary of corporation, V. Kupriyanov⁴⁶². *Lietuvos dujos* management *de facto* has not negotiated with *Gazprom* on the question of lower gas prices, because the same person (V. Golubev) was in the top management of both *Gazprom* and *Lietuvos dujos*.
- The Lithuanian government is also unhappy with *Lietuvos dujos*'s strategy, whereby the most important projects – such as the core pipeline from Klaipėda (the place of the future LNG plant) to Jurbarkas and the pipeline connection with Poland – are stalling. At the same time, a serious share of investments go to projects aimed at improving the technical capabilities of natural gas transit to the Kaliningrad oblast. *Lietuvos dujos* answers the accusations by saying that this is the fault of the Lithuanian government, which did not allocate enough funds to the implementation of these projects.

458 A. Zuokas kritikuoja “Lietuvos dujų” privatizavimą. ELTA. 2003-08-07.

459 The Lithuanian daily *Lietuvos žinios* reported that it seems that Lithuanian government is not interested in the success of these talks. Lithuania in these negotiations is represented by the lowest level officials (the deputy head of a division of the Ministry of Energy).

460 Už kokius darbus energetikoje – nuveiktus ar nenuveiktus – verčiamas A. Sekmokas?, Žinių radijas, „Dienos klausimas“, 2011-03-10.

461 Lietuvos Respublikos ūkio ministerija, Lietuvos valstybės valdomų įmonių veikla, 2011 m. pirmasis ketvirtis, http://www.ukmin.lt/lt/Valstybes%20valdomos%20imones/Lietuvos_valstybes_imoniu_veikla_wwww.pdf.

462 Интервью С.Куприянова, Ищем выход, Радио «Эхо Москвы», 2010-12-29, <http://www.echo.msk.ru/programs/exit/736676-echo/>.

At the same time, *Gazprom* representatives portray themselves as victims of the politicization of purely economic relations. Official representatives of *Lietuvos dujos* are not against the LNG terminal, but express doubts about need for such a project because, in their opinion, it is economically unfeasible and is purely political. But it is clear that the company does not want to be split or to face serious competition from the LNG terminal, which could be much cheaper. *Gazprom* also states that the Lithuanian government, which is planning to strictly implement Third Energy Package, is violating the privatization agreement because this results in the seizure of private property for the shareholders⁴⁶³. Lithuania, in fact, is not discriminated against and the Russian company adheres to its obligations and the price of natural gas for Lithuania is calculated purely on the basis of the formula agreed upon by both *Gazprom* and the Lithuanian government. At the same time, a higher natural gas import price for Lithuania is motivated by the fact that *Lietuvos dujos*, in contrast with its Latvian and Estonian colleagues, is not buying the quantities of natural gas agreed to in the privatization contract. Discounts for the other Baltic countries were a result of their fulfillment of obligations to increase gas imports. Moreover, *Gazprom* is not asking *Lietuvos dujos* to pay fines for unused gas, the basis for which is included in the “take or pay” contract.

In Lithuanian politics space there is a constant discussion of which strategy would be more effective dealing with *Gazprom*. Some opposition parties (mostly Social democrats) criticize the government for harsh rhetoric and the overly rapid implementation of the Third Energy Package. In their words, it not worth angering *Gazprom* while Lithuania still has no viable alternative (the LNG terminal is not built). The other side is claiming that the problem is the inflexibility of *Gazprom*, which could provide some minor discounts to stop Lithuanian plans for greater energy independence. Maybe the most harsh assesment of the dealings with *Gazprom* was given by Lithuanian President D. Grybauskaitė, who allegorically compared asking for lower natural gas prices with the situation in 1940 when a Lithuanian delegation went to Moscow.

From the start of independence, corporate intermediaries were very important in facilitating the Lithuanian import of natural gas from Russia. Currently, there is only one visible natural gas intermediary: *Dujotekana*, which pushed all other competitors out of business, was created in 2001. The operations of this company could be described as having four characteristics:

First, from 1992-2000 the existence of natural gas intermediaries was explained by the fact that they served as a guarantor for payments for gas in an environment of unstable payments and a lack of trust⁴⁶⁴. After 2004, when *Gazprom* became

463 “Gazprom” prašo neskubėti, Viešas pareiškimas, Lietuvos žinios, 2010-11-08.

464 For example, in 1999 *Gazprom* even used the sanctions (cutting 50% of the natural

one of the shareholders of *Lietuvos dujos*, the need for *Dujotekana* is even more questionable. This company, which at the end of 2010 had only 15 employees, has very substantial turnover and profits. The income of *Dujotekana* grew from 50.1 million euros in 2005 to 142 million euros in 2010. The head of *Dujotekana*, V. Orechov, in 2011 explained the need for the company by the fact that it provides is some kind of market liberalism (or, in other words, semi-competition and “choice” for consumers). In his words, *Dujotekana* is a normal wholesaler, just like all the others⁴⁶⁵. But it is clear that this company could exist and get serious revenues because there is will on the part of *Gazprom* top management and there is no effective opposition from the Lithuanian government.

Second, it is not clear who has become the real beneficiary of revenues from the resale of Russian natural gas and electricity to Lithuanian customers. It could be guessed that intermediary companies could be the way for some of *Gazprom*’s top management, or the whole company itself, to transfer some added value from Russia to Lithuania (as part of corrupt “capital flight” schemes). On the other hand, the relatively intransparent *Dujotekana* could be seen as a more effective tool for lobbying and other activities than JSC *Lietuvos dujos*, which has other shareholders (including the Lithuanian government) and must confirm to stricter transparency rules.

Third, the capability of the Lithuanian government to influence the operations of natural gas intermediaries is very limited. An analysis of the operations of the natural gas mediator company *Dujotekana* shows that its operations are highly dependent on the *status quo* in *Gazprom*’s top management (and, possibly, on the Russian ruling elite). *Gazprom* decides which company to choose, how much natural gas to sell them and for what price. For example, *Dujotekana* replaced other intermediaries at the same time that A. Miller replaced R. Viakhirev at *Gazprom*. A good example of the company’s dependence is the regulation of profit margins. In 2002-2007, *Dujotekana* sold natural gas to customers for much higher prices than *Lietuvos dujos* because its profit margins were not regulated and hence fluctuated between 15% and 30% (*Lietuvos dujos* margins were limited to 15%)⁴⁶⁶. In 2007, the Lithuanian Seimas passed amendments to the natural gas law which limited profit margins on natural gas suppliers, but *Dujotekana*, with the support of *Gazprom*, easily avoided these limitations. It began to purchase gas through *Gas Stream LT*, a company registered in Switzerland.

gas supply) in order to push *Lietuvos dujos* to repay a debt for the natural gas deliveries.

465 В. Орехов, Газ стал предметом политического торга, Экспресснедели, 2011-08-23.

466 Gamtinės dujos – Lietuvos klestėjimo ar pavergimo priemonė?, Žinių radijas, 2007-07-24, <http://www.ziniur.lt/archyvas/2007/11/dienos-klausimas/1924/gamtines-dujos-%E2%80%93-lietuvos-klestejimo-ar-pavergimo-priemone>.

Fourth, there is constant competition between different actors in Lithuania for the right to occupy an intermediary position, which guarantees income without considerable effort. The main strategy in this case includes attempts to get preferences from the *Gazprom* top management. For example, the head of *Dujotekana*, V. Orechov, publicly accused MEP V. Uspaskich of using political power (the introduction of a legal amendment that could effectively stop the existence of *Dujotekana*) to gain control of the gas intermediary business⁴⁶⁷. It is important to note that the shareholders of *Dujotekana* are also actively investing in other sectors of the Lithuanian economy.

3.2.3. Electricity sector

Russian capital is very active in the Lithuanian electricity sector. The Lithuanian electricity network is an integral part of the former USSR electricity system (along with the other Baltic countries, Belarus, Ukraine, etc). But not all of the Russian capital has been inherited from Soviet times; there are other important aspects of the Russian presence as well:

- As it was mentioned earlier, after the shut down of the Ignalina power plant, Lithuania became heavily dependent on electricity imports (and natural gas for electricity generation in local power plants). Currently, this niche is occupied by a subsidiary of the Russian corporation *Inter RAO UES* called *Inter RAO Lietuva*.
- Russia has declared that it is building a new nuclear plant in the Kaliningrad region and is interested in the Lithuanian market and electricity infrastructure (for transit purposes).
- In 2003, *Gazprom* acquired Kaunas Heat and Power Plant (KHPP). It's currently planning to build a new power plant in Kaunas.

After regaining independence, the electricity sector in Lithuania has attracted local and foreign intermediary companies, the operations of which are far from transparent.

Currently the Lithuanian electricity import market is dominated by the intermediary company *Inter RAO UES*, via *Inter RAO Lietuva*. The main business of *Inter RAO Lietuva* is importing electricity from Russia (mostly from power stations owned by *Inter RAO UES*) and other countries. *De facto*, *Inter RAO UES* has the exclusive right to export electricity from Russia to the Baltic

⁴⁶⁷ Šarūnas Černiauskas, V. Orechovas: V. Uspaskichas nori užvaldyti „Dujotekanos“ dalį dujų sektoriuje, <http://www.delfi.lt>, 2012-01-18.

markets, because it has transportation quotas in Russian electricity networks.

In 2011, *Inter RAO Lietuva* imported to Lithuania 6.2 tWh of electricity (compared to 5.3 tWh in 2010), which constituted 66.2% of total electricity consumption⁴⁶⁸ (the other largest actor was the Lithuanian power station *Elektrenai*, which produced 1.1 tWh in 2011⁴⁶⁹). In 2010-2011, electricity imported from Russia was 2-2.5 times cheaper than electricity produced at *Elektrenai* and other Lithuanian plants (mostly from imported from Russia natural gas). This creates the possibility for Lithuania to have lower electricity prices for consumers, but it also has a negative impact on the Lithuanian trade balance (in 2011, Lithuania spent around 600 million euros on electricity, and natural gas used in electricity production, imported from Russia).

In March 2011, *Inter RAO Lietuva* declared that it had entered into an agreement with *Inter RAO UES* on the power supply from the *Baltiyskaja* nuclear power plant, currently under construction in Kaliningrad, to the Baltic States and other neighboring countries. The agreement provides that *INTER RAO Lietuva* will supply up to 1,000 MW of electricity to the Baltic States and neighboring countries from 2017 through 2036. Depending on need, import volumes may be increased⁴⁷⁰. The Lithuanian government is openly against such plans, because it would interfere with plans to build a new nuclear plant in Ignalina (Visaginas nuclear plant) and, in general, would increase energy dependence on Russia. In this context, Lithuania and Estonia are planning to ask the European Commission to introduce import customs duties on electricity from the third countries⁴⁷¹.

To sum up, the interests of *Inter RAO UES* and its Lithuanian subsidiary, which could be derived from the nature of its current business, are that *Inter RAO UES* is interested in using the current and future Lithuanian infrastructure for its electricity business. Currently Lithuania has *de facto* the only way to export electricity from the *Baltiyskaya* power station, because links between the Kaliningrad region and Poland or the Scandinavian countries do not exist. This problem could be solved by building direct links between Kaliningrad and these countries (for example, building a power cable parallel to “Nord Stream”, or by the much easier option of transiting the electricity through Lithuania).

⁴⁶⁸ „Inter RAO Lietuva“ pernai padidino elektros pardavimus 50 proc. iki 8 mlrd. kWh, BNS, 2012-02-15.

⁴⁶⁹ Valstybinė kainų ir energetikos kontrolės komisija. Elektros energijos rinkos stebėsenos ataskaita už 2011 metus. <http://www.regula.lt>.

⁴⁷⁰ INTER RAO Lietuva to Import Electricity from the Kaliningrad Nuclear Power Plant. 2011-03-07 <http://www.interrao.lt/?p=90&lang=en>.

⁴⁷¹ Rytas Staselis, Rusijos energetikos bendrovės “InterRAO JES” antrinei įmonei Lietuvoje suteikta išskirtinė teisė ateityje parduoti Kaliningrade statomos jėgainės energiją Baltijos, Skandinavijos šalyse ir Lenkijoje, www.vz.lt, 2011-03-07.

It is interesting to note that the projects that are officially aimed at increasing Lithuania's energy independence from Russia (such as the "Swedlink" and "Litpollink") could in fact be used by *Inter RAO UES* to increase its presence in the markets of the Central European and Scandinavian countries. This picture fits with statements by a member of the board of *Inter RAO Lietuva*, Jonas Garbaravičius, that his company is interested in the integration of Lithuania and the Kaliningrad region into the UCTE system and the common energy exchange known as "Nordpool"⁴⁷².

Although *Inter RAO Lietuva* declared that *Inter RAO Lietuva* supports the building of the Visaginas nuclear plant, it's not clear how this project will fit into the *Inter RAO Lietuva* business plan. The Visaginas nuclear plant would be beneficial only if *Inter RAO Lietuva* would get the rights to become a seller of its electricity. In all other cases, electricity imported by *Inter RAO Lietuva* (including electricity from the Baltijskaya nuclear plant) would compete for the markets in local and neighboring countries and for the use of Lithuanian infrastructure. The company is also strictly against the proposed introduction of custom duties, because this would increase the price of imported electricity.

As in the case with natural gas intermediaries, there is a permanent active fight between Lithuanian (and possibly foreign) interest groups to enter the market for the sale of electricity. For example, in the summer of the 2011 there were already 64 companies registered as independent electricity providers⁴⁷³. *Gazprom* is also an active player in the Lithuanian electricity sector. In 2003, for \$35 million, *Gazprom* through an offshore company acquired a 99.49% share of the Kaunas heat and power plant, which generates around 80% of the heat consumed by the Kaunas central heating system. In 2012, after years of permanent conflict with the authorities of Kaunas city, it decided to sell the plant to an offshore company that is controlled by the shareholders of *Dujotekana*. The main official reason for the conflict was the failure of *Gazprom* to fulfill the investment obligations taken on during the privatization process. Kaunas city and central authorities also rejected *Gazprom* plans to build a new power station. The main argument here was that the *Gazprom* project would only increase Lithuania's dependence on natural gas imported from Russia. At the same time, *Gazprom* plans to build a new plant in Kaunas came into conflict with the interests of other players on the energy market, such as *Fortum heat* and *Inter RAO UES*.

472 Jonas Garbaravičius: Rusijai būtų naudinga Kaliningrado energetiką integruoti į „Nord Pool“ sistemą. BNS. 2011-01-24.

473 Valstybinė kainų ir energetikos kontrolės komisija, Nepriklausomo tiekimo licencijas turinčios įmonės, <http://www.regula.lt/lt/elektra/licencijavimas/licenciju-turetojai/nepriklausomo-tiekejo-licencijas.php>.

Another important question related to Russia's presence in the Lithuanian electricity sector is the relations between the German company *Nukem technologies* and the Lithuanian government. In 2005 a contract between the German company *Nukem technologies* and the Ignalina nuclear power plant on the building of storage units for used nuclear fuel was signed. The provisions of the contract are intentionally or unintentionally very unfavorable for the Lithuanian side, and the building of the storage facilities are behind schedule without any negative consequences for *Nukem technologies*⁴⁷⁴. In 2008, the Russian company *Atomstroyexport* acquired control of *Nukem technologies*.

3.2.4. Transportation sector

The most Russian capital in the Lithuanian transit sector is identifiable in the Klaipėda port and in railroad transit. One of the most important (and later scandal-ridden) projects in the Russian – Lithuanian economic relations is so-called "2K" (Kaliningrad – Klaipėda). In 2000 Moscow declared the new transit strategy in which the aim to rely on its own existing and planned to build ports in the Baltic sea was stressed. In order to implement this strategy Russia removed discounts for railroad transportation tariffs toward port of Klaipėda. Transportation to Klaipėda became 40% more expensive than through the port of Kaliningrad. To attract more goods to both ports, the Lithuanian and Russian sides decided to create the project "2K" (Klaipėda and Kaliningrad), in which it was planned to harmonize the railroad transportation tariffs and compete with other Russian and Baltic States ports. *De facto*, this project failed because, despite a few unilateral discounts from *Lithuanian railroads* (in the direction of Kaliningrad port), the Russian side didn't lower its tariffs in the Klaipėda direction. The main outcome of this failure is that the port of Klaipėda lost a significant share off Russian transit goods. Kaliningrad port increased its cargo turnover, but this increase wasn't very durable.

There are different explanations for the failure of the 2K project. In Lithuania, this project is usually seen as an attempt by Russian capital to take control over the transit industry through Lithuania, and even port of Klaipėda. Lithuanian media reported that Russian companies (*MTK*, *Medial trans*, and others) were planning to become the main operators of the joint Lithuanian–Russian transit company, which would control transit to both the Kaliningrad and Klaipėda ports. It was planned that in the future both ports could become a single entity,

474 Osvaldas Čiukšys, Gal kažkam iš IAE ir tuometės Ūkio ministerijos buvo naudinga laiku užsimerkti?, *veidas.lt*, 2011-03-02.

dominated by Russian capital. These companies are reported to be connected with V. Jakunin (currently the head of Russian railroads), the shareholders of *Dujotekana* and other persons⁴⁷⁵. The failure of the project could be also be due to the lobbying of competing ports. For example, in 2006 the head of the Kaliningrad port expressed the opinion that the 2K project failed because of the actions of competing ports in Russia and the other Baltic countries.

In 2006 the Lithuanian Seimas amended the railroad laws to include the provision that “the right to use the public railway infrastructure for transit rail service is awarded exclusively to the railway companies (carriers) which are owned or have all the shares owned by the Lithuanian State”⁴⁷⁶. These provisions removed the possibility for other (including Russian) operators to enter the transit market. Russia was unhappy with these amendments. The biggest incomes for *Lithuanian railroads* are received from the transportation of Russian goods in transit between Kaliningrad and “mainland” Russia. This transit represents the biggest share of *Lithuanian railroads*’s income and profits. A possible liberalization of the railroad sector could considerably lower the income of *Lithuanian railroads*, and thus their capability to subsidize passenger transportation, invest in infrastructure, etc. At the same time, in 2010 the daily *Lietuvos žinios* reported that the Russian company *Transkonteiner* (a subsidiary of *Russian railroads*) is trying to become the main operator for NATO cargo transit from the Klaipėda port to Afghanistan⁴⁷⁷. Klaipėda is also actively looking to become the main transit hub for Chinese goods to Europe and is competing in this sphere with the other Baltic ports (including Russian ones). The success of such plans and the future of shuttle cargo trains is heavily dependent on cooperation with Russian and Belarusian railroads and state institutions (the questions of tariffs, the effectiveness of the border and custom checks, etc).

The relations of *Lithuanian railroads* with Russia and Belarus in the transport sector has a broad cooperative agenda. There is a list of shuttle trains, such as *Vikings* (a joint project between Lithuania, Belarus and Ukraine), *Saule* (between Klaipėda and Kazakhstan/China, the first pilot train was launched at the end of 2011), *Merkurijus* (from Klaipėda to Moscow, reintroduced in March 2012), and *Šeštokai Express* (from Western Europe to Russia through Lithuania,

475 Demokartinės politikos institutas, Projektas 2K: Interesai, grėsmės, įtakos, Analitinė pažyma, 2006-12-07.

476 Lietuvos Respublikos Seimas. Lietuvos Respublikos geležinkelių transporto kodekso patvirtinimo, išgaliojimo ir taikymo įstatymo 4 straipsnio pakeitimo ir papildymo, geležinkelių transporto kodekso 3, 4, 6, 7, 10, 11, 12, 13, 16, 19, 28, 30, 48 straipsnių ir priedo pakeitimo ir papildymo bei kodekso papildymo 30(1) straipsniu įstatymas. 2006-06-08, Nr. X-653, Vilnius.

477 Jurga Tvaskienė. Generolas V.Tutkus vėl tarnauja Rusijai. Lietuvos žinios. 2010-02-27.

started in March 2012). There are ongoing developments in the project to launch a fast train between Vilnius and Minsk.

Belarus has become an important customer of transit services from the Klaipėda port (mostly because of the close geographic distance, effective service, and good tariffs). One of the most interesting projects for Lithuania is the transportation of Venezuelan oil to Belarus using the oil terminal *Klaipėdos nafta* and *Lithuanian railroads*. In September 2010, *Klaipėdos nafta* successfully transported a pilot shipment of 80,000 tons of Venezuelan oil from the tanker *Minerva* to the *Novopolock* oil refinery in Belarus⁴⁷⁸, but there were no further shipments because import through Ukraine was more effective. Thus, oil transit through Lithuania is seen as a reserve option. In general there is the tendency for the Belarusian government to use the question of transit (both of oil and other goods) as a “carrot” for the Lithuanian government and businesses in order to “soften” Lithuania’s policy toward Belarus.

3.2.5. Manufacturing

An analysis of Russian investment in the Lithuanian manufacturing sector shows that it has had a very positive impact for the Lithuanian economy. The three most significant Russian investments in Lithuanian manufacturing sector are as follows:

- In 2002, the Russian chemical corporation *Eurochem* for 15.5 million litas acquired a 70.3% share of one of the world’s biggest producers of chemical fertilizers, *Lifosa*⁴⁷⁹ (later the Russian investors’ share grew to more than 99.1%), which was on the verge of bankruptcy (its total debt reached 240 million litas).
- In 2003, the Russian corporation *Mechel* acquired 100% of shares of the bankrupt Lithuanian metal works factory *Nemunas*.
- In 2002, the Russian company *Technonikol* (one of the biggest producers of roofing materials in Russia) through its subsidiary *Oxford limited* acquired a 60.3% share of the Lithuanian producer of the bitumen roofing materials *Gargzdų mida* for 5.75 million litas.

An analysis of Russian investment in the Lithuanian manufacturing sector could distinguish three main characteristics of this process:

478 Vidmantas Matutis, Transportation of Venezuelan oil through Klaipėda is to increase, Jūra, 2011-05-24, <http://www.jura24.lt/en/news/marine-business/transportation-of-venezuelan-oil-through-klaipeda-is-to-increase-353951>.

479 “Lifosa” perejo į “Evrochim” rankas, Verslo žinios, 2002-08-22, Nr. 163, 6p.

- Lithuanian factories were acquired by Russian companies that were interested in expansion into global markets and export both raw materials and also products with higher added value. On the other hand, the attractiveness of Lithuanian factories was greatly improved by the fact of Lithuania's accession to the EU (because of the absence of trade barriers inside the EU and the possibility to attract finances from EU funds).
- Russian capital arrived at a moment when Lithuanian companies were bankrupt or had serious financial difficulties. This allowed the investors to acquire these companies for very low prices.
- The arrival of Russian investors greatly improved the situation for Lithuanian companies. They received funds for material investments, a supply of the raw materials at good prices, and investors helped with the search for new export markets. The success of the companies was greatly influenced by the fact that Russian investors not only wanted to acquire the current market share of Lithuanian companies, but also to get new ones (investment from Russia in this case was different from many Western TNCs, the branches of which have usually distributed local markets between themselves).

It is important to note that from 2004 there has been practically no information about the arrival of new Russian investors to the Lithuanian manufacturing sector (one of the rare exceptions was the acquisition of shares of the Lithuanian refrigerator producer *Snaige* by the Russian industrial refrigerator producer *Polar* in December 2011). This could be explained by the fact that the most attractive Lithuanian factories are already owned by foreign investors and are operating successfully. Thus, the possible acquisition price is not attractive to Russian investors.

3.2.6. Financial sector

Currently the presence of Russian capital visible in the Lithuanian financial sector is minimal. In Lithuania only one bank – *Snoras* – was owned by Russian capital, and the story of this ownership ended with scandal ridden bankruptcy. The operations of this bank had some aspects that are difficult to explain without insider information: When *Snoras* was acquired by the Russian bank *Konversbank* in 2003, it was unclear for analysts how a small Russian bank managed for 87

million euros to acquire a Lithuanian bank with capital (at that moment) of more than 290 million euros.

Moreover, when *Snoras* tried to open a branch in the United Kingdom, its application was rejected by the UK banking authorities. *Snoras* was accused of providing incomplete and unreliable information. The other reason was that its main shareholder, V. Antonov, had a questionable reputation⁴⁸⁰.

In November 2011, the Lithuanian government and Central Bank decided to nationalize *Snoras* because of serious financial problems and the suspicious activities of its owners (the massive withdrawal of financial resources from Lithuania). In the beginning a reorganization was planned, but later it was decided to begin bankruptcy procedures. The main reason was that there was around a 1 billion euro “hole” in the bank's accounts, and thus the impossibility to repay its financial obligations. The head of the Lithuanian central bank characterized the operations of *Snoras* as a mix of semi-criminal activities (such as lending to its shareholders or affiliated companies, suspicious lending to clients in Russia and offshore accounts, the usage of the bank's financial assets for the consumption purposes of its shareholders) and overly active and not fully calculated expansion (the creation of an extensive retail network, the acquisition of the Latvian bank *Krajbanka*, an overly active lending policy, etc.). The former owner of *Snoras*, V. Antonov, who at the moment of writing was asking for political asylum in the UK, portrays himself as the victim of a conspiracy. He alleges that the main actors of this conspiracy are the global and local competitors of his business empire.

The *Snoras* affair has shown a weakness of Lithuanian supervisory institutions. The Central Bank, despite swift action at the moment of nationalization, for a long time was very tolerant of some of the faults in *Snoras*'s activities, and thus the scandal caused the head of the credit institution supervisory division of the Central Bank lost his job (one of the main reasons was direct affiliation with *Snoras* bank). It seems that the Lithuanian banking authorities learned some lessons from the *Snoras* case, and in April 2012 refused to allow the Russian bank *Investtorgbank* to open a subsidiary in Lithuania. The main explanation was that the bank failed to provide complete information about its shareholders⁴⁸¹.

It is clear that *Snoras* is not the only bank that could be suspected of unclear financial operations related with Russian capital. Leaked facts show that Lithuanian banks are at least sometimes used for capital flight from Russia and money laundering schemes, but the real turnover of such operations is impossible to identify. For example:

480 “*Snoras*” – rusiško verslo įkaitas, Diena.lt, 2009-08-14.

481 Rusijos bankui neleista įsikurti Lietuvoje, 2012-04-19, <http://www1.lrytas.lt/-13348305281332791383-rusijos-bankui-investtorgbank-neleista-%C4%AFsikurti-lietuvoje-papildytas.htm>.

- In 2010 a Lithuanian court seized 10 million euros, which were transferred to an *Ukio bankas* account from the Russian bank *Diskont*. This transfer was identified by the Lithuanian courts as part of a money laundering scheme.
- In 2011 a Lithuanian court forbade the former prefect of the one of Moscow's districts, Y. Khardikov, who got asylum in Lithuania, to access his account in a Lithuanian bank to which he transferred 8 million euros from Russia⁴⁸².

3.2.7. Other sectors

The amount of identifiable Russian capital in the Lithuanian mass media sector is very limited. Possibly the most significant event in this sector happened in 2009, when the bank *Snoras* (controlled by Russian capital), through its affiliate company *Snoras asset management* for around 5.8 million euros acquired a 34% share in one of the biggest Lithuanian mass media groups, *Lietuvos rytas* (including one of the most influential newspapers in Lithuania, *Lietuvos Rytas*, the television company *Lietuvos ryto televizija*, several regional newspapers, special interest magazines, etc.)⁴⁸³. It was difficult to identify any serious pro-Russian shift in the *Lietuvos rytas* editorial policy, though some negative aspects of the newspaper's new ownership showed up in investigations surrounding the *Snoras* bankruptcy. *Lietuvos rytas*, one day before nationalization, published an article that accused the Lithuanian president of assault on Lithuanian capital banks in favor of Scandinavian-owned ones (*de facto*, this could be evaluated as pressure on the Lithuanian Central Bank in the *Snoras* affair). Later, during the scandal, the newspaper actively supported the position of its owners (*Snoras*).

Another big player in the Lithuanian mass media sector that is related with Russian capital is *Scaent Baltic*, which owns the popular monthly magazine *The Economist IQ*. Any serious pro-Russian bias could not be identified in articles from the media outlet (with some minor exceptions that were related to the electricity intermediary).

Russian and Belarusian investment into the Lithuanian real estate sector is difficult to evaluate. The state company *Registru centras* does not collect information about the citizenship of purchasers of real estate. Nonetheless, the mass media often publishes information based on interviews with real estate brokers, which identify some of the interest from Russian and Belarusian citizens

482 Buvusiam Maskvos prefektui neleista naudotis sąskaitomis Lietuvos bankuose. BNS. 2011-08-12.

483 „Snoro“ grupės įmonė taps didžiausia „Lietuvos ryto“ akcininke, *Lrytas.lt*, 2009-06-23.

in the acquisition of Lithuanian real estate (mostly in Vilnius and the seaside resorts of Palanga and Nida).

3.3. Main Lithuanian investors in Russia and Belarus

Lithuanian businesses are the most active investors from the Baltic countries in Russia and Belarus. The main explanations for this are size of the Lithuanian economy and the fact that a significant share of Lithuanian companies are still owned by local capital and are more flexible in their investment decisions. Lithuanian investors are mostly attracted to the Russian and Belarusian markets because of easy access to the local market (local production helps to avoid customs barriers), the cheaper work force and energy resources, and logistical needs. It must be noted, however, that many of these benefits (which are in fact diminishing because of growing labor and energy prices) are balanced by the often difficult investment climate (a high level of corruption, the frequency of hostile takeovers, administrative barriers, the unstable exchange rates of the local currencies).

- The biggest share of Lithuanian investment in Russia is attracted by the Kaliningrad region. This fact could be explained not only by geographical proximity, but also by the operation of a free economic zone in the region. The free economic zone regime is actively used by Lithuanian businessman to enter the “mainland” Russian market. Some of the most important Lithuanian investors in the Kaliningrad region are: *Arvi ir ko*, which built a fertilizer factory in Chernyakhovsk – the amount of investment was around 17 million euros⁴⁸⁴;
- *VICI* built a fish processing factory called *Viciunai RUS* – the investment size was 5 million euros;
- The meat processing factory *Kaliningradskij delikates* – an investment of 3.7 million euros;
- Sweets factory *Naujoji ruta* – an investment of 2.3 million euros⁴⁸⁵. *PST investicijos* together with *Panevėžio keliai* in 2011 are planning to begin construction on a multifunctional shopping complex called *Poliana city*. The approximate size of investment is 100 million euros⁴⁸⁶.

484 О предприятии, <http://www.arvinpk.ru/ru?cid=32>.

485 Пресс-служба правительства Калининградской области, Николай Цуканов: «Развитие сотрудничества с агропромом Литвы очень важно для Калининградской области», 20.06.2011, http://www.gov39.ru/index.php?option=com_content&view=article&id=15457:-l-r&catid=36:news&Itemid=58

486 Imasi projektą už Lietuvos sienų, *Mano eksportas*, 2011/10, <http://mano.vz.lt/index.php?act=mprasa&sub=article&id=932>.

Currently, the flow of Lithuanian investment to Kaliningrad has slowed down, because business conditions in the region have become less attractive (mainly because of the introduction of the Custom union, an increase in the prices for resources and labor, and limitations on the use of the free economic zone).

- The biggest projects in “mainland” Russia are: Real estate projects developer *Hanner* and one of the biggest road transport companies, *Girteka*, are building a logistics terminal in Pushkin, Leningrad oblast, which is scheduled to open by the end of 2011. The estimated cost of the project is \$100 million.⁴⁸⁷ *Arvi ir ko* is planning to build a turkey farming complex in the Chuvash republic. The investment size is 21 million euros⁴⁸⁸. Also, the company is planning to acquire the *Raevsky* sugar factory in the Bashkiria republic and invest around 100 million euros⁴⁸⁹.

Over the last few years Lithuanian investors have become very active in the Belarusian market. One of the factors that has increased Belarus’s attractiveness is the creation of the Custom union. The biggest investment projects are:

- Lithuanian company *UBIG* is developing multifunctional sport, trade and entertainment complex in Minsk called *Stadium*. It was originally planned that the size of investment in the project will be around 250 million euros, but in 2010 the Lithuanian company declared its plans to increase the level of investment to 500 million euros⁴⁹⁰. In August, 2012, Lithuanian company declared that this project is stalling, because of the actions of the Belarusian side. *UBIG* is planning to apply to Stockholm arbitrage in order to get compensation from Belarusian government.
- The Lithuanian company *Vakaru medienos grupė* is a building wood processing factory in the free economic zone in Mogiliov. The factory should begin operations in the second quarter of 2012. The cost of the joint project between *Vakaru medienos grupe*, the bank *Snoras* and the EBRD is around 72 million euros. Lithuanian investors will create 1,200 jobs⁴⁹¹.

487 Lietuvos statys logistikos kompleksą Sankt Peterburge, www.delfi.lt, 2011-01-28.

488 В Чувашии будут выращивать литовских индеек, Коммерсантъ(Чебоксары), №60 (90), 2011-04-07.

489 Литовская компания Arvi намерена приобрести Раевский сахарный завод в Башкирии и вложить в него до 100 млн евро, РБК, 2011-06-10.

490 Белорусско-литовская компания “Стадиум” рассматривает возможность увеличения инвестиций в строительство объектов в Минске, 2010-03-22, Интерфакс — Беларусь.

491 Investicijas iš Lietuvos paveržia Baltarusija, 2011-07-05, <http://iq.lt/titulinis/investicijas-is-lietuvos-paverzia-baltarusija/>.

- Leading Lithuanian retailer *Senukai* (51% of shares belong to Finnish capital) has a branch in Belarus, *Oma*, which in 2010 opened its first big do-it-yourself hypermarket in Minsk. Also, *Senukai* is building a second hypermarket in Mogiliov. The company also owns five smaller shopping centers⁴⁹². The top management of *Senukai* also declared that the company is planning to invest around 150 million euros in the Belarusian manufacturing sector.
- *VICI* is planning to build a factory in the Minsk free economic zone.

It must be noted that the harsh economic crisis in Belarus has not placated the intentions of Lithuanian investors. In some circumstances, the crisis could even improve investment conditions because it will lower costs for exporting manufacturers. In Russia, and particularly in Belarus, good relations with the central and local governments contribute considerably to the success of investment projects. In many cases this is a “must have” prerequisite.

4. Political implications of economic relationship

An analysis of the Lithuanian position on economic relations with Russia shows that it is quite complex, but that two sometimes contradictory components can be distinguished.

- Lithuania aims to increase its economic independence (the most important aspect being energy independence) from Russia. The Lithuanian government’s position toward economic relations with Russia could be partly explained by the historical legacy of the years before and after regaining independence in the 1990s. The Lithuanian national security strategy, approved by the Seimas in January 2005, declares that one of the most important points is that the “overwhelming dependence of the Republic of Lithuania on the strategic resources and energy supplies of one country or the concentration of foreign capital representing an economy in which the free market is not secured or stable, in one or several economic sectors of strategic importance to national security, is a potential danger not only for economic prosperity but also for the security of the country”⁴⁹³. It is clear that this paragraph is explicitly speaking about Russia.

492 Ома. О нас. [Www.oma.by](http://www.oma.by).

493 Republic of Lithuania Seimas. Resolution on the approval of the National security strategy, 28 May 2002 No IX-907 (version of 20 January 2005 No X-91).

- There is interest in increasing the export of goods to Russia, attracting more transit goods to Klaipėda and creating favorable conditions for Lithuanian investments in Russia.

Looking at the broader context of Lithuanian foreign policy, it can be seen that Vilnius is on a permanent quest to find the golden balance between political/national security interests and economic interests (the benefits received from economic relations with Russia).

The Lithuanian government's attitude toward economic relations with Belarus is even more complicated to characterize. Lithuania is an active promoter of democratic changes in Belarus, but at the same time it is interested in questions such as the transit of Belarusian goods through the port of Klaipėda, the transit of Ukrainian and Russian electricity through Belarus to Lithuania, favorable conditions for Lithuanian goods and investors in Belarus, and other similar questions. This contradiction is particularly visible in the question of economic sanctions against Belarus. On the one hand, Lithuania is a promoter of democratic change in Belarus and is meant to support European Union economic sanctions against Minsk. On the other hand, such sanctions could directly negatively influence Lithuanian economic interests, which are much bigger than for other EU countries that have no such close relations with Belarus. For example, in April 2012 the EU imposed additional economic sanctions against Minsk. For the first time it introduced sanctions against some big Belarusian companies related to the A. Lukashenko regime. In this case, Lithuania actively supports the position that the EU must use selective sanctions against high officials in Belarus and some businesses related to the A. Lukashenko, not against its citizens and other businesses because the positions of the Russia in Belarus will only improve.

In this chapter the two main aspects of Russian / Belarusian influence on Lithuanian politics and economics are analyzed. *First*, Lithuanian businesses exporting goods (and services) and investing in Russia and Belarus are susceptible to direct or indirect sanctions imposed by the governments of these countries as an answer to “unfriendly” Lithuanian foreign policy. *Second*, the influence of Russian capital on Lithuanian internal and foreign policy.

4.1. Lithuanian companies dependency on the Russian and Belarus markets

As was previously mentioned, there is a clear contradiction between the economic interests of Lithuanian companies, which rely on Russian and Belarusian markets, and the foreign policy of Lithuanian governmental institutions. When the Lithuanian government openly criticizes Russia and Belarus for their policies, it is difficult to expect that Lithuanian economic actors will get specific preferences from these countries, where the business and top level politicians are deeply interrelated. Such fears have some ground – in the 2000s there were cases when Russia used economic sanctions against Lithuanian businesses. One of the most prominent cases was the shut down of the *Druzhba* pipeline by *Transneft* in 2007.

Another important case can be seen in the sanctions against Lithuanian road carriers and milk products exporters in 2009. In August 2009, Russian customs began very harsh checks of Lithuanian road carriers. Russian customs explained that such checks were induced because Lithuanian road carriers systematically violated customs regulations. Most of the violations were minor, and it seemed that Russian customs specifically tried to find them. Lithuanian carriers registered huge losses and began to lose their share of the transportation market between the EU and Russia. At the same time (in August 2009), Russia imposed a ban on milk imports from some Lithuanian milk companies. Officially this was because of traces of antibiotics in the products exported to the Russian market⁴⁹⁴. Both problems were solved only after the heavy involvement of Lithuanian officials. Despite a rapid reaction and a lifting of most sanctions, the Russian measures clearly had a negative effect on the Lithuanian economy. Data published by the Lithuanian Ministry of Agriculture shows that milk producers lost more than 30 million euros in export revenues because of the Russian sanctions⁴⁹⁵.

There are two explanations for the Russian sanctions:

- The Russian government wanted to defend local companies from foreign competition. For example, the Lithuanian road carriers association *Linava* explained that the problems with Russian customs were a result of competition from their Russian colleagues, ASMAP. The Lithuanian weekly *Veidas* cited the Russian vice-minister of transport, E. Moskvichiov, who in February 2009 during an ASMAP conference declared that the share of Russian carriers in the local market should be

494 Arūnas Milašius, Rusija nebeįsileidžia 4 Lietuvos bendrovių pieno produktų, *www.vz.lt*, 2009-08-17.

495 Draudimai vežti į Rusiją eksportą sumažino 100 mln. Lt., *www.vz.lt*, 2010-03-22.

increased from 38% to 50%. Lithuanian carriers were named as one of the main competitors⁴⁹⁶.

- The sanctions were revenge for “unfriendly” Lithuanian foreign policy toward Russia. This explanation is supported by the fact that Russia has used similar sanctions in other cases. Before the sanctions, Lithuania was an active supporter of the Georgian position during the Russia–Georgia military conflict. But as an additional trigger for the sanctions, on July 3 2009 a resolution on the equal treatment of Stalin’s and Hitler’s crimes was adopted during the Parliamentary Assembly of the Organization for Security and Cooperation in Europe (OSCE) in Vilnius⁴⁹⁷.

After 2009 there was some minor Russian pressure on the Lithuanian transportation business. For example, Lithuanian road carriers are dependent on the permits that the Lithuanian and Russian sides negotiate at the beginning of each year⁴⁹⁸. In April 2012, Russia introduced plans to strictly limit the reexport of goods to Russia through Lithuania (and thus the business of Lithuanian road carriers) by limiting the use of bilateral transportation permits for such operations⁴⁹⁹.

It is clear that Russia has a much greater capability to influence Lithuanian business. For example, it can impose limitations on the operations of Lithuanian investors, bring pressure on the customers of Lithuanian production, etc. At the same time, Lithuania has a minimal number of possibilities with which to answer the Russian sanctions. Its foreign trade policy is fully regulated by EU law. The possibility to limit goods or energy transit to Kaliningrad are also ineffective, because this will only hurt the Lithuanian economy and energy security. This means that the Lithuanian economy is very susceptible to possible Russian pressure and that the only solution in such cases – besides the good will of Moscow – is to receive high level support at the EU level. Moreover, Russia has carrots to accompany its sticks.

In the case of Belarus there is no clear link between Lithuania’s foreign policy toward this country and difficulties faced by Lithuanian companies that export or invest there. On the other hand, high level political support from the Belarusian government is very important for the success of businesses in the country. For

example, in 2010 a delegation of Lithuanian industrialists in Minsk met with A. Lukashenko. During this meeting, the Belarusian president officially declared that he will support Lithuanian investment in Belarus. This meeting had very positive impact on Lithuanian investors because they were able to use this statement when dealing with Belarusian officials⁵⁰⁰. Yet the Lithuanian transit sector could feel the negative effect of Lithuania’s support of economic sanctions toward Belarus. The Ambassador of Belarus in Lithuania, V. Drazhin, in April 2012 speculated that economic sanctions against Belarus could lead to a decrease in the transit of Belarusian goods through the port of Klaipėda⁵⁰¹.

Lithuanian businessmen recognize this dependency on Russia (and Belarus) and try to influence the official Lithuanian position toward the countries. One of the most active business organizations that tries to “soften” Lithuanian foreign policy towards Russia (and Belarus) on sensitive questions is the Lithuanian Confederation of Industrialists. A significant part of this organization’s most active members are export to and invest in Russia and Belarus. For example, *Achemos grupe* is interested in lowering the price of natural gas (they are one of the biggest customers, and purchase from *Gazprom* directly) and fostering more active transit of Russian (and Belarusian) goods through its terminals in the Port of Klaipėda. Some examples include:

- In March 2005 the head of the Confederation, B. Lubys, urged President V. Adamkus to attend the Victory day celebration in Moscow. In his words, there is no need to live in the past, and such a visit would bring positive economic benefits to Lithuania⁵⁰².
- In the words of the former Lithuanian minister of foreign affairs, the Lithuanian Confederation of Industrialists was one of the main initiators of the visit by Belarusian President A. Lukashenko to Vilnius in 2009⁵⁰³. Other major supporters of better relations with Belarus include the Port of Klaipėda and the oil terminal *Klaipėdos nafta*.
- In April 2012 the Confederation actively opposed Lithuanian support for economic sanctions against Belarus. It published estimates that such actions could cost billions of litas for the Lithuanian economy⁵⁰⁴.

496 Inga Razmaitė. Kiekvieną nemalonėn patekusį iš po rusų letenos trauks atskirai, Verslo žinios, Nr. 156, 3p. 2009-08-18.

497 Valinskas: Lietuvos vežėjai „politiniu sprendimu“ išstumti iš Rusijos rinkos. BNS, 2009-08-19.

498 Lietuvos Respublikos susisiekimo ministerija, Sugriežtinta Lietuvos vežėjų kontrolė gali būti Rusijos ir Lenkijos nesutarimų pasekmė, <http://www.sumin.lt/lt/naujienos/10855>

499 Rusai smaugia užsienio vežėjus, www.delfi.lt, 2012-04-27.

500 Эгле Самошкайте, Перевыборы Лукашенко вызвали политическую бурю, но не сказались на литовских бизнесменах, ru.delfi.lt, 2011-02-13.

501 Ambasadoriaus įspėjimas: dėl ES sankcijų Baltarusija gali atsisakyti krovinių pervežimo per Klaipėdos uostą, BNS, 2012-04-12.

502 Pramonininkai ragina V. Adamkų vykti į iškilmes Maskvoje, ELTA, 2005-03-03.

503 Vladimiras Laučius, V. Ušackas - tikrasis draugystės su A. Lukašenka ir Rusija architektas?, Delfi.lt, 2011-09-07.

504 Sankcijų Baltarusijai gali sužlugdyti Klaipėdos uostą, BNS, 2012-04-12.

Lithuanian railroads is also very susceptible to Lithuanian political turbulence toward Russia and Belarus. The head of the company, A. Simenas, stated that his company could increase its cargo turnover by 70%, but Lithuanian foreign politics is the biggest barrier to fulfilling that potential. In his words, every public declaration against Russia and Belarus has an impact on the railroad business⁵⁰⁵. Despite some successes (such as a more flexible Lithuanian position toward Belarus after 2009), the business still has no major influence on Lithuania's policy toward Russia and Belarus, and most decisions are made by Lithuanian officials with different motivations.

4.2. Russian capital as the factor of the Lithuanian politics

The influence of Russian capital in Lithuania is often mentioned by high level Lithuanian officials as a factor that has a serious impact on Lithuanian politics. At the same time, most information related to this influence is classified or difficult to check. *Lietuvos dujos* has never supported any politicians since it was privatized. On the other hand, during a conflict with the Lithuanian government the company became a very active lobbyist (for example, it began to send letters to members of Seimas⁵⁰⁶, to give interviews to journalists, etc.).

One of the most visible companies in the Lithuanian political scene is the natural gas intermediary *Dujotekana*. In 2004, former US ambassador to Lithuania Keith Smith in a paper about regional energy security characterized *Dujotekana* as a tool that is used to "reward" local politicians and act as an instrument of Moscow's intelligence services.⁵⁰⁷ The most public attention it received was in 2006 following the mysterious death of Lithuanian State security department (SSD) officer V. Pociunas, who had investigated the 2K project and the operations of *Dujotekana* in Brest. A parliamentary investigation by the Seimas national security defense committee on the SSD operations was launched. During the investigation, in which most stenograms were made public, some SSD officials testified that they were working on an investigation of the operations of *Dujotekana* and its links with the Lithuanian politicians⁵⁰⁸.

505 Kazimieras Šliužas, Didžiausia transporto bendrovė planuoja tapti solidžiu tarptautinių krovinių vežėju, *www.alfa.lt*, 2011-09-08.

506 Parlamentaras prašo VTEK įvertinti Gazprom spaudimą Seimui, BNS, 2011-03-21.

507 Keith C. Smith, Russian energy politics in Poland, Ukraine and Baltic states, Center for strategic and international studies, 2004-10-19, http://csis.org/files/media/isis/events/041019_smith.pdf.

508 NSGK tyrimo medžiaga (stenograma Nr.6), *www.delfi.lt*, 2007.03.20.

At the same time, *Dujotekana* was spending around 600 thousands euros annually to support a wide range of political parties⁵⁰⁹. It is difficult to assess what the real balance is between purely economic and political aims in *Dujotekana's* lobbying activities. It is clear that *Dujotekana* is actively fighting for profit (for example, against the regulation of profit margins) and in order to keep its position as a natural gas intermediary. On the other hand, the company is involved in philanthropic activities by supporting both Lithuanian and Russian sport, culture, social services, and other organizations in Lithuania. It must be noted that the new head of *Dujotekana*, V. Orechov, declared that his goal was to make it a pro-European company, working in accordance with Lithuanian law.

Another intermediary – *Inter RAO Lietuva* – is not visible in Lithuanian politics. Shareholders of the company have declared that they are not supported by any political party and are staying out of politics.

The positions of two major Lithuanian political parties toward the "Russian factor" (including relations with *Gazprom* and *Dujotekana*) are quite diverse. Judicial acts and rhetoric show that the Lithuanian social democratic party is quite close to the position of *Lietuvos dujos* and *Dujotekana*. For example, in 2007 Prime Minister G. Kirkilas and his party were against the regulation of profit margins in the natural gas trade. In 2011, the party voted against a new natural gas law. This position was explained by the fact that Lithuania has a limited capability to influence *Gazprom* and that such a strict stance will only anger the company and bring even higher prices for natural gas. The Lithuanian conservative party positions itself as an active fighter against the negative aspects of Russian capital in Lithuania. It is one of the main opponents of *Gazprom* and a supporter of strict policies toward the company and its intermediaries.

When speaking about the influence of Russian capital on Lithuanian politics, it is important to mention the impeachment procedure of President Rolandas Paksas in 2004. The Russian citizen and businessman Yuri Borisov (the owner of the Lithuanian company *Avia Baltika*, which actively exports its aircraft and helicopter repair services to Russia) was the main financial supporter of the R. Paksas election campaign, and his relationship with this businessman was one the main reasons for the presidential impeachment.

To sum up, the Russian influence is one of the most important topics in the Lithuanian political discourse. From the available highly fragmented and biased information it is quite difficult to assess real extent of this influence.

509 Eglė Markevičienė; Agnė Pačauskaitė, "Dujotekana" kratosi Kremliaus įmonės įvaizdžio, *Verslo žinios*, 2006-12-05, Nr. 235.

Conclusions

Russia is one of Lithuania's most important economic partners. Russia is an important market for Lithuanian goods and services, particularly in the fields of transport and tourism. Russia is also one of the biggest investors in the Lithuanian economy (the most substantial share of Russian investors came to in Lithuania from 2002-2004). On the other hand, it is impossible to identify the real extent of the Russian capital in the Lithuanian economy, because there are a huge range of options to hide the country of origin of investments. Russia has broad range of tools to pressure Lithuania – from the energy resource prices (80% of Lithuania's consumption is dependent on energy resources imported from Russia) to worsening conditions for Lithuanian exports and investments. Thus, Lithuanian businesses involved in Lithuanian-Russian economic relations is highly susceptible to pressure.

The Lithuanian government is on a permanent quest to find the golden balance between political/national security interests and the economic interests in economic relations with both Russia and Belarus. On the one hand, there is the aim to see democratic developments in both countries and a cautionary approach toward possibly unfriendly economic influence. On the other hand, there is a clear interest to increase the export of Lithuanian goods and services, to attract bigger transit flows to the Port of Klaipėda and to improve conditions for Lithuanian investors in both countries.

Russian capital also has an important place in the Lithuanian internal political agenda, where it is often used as an argument in political struggles. But an analysis of Russian–Lithuanian economic relations shows that portraying Russian capital as a “force of evil” is at least not fully fair. Russian investment into the Lithuanian economy could be divided in two main types. On the one hand, investment into manufacturing is very productive and could be evaluated as very positive for the development of the Lithuanian economy. On the other hand, Russian investment in some “sensitive” sectors (particularly energy) has lead to rigid conflicts, such as the conflict between the Lithuanian government and *Gazprom*, *Dujotekana's* involvement in Lithuanian political scandals, and the privatization of the *Mazeikiiai* oil refinery. Also, there are clearly identifiable interests groups in Lithuania (such as intermediaries in the energy sector), which by themselves have become an important factor in Lithuanian-Russian economic cooperation.

It must be noted that most challenges for Lithuanian-Russian economic relations arise in situations where faults in both countries' political and economic systems are involved. On the one side there is widespread corruption, a close

relationship between state and businesses and other problems in modern Russia that have a big impact on the operations of the biggest companies. At the same, it seems that the biggest part of Russian interest in Lithuania are purely economic – to get highest possible profits. On the Lithuanian side, there are problems such as the non-transparent decision making process (particularly in the energy sector), the sometimes too deep “geopolitization” of economic relations, a lack of high quality analytical capabilities, weak energy (and other sector) supervision capabilities, which creates a substrate for non-transparent “cooperation” and very politicized conflicts. It is worth mentioning that many problems that could seem to have arisen because of the Russian origin of capital are in fact much more universal and have their roots in Lithuania. Very indicative example is the operation of the French company Dalkia in the Lithuanian central heating sector. In this case the Lithuanian government and consumers have serious problems.

Lithuanian economic relations with the Belarus are developing at a rapid pace. At the same time, because of the size of the economy and lack of energy resources Belarus has much less economic influence on Lithuania. For example, Belarusian capital is almost not present in Lithuania, while at the same time Lithuanian investments in the country are rapidly growing. Belarus is an important export market for Lithuanian transport and tourism services. Lithuania also depends on the transit of energy resources through Belarus and cooperation with Belarusian railroads. Sometimes Minsk attempts to use this dependency to manipulate Lithuania's foreign policy (for example, in the case of EU sanctions). At the same time, Belarusian-Lithuanian economic relations are more balanced because benefits from economic cooperation with Lithuania are proportionally much more important for Minsk than Moscow. To sum up, Lithuanian–Russian and Lithuanian–Belarusian economic cooperation has good potential for development, and even in the problematic sectors the involvement of serious political will could create a great deal of value for the Lithuanian economy.

Through the analysis of Lithuanian economic relations with Russia and Belarus the following recommendations to the Lithuanian government could be given:

- Lithuania should increase bilateral communication with Russia (and Belarus, taking into the account the limitations imposed by EU sanctions) both on the highest and lower levels. The economic agenda should get more attention in these communications.
- In order to solve the negative aspects of Russian capital in the energy sector, two main improvements of government policy in this sector should be achieved. This sector needs much greater transparency (for example, decisions should be openly discussed with experts and society

without hiding behind the term “decisions of strategic importance”). Also, Lithuania should strengthen its supervision institutions and allow them to achieve maximum independence from both internal and external interest groups.

- It is worthwhile to once again analyze the situation and thoroughly measure the importance of economic relations with both countries, especially considering their influence on different sectors of the economy and their added value.
- Opportunities created for Lithuanian businesses by both the creation of the Eurasian economic area and Russia’s accession to the WTO should be analyzed in order to create new export and investment opportunities.
- The main goal for Lithuania is to attract investment from Russia, which will have a real positive impact for the Lithuanian economy. Thus, all possible attention should be given to the attraction of “green field” export oriented Russian investments in the manufacturing and service sectors.

ESTONIA – RUSSIA – BELARUS: THE POLITICAL IMPLICATIONS OF ECONOMIC RELATIONS

Karmo Tüür, Raivo Vare

The primary focus of this paper is to provide an overview of the politico-economic impact of Russia and Belarus on Estonia. To do this we will do three things: a) give brief overview of how and why economic relations between the countries evolved in the post-soviet period in the way they did; b) map the participants that are involved in Estonia’s foreign economy on both the state and non-state level; and c) draw conclusions about the political impact of economic relations.

This research is based on two methods: an analysis of open statistical databases and expert-interviews to get the information directly from the participants that are involved in economic and/or political relations between countries. For experts we chose mainly representatives of the relevant Estonian ministries, agencies, and associations, as well as several big companies whose business interests lay in Russia and/or Belarus.

The study is divided into several parts. The first part reviews the establishment of the current politico-economic relations, from the dissolution of the Soviet Union up to 2011. The second and third parts discuss the participants involved in economic relations, both on a state level (including local governments, etc.) and in business. The fourth part elaborates on the political background of economic relations – in other words, what kind of political influence those relations had in Estonia. In conclusion, the authors answer the question posed in the title of this study: what kind of influence Russian and Belarusian foreign economic policy has on Estonia – if there is any influence at all.

It should be said in advance that this paper is very asymmetric in its balance between Russia and Belarus. The two countries have enormously different proportions in the Estonian economy. Estonia does not have common border with Belarus and has very limited contact via infrastructure (railways and electric grids). In some cases, we cannot speak about any Belarusian share in various spheres of the Estonian economy.

As both authors have been involved for years in Estonian-Russian (and to a lesser extent in Estonian-Belarusian) relationships – one as theorist, the second as practitioner – some parts include expert opinions that may not be referred to. Information about ministries and agencies was received via interviews, and due to political sensitivity all the interviewees names are known only to the authors.

1. Major trends and areas of economic relations

1.1. *The dynamics of economic relations between Estonia and Russia*

The history of the Estonian-Russian economic relations must be reviewed with close attention to political relations between the states, and also in the context of broader economic developments. Historically, the development of Estonian-Russian economic relations may be divided into four stages:

- 1991-1994/95 (from the restoration of independence to so-called double customs duties, the key is a sharp decline of Russia's share in the economy);
- 1995-2004 (from double customs duties to the EU, the key is a restructuring of relations – a decline in the export of the Estonian goods and a rising share of transit);
- 2005-2007 (from joining the EU to the Bronze Night, the key is trade growth);
- 2008-present (in the aftermath of the Bronze Night, the key is overcoming a setback, which has now been done in the majority of sectors)

1991 – 1994/95

The restoration of Estonia's independence in 1991, when the Soviet model of economic cooperation fell apart rapidly and irreversibly, must be considered the starting point of economic relations. The Russian Federation, which played a pivotal role in Soviet government structures and bureaucracy, as well as in the socialist economy, on the basis of a right of succession right started to take over economic entities and conduct independent foreign economic policy. This policy diverged relatively fast from the principle of equal treatment toward one of applying economic pressure and linking economic and foreign policy.

Although in the spring of 1992 Prime Ministers Yegor Gaidar and Tiit Vähi signed a free trade agreement between Estonia and the Russian Federation, which regrettably never came into force, by the end of that year there already appeared the first signs of limitations on the supply of energy resources (oil products), the freezing of financial assets (in the case of Vneshekonombank), a drying up of orders traditionally placed by clients of Estonian companies, and so forth. Such measures were actually aimed at achieving other goals, i.e., to impose Russian interests in sensitive issues: the withdrawal of troops, special treatment for the Russian minority, the autonomy of North-East Estonia,

problems surrounding the ownership of state enterprises, issues of border and customs control, and so on.

Indirectly, this indicated a desire to apply to Estonia and the other Baltic states the same policy that forced other former Soviet republics into a Russia-led CIS (this policy worked with other states that did not restructure their economies because they wanted to preserve economic ties and the well-being of local elites). However, this strategy did not work in the case of Estonia because of the country's flexibility due to its geographical location, historical traditions, and small size – Estonia, supported by a successful economic policy and foreign investments, in fact accelerated the restructuring of its economy and re-orientation to Western markets.

Aside from political reasons, the total collapse of the Soviet model of economic co-operation and the disappearance (and replacement) of earlier economic ties has played very large and often more decisive role in the development of economic cooperation at the grass-roots level. The resulting confusion provided an opportunity for companies and businessmen from the two states to develop commercial relations that were sometimes uncontrolled, and were later described by their participants as “the Wild West”. For Estonia, it meant, among other things, a fast realignment from domestic markets to export markets: the former Soviet large-scale industries disappeared and the export of raw materials from Russia saw explosive growth (due to the availability and effective functioning of Estonian ports). In the beginning, metals were the main export item, elevating Estonia to the number two spot among metal exporters in the former USSR, and in the next stage oil products moved ahead to become the key export article.

Nevertheless, in their political rhetoric, representatives of the above-mentioned industrial sectors defended the restoration of earlier cooperation ties. This argument was used most extensively in the industrial region of North-East Estonia, which has a predominantly Russophone population consisting of economic immigrants who moved there in large numbers after the Second World War. The issue culminated in the so-called movement for Russophone autonomy, which continued until 1993 and was supported by powerful conservative forces in Russia.

During that period a dramatic realignment of the Estonian economy from East to West was taking place. In 1990, the (subsequent) CIS states' share in Estonia's trade balance was 95%, but by the end of the period it had already dropped to approximately 30%, of which Russia's share was two-thirds. From 1991-1994 Russia's share decreased almost 2.5 times over. (See the table provided by Eesti Pank [the Bank of Estonia] below).

Late 1994 to early 1995 may be considered the end of this period: by this time the withdrawal of Russian troops from Estonia had been mostly completed

and Russia introduced double customs duties for Estonia – or, to be precise, in mid-1994 cancelled Estonia's reduced customs duties, in contrast to the other Baltic states (Latvia and Lithuania)

Table 1. Estonia's trade with Russia between 1991 and 1994 (million kroons)

	Turnover	Share of total turnover (%)	Export	Share of export (%)	Import	Share of import (%)	Balance
1991	492.9	51.6	288.4	56.5	204.5	45.9	83.9
1992	2612.9	24.5	1156	20.8	1456.9	28.4	-300.9
1993	4439.9	19.7	2406.6	22.6	2033.3	17.2	373.3
1994	7530.1	19.6	3920.5	23.1	3609.6	16.8	310.9

Source: Statistics Estonia.⁵¹⁰

1995-2004

The next stage of relations was characterised by the rapid continuing decline of Russia's share in Estonia's foreign trade, on the one hand, and a rapid growth of direct investment in the Estonian economy as a result of successful privatization (mostly from Scandinavia, with Finland and Sweden in the lead), on the other.

However, this period also saw fast growth in the logistics sector, which thrived on the rapidly rising export of Russian oil products and other raw materials (metal products, grain, timber, chemicals and fertilizers). There were two main causes of this growth: The fast adaptation and competitive development of the Estonian logistics sector and its infrastructure (supported by historical heritage), i.e., the transit sector;

A rapid growth in the export of raw materials from Russia, "the Wild West" atmosphere in the Russian logistics sector, and poor infrastructure capacity in Russia.

This stage of inter-state economic relations lasted until 1999 – the year marked by the so-called Russian crisis – i.e., Russia's default. The earlier Asian crisis had not meaningfully affected inter-state trade, but the Russian crisis brought trade with Russia to an unprecedented low level. Estonian exports to Russia became a major victim due to the insolvency of Russian partners, especially in such traditional export areas as agricultural and food industry products and construction services. Thus, according to data from Eesti Pank, Russia's share in Estonia's exports fell from a pre-crisis level of 17% in 1997

⁵¹⁰ Compilation from Statistics Estonia and Estonian Bank databases, made by authors, data available at http://www.eestipank.info/pub/et/dokumendid/publikatsioonid/seeriad/bulletan/bylletaan95/_3/bilanss/index.html?ok=1.

to just 6.5% in 2000. Nevertheless, transit continued growing because Russia needed more foreign currency from the export of raw materials than before. Imports from Russia also remained at the previous level because the import of fuel – amounting to almost half of the total (especially the import of so-called "transit fuel" for re-processing and re-export) – did not fall, and even somewhat increased.

To sum up, evaluations of Russia's economic influence after this period have been mostly focused on the transit sector, because Russia's share in other sectors of the economy became marginal. The development of a legal framework for inter-state economic relations also intensified during this time. An intergovernmental commission was established, and started preparing major agreements on economic cooperation and social issues. These agreements were finalized and mostly signed, or at least initialled, in the next stage of relations.

Table 2. Estonia's trade with Russia 1995-2003 (million euros)

	Turnover	Share of total turnover (%)	Export	Share of export (%)	Import	Share of import (%)	Balance
1995	527.2	16.4	238.2	17.7	289	15.5	-50.8
1996	588.7	14.4	264	16.5	324.7	13.1	-60.7
1997	1029.2	15.7	490.9	18.8	538.3	13.7	-47.4
1998	857.2	11.9	388.6	13.3	468.6	10.9	-80
1999	773.9	11.6	261.1	9.3	512.8	13.3	-251.7
2000	1028.2	10.6	284.5	6.8	743.7	13.5	-459.2
2001	1079.8	10.5	384.9	8.6	694.9	11.9	-310
2002	1179	10.9	456.3	10.0	722.7	11.7	-266.4
2003	1247.7	10.4	566.3	11.4	681.4	9.7	-115.1

Source: Compilation from Statistics Estonia⁵¹¹

2004-2007

The next stage of Estonian-Russian economic relations is characterized by a dual process in which relations between the two states cooled down as a whole (in connection with the process of Estonia's accession to NATO and a policy of the new Russian administration that was aimed at the restoration of its status as

⁵¹¹ Compilation from Statistics Estonia, made by authors, data available at http://pub.stat.ee/px-web.2001/Database/Majandus/25Valiskaubandus/05Valiskaubandus_1995-2003/01Pehikaubandus/01Pehikaubandus.asp.

a great power) but, at the same time, a slow legal ordering of economic relations continued (in connection with the process of Estonia's accession to the EU, which was happening simultaneously).

After Estonia joined the EU on May 1, 2004, the double customs duties that impeded the development of economic relations were abolished. This resulted in a sharp increase in the volume of export-import operations between Estonia and Russia. Thus, Estonia's exports to Russia grew approximately 2.8 times from 2004-2007 (the share of total exports increased by 57%) and imports approximately 2 times (the share of total imports increased by 10.7%) (See the table below, based on data from Statistics Estonia). Since the Estonian economy as a whole was growing at a faster pace during this period, an increase in trade with Russia did not significantly change the latter's trade share.

Table 3. Estonia's trade with Russia 2004-2007 (million euros)

	Turnover	Share of total turnover (%)	Export	Share of export (%)	Import	Share of import (%)	Balance
2004	884.4	7.7	267.0	5.6	617.3	9.2	-350.3
2005	1 156.4	8.0	401.6	6.5	754.8	9.2	-353.2
2006	1 994.7	10.8	605.3	7.8	1 389.4	13.0	-784.2
2007	1 867.0	9.6	709.6	8.8	1 157.3	10.1	-447.7

Source: Compilation from Statistics Estonia⁵¹²

2008 - to date

A deterioration of relations in 2007 because of the tensions around the so called Bronze Soldier caused a decline in inter-state trade, which was further aggravated by the subsequent global economic crisis. In 2009, trade turnover between Russia and Estonia declined by 27.5% according to Statistics Estonia (in 2008, trade turnover fell by 8.2% year-on-year). Only in 2011 did the pre-crisis export-import volume start to recover. However, as illustrated by the data provided by Statistics Estonia below, Russia's export share is falling again. The post-crisis recovery of Estonian exports has largely been caused by growing exports to Scandinavia and Germany, for which Estonian companies are mostly subcontractors. Thus, Estonia's trade turnover has been largely re-oriented toward

⁵¹² Compilation from Statistics Estonia, made by authors, data available at <http://pub.stat.ee>.

Western Europe, with the exception of the food industry's exports to Russia, which have almost doubled (mostly thanks to dairy products)⁵¹³

Table 4. Estonia's trade with Russia 2008-2011 (million euros)

	Turnover	Share of total turnover (%)	Export	Share of export (%)	Import	Share of import (%)	Balance
2008	1,712.8	8.8	880.4	10.4	832.4	7.6	48.0
2009	1,198.6	8.7	601.1	9.3	597.4	8.2	3.7
2010	1,607.3	8.9	844.5	9.7	762.8	8.2	83.9
2011	2,369.6	9.6	1,325.40	11.0	1,044.20	8.3	-162.9

Source: Compilation from Statistics Estonia⁵¹⁴

It should be mentioned that it is not correct to say that this temporary decrease in trade was only caused by the so-called Bronze Night. If we look at Russian-Latvian and Russian-Finnish trade numbers, then there was a similar recession. Therefore, we can say that there were two coincidental factors – a bilateral crisis and the influence of the global economic crisis.

1.2. The dynamic of economic relations between Estonia and Belarus

Belarus does not share a border with Estonia, and therefore communication has always taken place through other neighbors – namely, Russia and Latvia. Thus, any Belarus-related statistics that Estonia has are very insufficient, and it seems that this sort of information about Belarus can in fact be better found in the statistics of intermediary countries. This is why all the numbers given below should be viewed with caution, and more attention should be paid to the trends than the figures. Additionally, political aspects have influenced the under-development of cooperation in the economy. This includes the economic structure and the regime of investment that has been established in Belarus, as well as the attitude of international partners – including the political attitude of the European Union, which has somewhat filtered to the grass-roots of

⁵¹³ Compilation from Statistics Estonia, made by authors, data available at <http://statistikaamet.wordpress.com/tag/import/>.

⁵¹⁴ Compilation from Statistics Estonia, made by authors, data available at http://pub.stat.ee/px-web.2001/Database/Majandus/25Valiskaubandus/03Valiskaubandus_alates_2004/03Valiskaubandus_alates_2004.asp.

Estonian business. That is why Estonian embassy in Minsk was only established in late 2009.

Statistically, it can be said that Belarus has never been one of Estonia's most important foreign trade partners or foreign investors. In the 1990s, its role was almost non-existent compared to the proportion of Russia in Estonia's foreign trade, but it began to grow in the last decade. Only a few Estonian companies have invested in Belarus. However, Belarus has historically had a relatively solid place in transit routes to Estonia (mainly fuel transport). Before, these were mainly petroleum products for export shipments to the West. Lately, the periodic shipments associated with the so-called "Venezuelan oil project" have attracted attention because through that project Venezuelan oil is being transported to Belarus as a substitute for delayed deliveries of Russian petrol.

Table 5. Belarus-Estonia trade 2004-2010

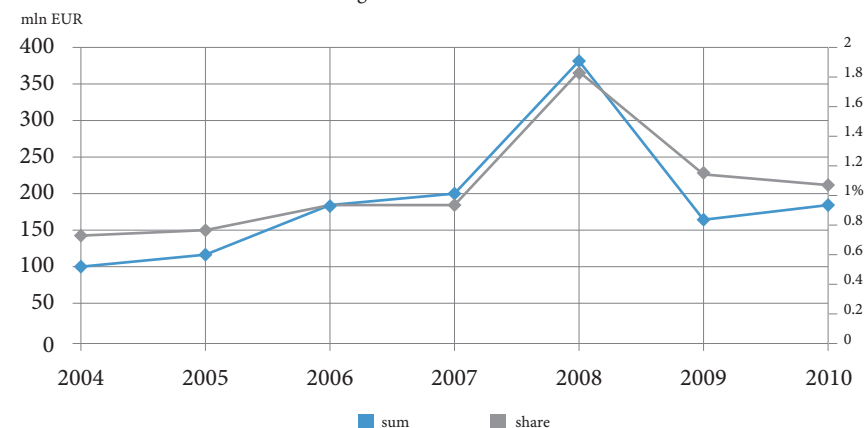
	Export, mln EUR	Share in the total export, %	Import, EUR	Share in the total import, %	Balance, EUR
2004	11.0	0.23	81.6	1.22	-70.6
2005	16.1	0.26	103.8	1.26	-87.6
2006	44.0	0.57	145.9	1.36	-101.9
2007	36.1	0.45	162.5	1.42	-126.4
2008	54.3	0.64	318.3	2.92	-263.9
2009	37.8	0.58	118.1	1.62	-80.3
2010	63.4	0.72	118.4	1.28	-55.0

Source: Statistics Estonia⁵¹⁵

According to the data of the Bank of Estonian and Statistics Estonia, Belarusian trade hasn't exceeded 2% of Estonian foreign trade. Belarus has always been the 10th-20th Estonian import partner and the 20th-30th export partner. The most important export articles were machinery and mechanic devices (at about one-third of the total), and transportation utilities, chemical products, textile and textile fabrics (at about one-tenth of the total). The key import articles, in the range of four-fifths of the total, were mineral products (such as mineral fuel), while on the scale of one-sixth to one-fifth were metal and products made out of iron (ferrous metals and its products) and, finally, in the range of one-tenth, chemical products.

⁵¹⁵ Compilation from Statistics Estonia, made by authors, data available at <http://pub.stat.ee/px-web>.

Chart 1. Belarus in Estonian foreign trade 2004-2010



Source: Statistics Estonia

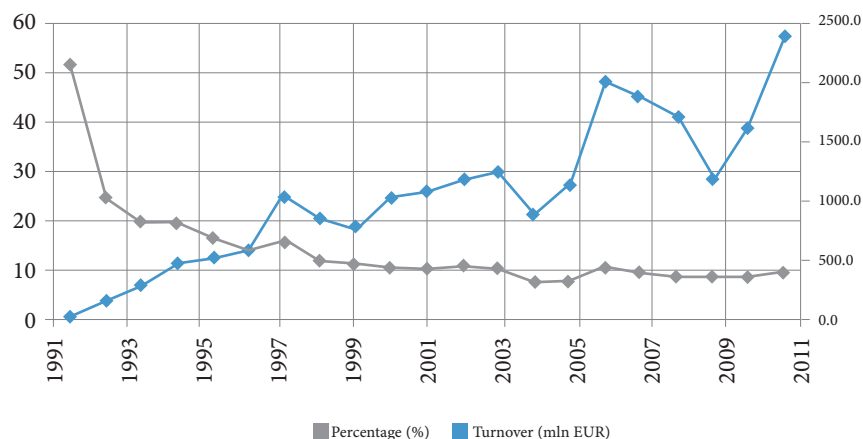
1.3. Export-import characteristics and transit

Throughout these years, food products remained the main export item to Russia: predominantly fish and dairy products, meat, alcoholic beverages, and sweets. Vehicles (passenger cars and seat belts) were another important export item, followed by machinery, equipment, and chemical products. Naturally, mineral products have been the biggest import item due to a strong growth in the import of motor fuels, both for domestic consumption and for processing, that occurred in recent years, especially before the Bronze Night. Natural gas accounted for approximately one-fifth of the import of mineral products. Mineral products were followed by timber and wood products (mostly unprocessed or minimally processed) and metal products (mostly steel and scrap metal).

The statistics must be viewed with certain reservations. The long history of double customs duties, Russia's negative attitude to Estonia at a political level, the peculiarities of Russia's export regulations, and the general uncertainty of the Russian businessmen regarding their domestic business environment have created a strong incentive for participants of economic cooperation at the grass-roots level to hide their country of origin and the identity of the actual parties to transactions. Companies that export to Russia have benefited from several schemes through the use of this. For example, in the case of exports, goods of

Estonian origin were placed into a bonded warehouse at their real price, and after being shipped to Russia a much lower price was indicated in the customs declaration. Sometimes another country of origin was also indicated. The Estonian goods were also often exported to Russia through neighboring states, especially Finland, where the country of origin of the goods was correspondingly altered. Another possibility has been registering a company in Finnish or Latvian jurisdictions and then changing customs codes regarding the country of origin. The last option has been often used in the export of food products.

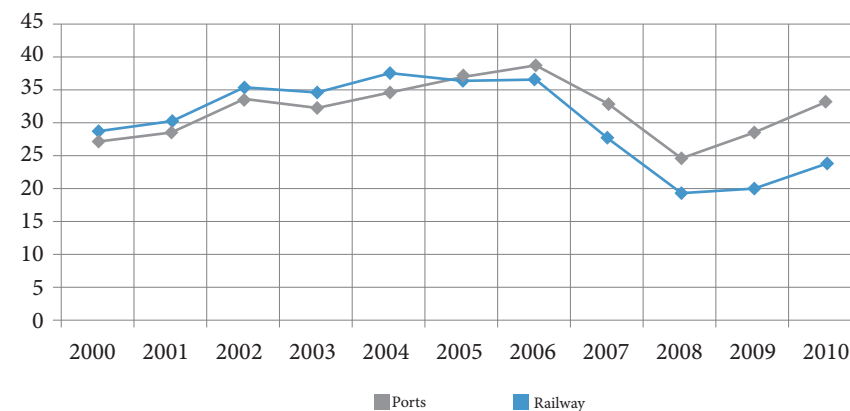
Chart 2. Russia in foreign trade of Estonia 1991-2011



Source: Compilation from Statistics Estonia

All of this gives rise to the following expert evaluation: after the sharp decline during the first stage of relations and the subsequent stable share of at least 16-17% through the end of the 1990s, Russia's share in Estonia's foreign trade then again declined over the last decade, and stabilized at 9-10%. The transit sector faced a significant setback after the events of the Bronze Night in 2007, but this has not had a big impact on Russia's overall percentage in Estonian foreign trade.

Chart 3. Transit goods carried on railway and through the ports of Estonia 2000-2010



Source: Goods in Transit in 2000-2010⁵¹⁶

An especially sharp drop occurred in the carriage of coal and fertilizers – respectively, from 9 million and 2.2 million tons before the crisis to 0.5 million and 0.42 million tons afterwards – with a slow return to growth only seen in 2009 (to 1.85 and 1.4 million tons). At the same time, the carriage of oil products dropped only temporarily, by 1 million tons in 2008, and now has already surpassed its pre-crisis level.

However, Estonian-Russian exports and imports also fell in 2009 – respectively, by 31.7% and 33.1% year-on-year, only to rise in 2010 by 40.9% and 44%. To sum up, the decline caused by temporary tensions and the crisis has been overcome, and the pre-crisis level of economic relations has been restored in all material aspects.

The current trade relations between Estonia and Russia are illustrated by the table below. As the table shows, Russia has actually risen to fourth place among Estonia's export partners (the high place held by Nigeria can be explained by the re-export of Russian oil products) and to fifth place among import partners. That fact notwithstanding, Russia's share is several times smaller than that of the European Union (EU27) and the euro-zone (Eurozone17), smaller than the share of Finland or Sweden, and higher than Latvia's by just a small margin.

⁵¹⁶ Piret Pukk, Goods in Transit in 2000-2010. Quarterly Bulletin of Statistics Estonia, 2/11, p.91.

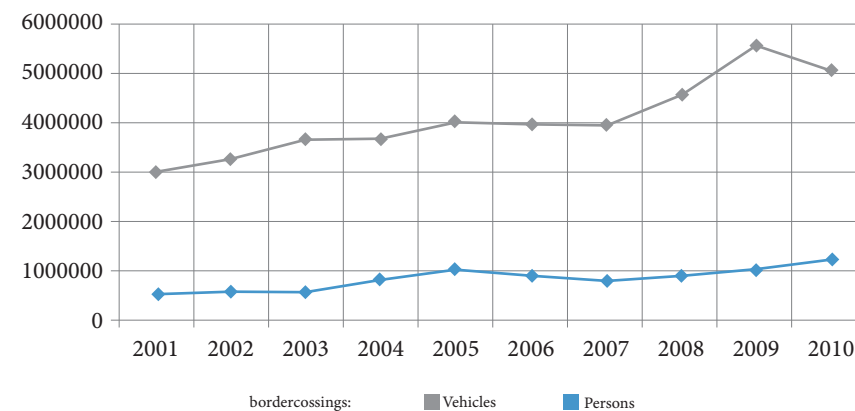
Table 6. Estonia's main trade partners, May 2011

Destination state, association of states	Export, MEUR	Share, %	Change, compared with last year's same month (%)	Destination state, association of states	Import, million euros	Share, %	Change, compared with last year's same month (%)
Total	1,116.0	100	53	Total	1,140.4	100	44
EU27	677.5	61	42	EU27	868.1	76	39
Eurozone17	320.5	29	43	Eurozone17	393.0	34	30
CIS	120.3	11	64	CIS	131.3	12	26
1.Finland	160.2	14	22	1.Finland	137.0	12	19
2.Sweden	155.2	14	71	2.Germany	126.6	11	43
3.USA	109.8	10	94	3.Latvia	117.8	10	54
4.Nigeria	96.5	9	433	4.Sweden	97.9	9	34
5.Russia	95.6	9	61	5.Russia	94.8	8	19
6.Latvia	68.8	6	13	6.Lithuania	91.3	8	8
7.Germany	50.5	5	28	7.Poland	75.0	7	58
8.Lithuania	46.9	4	20	8.China	47.7	4	140
9.France	41.3	4	199	9.Great Britain	44.1	4	259
10.Norway	35.4	3	68	10.Norway	39.7	3	609

Source: Statistics Estonia⁵¹⁷

1.4. Border crossing and tourism

The statistics gathered at border crossings between Estonia and Russia during the last decade also serve as good illustration of Estonian-Russian economic relations. It is seen that overall border crossing is growing, but the dynamics of traffic density of persons and vehicles is not always incidental – it can be explained by the internal logic of cross-border trade (changing prices of gasoline or a limitation on some goods, such as tobacco and vodka).

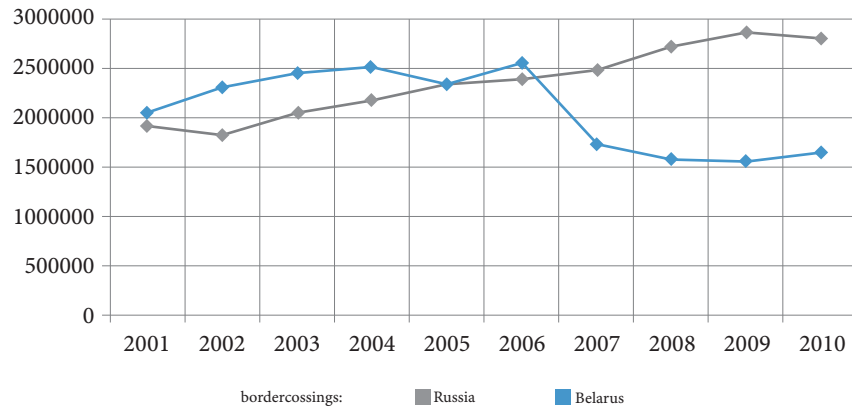
Chart 4. Border crossing on the Estonia-Russia border 2001-2010Source: Police and Border Guard Board⁵¹⁸

The next chart will show the number of citizens of Russia and Belarus who crossed the Estonian-Russian border. There are two circumstances that should be treated cautiously when looking at this data. At first it reflects only the number of those who crossed the Estonian-Russian border and not the Estonian-Latvian border (which is an internal border of EU, and therefore there are no border guards or other officials), and one can only guess how many of them arrive through Latvia – this is especially the case for citizens of Belarus. Looking carefully at the two vertical axes – the left one is for Russia and the right one for Belarus – we see that from approximately 5 million persons who crossed Estonian-Russian border in 2010, there were 2.8 millions citizens of Russia and only 8,000 citizens of Belarus.

⁵¹⁷ Compilation from Statistics Estonia, made by authors, data available at <http://pub.stat.ee>

⁵¹⁸ Information provided by Estonian Border Guard office (non-published).

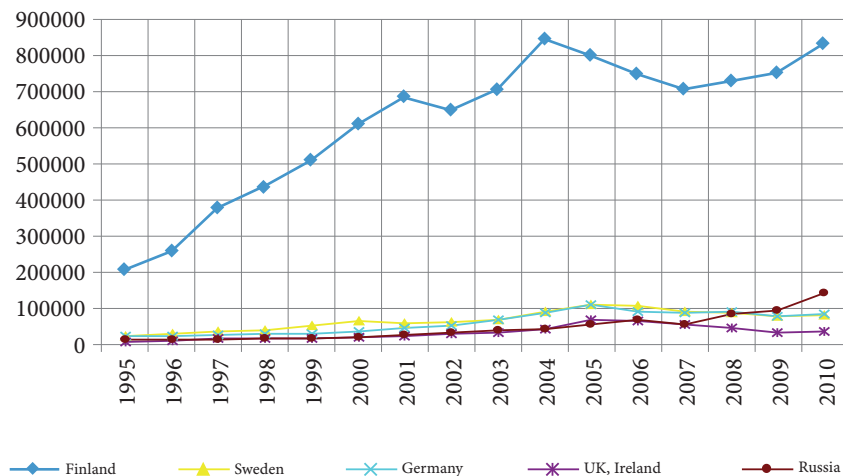
Chart 5. Border crossing by citizens of Russia and Belarus on the Estonia-Russia border 2001–2010



Source: Police and Border Guard Board⁵¹⁹

A growing number of Russian tourists in Estonia is also descriptive to some extent of the development of inter-state relations. Although the share of Russian tourists is still small compared to Scandinavia's share, and especially Finland's share, it has grown steadily, with the exception of a temporary drop after the Bronze Night.

Chart 6. Incoming tourists in Estonian accommodation establishments 1995–2010



⁵¹⁹ Information provided by Estonian Border Guard office (non-published).

Visiting Estonia is once again becoming popular in Russia. An especially strong growth is noticeable in the number of Russians from the big cities who come to Tallinn for New Year's Eve, and to Estonian spas all year round. A good example of regional tourism is seen in the Pskov region and the south-eastern part of Estonia (day-tour tourists from Pskov are prominent clients even at Tartu water parks, restaurants, etc).

One can conclude that cross-border trade and tourism between Estonia and Russia is showing really impressive growth despite political disturbances. Although Russian tourists are not the main clients for Estonian hotels and spas (except in border areas in the eastern part of Estonia), most of local businesses are more than happy to see Russian tourists because of their generosity.

Unfortunately we can not provide any information on tourists from Belarus because the country is not included in tourism information databases.

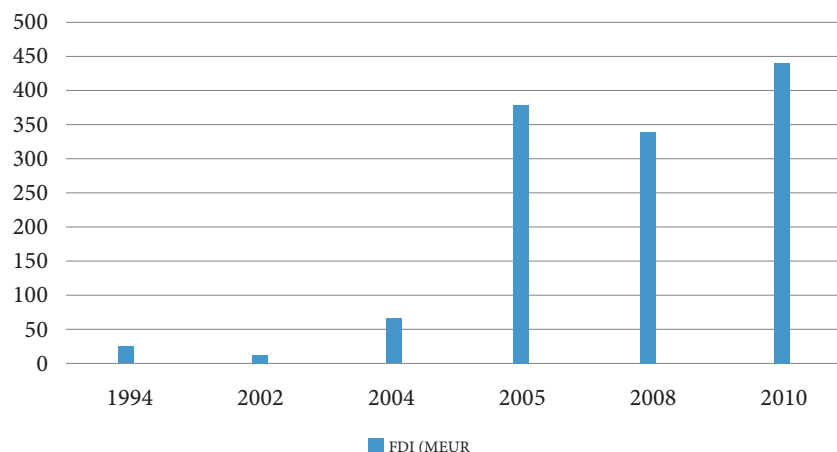
1.5. Investment

Russian investments in Estonia's economy are more difficult to evaluate because the country of origin as such does not provide adequate information about the actual amount of investment, inasmuch as statistics show only the jurisdiction of an investor and not his actual origin. Moreover, it is generally known that Russian businessmen routinely use other jurisdictions, even for investment in their home country, including some notorious offshore jurisdictions. For example, it is estimated that approximately two-thirds of foreign direct investment (FDI) in Russia is actually Russian money being re-invested through other jurisdictions⁵²⁰.

Initially, FDI of Russian origin was rather modest, but it has been often discussed in recent years that the inflow of Russian capital to Estonia made the latter one of the FDI leaders in Eastern and Central Europe – a process which has accelerated since Estonia's joined the EU. This is illustrated by the chart below.

⁵²⁰ Kari Liuhto. Russian tycoons are Russia's largest foreign investors, available at <http://www.neurope.eu/blog/russian-tycoons-are-russia-s-largest-foreign-investors>.

Chart 7. Russia originated FDI to Estonia



Source: author's assessments; Estonia's Balance of Payments Yearbook⁵²¹

Russia's FDI in Estonia moved to fourth place – below Sweden, Finland, and the Netherlands – and amounted to 3.3% of the total FDI in Estonia in 2008, 3.1% in 2009, and 3.5% in 2010. One-third of Russia's direct investment in Estonia goes to the transit sector (transportation, warehousing, and communications), one-fourth to wholesale and retail trade, and one-seventh to industrial companies.

Yet this is not the whole picture. Market participants are well aware of the fact that several investments into a number of big Estonian transit and logistics companies formally originated in some other country, when the actual origin of the capital was Russia. One example is the terminals in the Port of Muuga – which are among the biggest oil products, fertilizer, and coal processing terminals in the Baltic Sea Region – with a share of Russian capital estimated at between 50% and 100%. The pPort of Sillamäe is the only one where a Russian partner openly owns half of the shares in the company that owns the port; Russian companies are also openly represented among the owners of the chemical and oil terminals in the same port, and are among the owners of a new container terminal in the Port of Muuga. For the last 6-7 years, information has been circulating about Russian capital investment into real estate, especially in the high-end segment. However, only isolated examples have become publicly known, such as a failed development project on an island on the Piritä River. As a rule, the formal buyers

⁵²¹ Compilation from Bank of Estonia databases, made by authors, data available at http://www.eestipank.info/pub/et/dokumendid/publikatsioonid/seeriad/mbil_RIP/mbaasta/.

of such projects are not physical persons, but rather are companies registered in an EU jurisdiction, or sometimes companies from Switzerland or Cyprus. Therefore, the statistics do not show the actual situation. Some experts claimed that Russians own in one way or another up to one-third of Estonian transit companies, and up to one-tenth of exclusive real estate in Tallinn and its vicinity.

Regarding Estonia's recent investment in Russia, the situation according to available statistics is as follows: in 2008, Estonia's direct investments into the Russian economy amounted to 217 million euros (4.6% of Estonia's total FDI), in 2009 204 million euros (4.5%), in 2010 278.08 million euros (5.3%, putting it in fourth place among different countries originating FDI, below Lithuania, Latvia and Cyprus). The recent data indicate a growth, though not particularly remarkable.

Belarusian direct investment plays no role for the Estonian economy at all. According to statistics, these investments amounted to 3 million euros (approx. 0.04% of all FDI to Estonia). At the same time, Estonian foreign investment amounted approximately 80 million euros (approximately 0.6%), concentrating on the spheres of professional, scientific and technical activities, trade, the repair of transport equipment, real estate, transportation, and storage. In view of recent events in Belarus, there is no reason to expect a significant growth in Estonian direct investment there. Nevertheless, an increase in the interest of Belarusian private investors in Baltics as a whole cannot be ruled out, especially towards Latvia and Lithuania, but also towards Scandinavia through Estonia.

2. Central and local government in economic interaction with Russia and Belarus

2.1. Russian case

Contacts at the national level between Estonia and Russia are rather minimal, with the exception of some isolated sectors. There have been just two meetings between the heads of state – in 1994 between Lennart Meri and Boris Yeltsin (in Moscow, on the issue of Russian troop withdrawal from Estonia) and in 2008 between Toomas-Hendrik Ilves and Dmitri Medvedev (during the Finno-Ugric festival in Khanty-Mansiysk). Although Arnold Rüütel and Vladimir Putin also met in 2003 and 2005, both meetings were informal in terms of protocol, i.e., they were not pre-arranged. It should be noted that these meetings were rather one-sided. Although President Ilves visited Russia on three occasions, the President of the Russian Federation has never visited Estonia. At the same time, presidential meetings between Estonia and Russia are largely irrelevant for the regulation of

economic relations, because in Estonia the president's office holds a representative rather than a decision-making mandate.

Cooperation at the government level does exist, but only at a very formal level. On paper, there is the Intergovernmental Commission, established in 1998, which is supposed to organize cooperation – but in reality the commission has held no meetings since 2003. Meetings between prime ministers are rarer still: there has been just one face-to-face meeting (between Siim Kallas and Mikhail Kasyanov in Saint Petersburg in 2002). Russian Prime Minister Mikhail Fradkov visited Tallinn in 2004, but he did not meet his Estonian counterpart at the time. It is customary for governments to be in closer contact with each other and to sign cooperation agreements, but in the case of Estonia and Russia such an agreement exists only as a draft (Estonia even has a similar document with India).

At the level of ministries, the picture is extremely mixed. Sometimes there are very close and intensive contacts (e.g., between the ministries of agriculture), which is contrasted by an almost complete vacuum in other cases (e.g., the ministries of defense).

A leading role in this context should belong to the Ministry of Foreign Affairs. This is also the only agency in both countries that has separate units dealing exclusively with the neighboring country. However, there is still no customary cooperation agreement between the Ministries of Foreign Affairs of Estonia and Russia (Estonia has similar agreements with the foreign ministries of approximately 50 states). The Ministry of Foreign Affairs should supervise, or at least participate in, the signing of all important bilateral economic agreements, but these processes progress at a snail's pace. The broader framework is partly to blame – since Russia is in the process of joining the WTO and re-shaping its relations with the EU, it would be difficult to forge broader-based bilateral economic and trade relations with only one participant prior to the conclusion of framework agreements.

Due to the internal logic of the Ministry of Economic Affairs, there is no separate unit dedicated to Russia-related issues. It has instead a number of partners in Russia, because many areas that are consolidated under one ministry in Estonia are distributed between different ministries and agencies in Russia (the Ministry of Industry and Trade, the Ministry of Communications, the Ministry of Transport, etc., as well as many government services and agencies). Somewhat paradoxically, there are few direct ties with these partners, because the bulk of economic and political relations no longer occur at the bilateral level, but instead goes through the EU or, to be more precise, through the European Commission.

Since the parties function in different financial and legal environments, even cooperation on cross-border infrastructure runs into obstacles (e.g., a new bridge over the Narva River or a dam for the hydroelectric power plant on the same river).

The area of responsibility of the Ministry of Economic Affairs covers the biggest segments of Estonian-Russian economic relations, such as railways and the power industry; nevertheless, cooperation agreements exist between individual companies in these sectors rather than the ministries. Although respective officials acknowledge the possible need for a joint economic commission or a corresponding system of agreements, at the moment the state regulates relations of this type through laws, while energy is sold through exchanges. As a rule, economic relations proceed without state intervention (though unofficial constraints do exist, as will be shown below).

The Ministry of Agriculture provides an example of closer ties with its partner ministry in Russia and its subordinated agencies (the veterinary service [corresponding to our veterinary board] and the agricultural agency [Rosselkhoznadzor]). These contacts occur on a daily basis, but purely technical procedures are often apparently affected by political considerations (especially regarding the introduction of limitations). Once again, a memorandum of understanding has been waiting for approval for 1.5 years, but no opportunity has yet been found to organize a meeting of the ministers and sign the memorandum.

The area of responsibility of the Ministry of the Environment is also a rather good example of cooperation with Russia; a framework agreement between the respective ministries was signed in 1996⁵²² (in addition, four agreements on Lake Peipus and fisheries were concluded). Although the wording of the framework agreement is rather general, it nevertheless provides a framework for further actions, an example of which is the commission on trans-boundary water bodies⁵²³.

In the case of ministries not directly concerned with the economy, there are examples of both cooperation and the absence thereof. In the Ministry of the Interior, the picture is mixed. Although this ministry does not directly deal with

522 Co-operation Agreement on Environment Protection between the Governments of the Republic of Estonia and the Russian Federation, Pskov, 11 January 1996, available at <http://www.envir.ee/orb.aw/class=file/action=preview/id=391163/kahepoolsed+kokkulepped.pdf>.

523 The Estonian-Russian joint intergovernmental commission on the protection and use of trans boundary water bodies, available at <http://www.valitsus.ee/et/valitsus/40262/pihkvaa-arutatakse-est-vene-piiriveekogude-kaitse-ja-kasutamise-kusimusi>.

the economy, it has certain control and anti-crime functions. This ministry has cooperation protocols⁵²⁴ with its Russian counterpart. Some units of the Ministry of the Interior deal exclusively with internal security and lack almost any contact with Russia, whereas other units actively promote cross-border and trans-boundary relations. Thus, cooperation between the Russian and Estonian border guards has been professional and has not been affected by political problems in inter-state relations (neither by the lack of a border treaty, which is an essential issue for border guards, nor by temporary crises such as the Bronze Night). To facilitate cooperation, the international treaty of 1994 even provided for an institution of special contact persons and border representatives⁵²⁵ (the format of their regular meetings has been established since 1996). Naturally, the criminal police, narcotics control, and the Financial Intelligence Unit must keep in touch with their Russian counterparts, but there are some gaps in this cooperation. It is again affected by the fact that Estonia is a member of international structures that do not have Russia among its members, for example, EUROPOL (the framework agreement between Russia and EUROPOL⁵²⁶ is being renewed⁵²⁷, but this process is complicated). A large part of the activity of the so-called control structures goes through multilateral organizations (the Egmont Group of Financial Intelligence Units⁵²⁸, the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism – MONEYVAL⁵²⁹, regional drug control

524 Press release, Estonian Ministry of Interior (15th Dec 2010), available at <http://www.siseministeerium.ee/siseminister-marko-pomerants-allkirjastas-venemaa-foderatsiooni-siseministeeriumiga-koostooprotokolli/>.

525 Agreement on the Activity of Border Representatives between the Government of the Republic of Estonia and the Government of the Russian Federation (1994), available at <https://www.riigiteataja.ee/akt/78585>; Nomination of border representatives (last in 2010), available at <https://www.riigiteataja.ee/akt/12840958?leiaKehtiv>.

526 Agreement on co-operation between the European Police Office and the Russian Federation (2003), available at <https://www.europol.europa.eu/sites/default/files/flags/russia.pdf>.

527 It was communicated in the autumn of 2010, that the agreement of 2003 became obsolete and negotiations on a new agreement began, available at <http://www.russianmission.eu/en/news/russia-europol-launching-negotiations-new-agreement>; Spring 2010: a draft of the new agreement is being elaborated, available at <http://www.russianmission.eu/en/news/negotiations-between-russia-and-europol>.

528 See <http://www.egmontgroup.org/> "In 1995, a group of FIUs met at the Egmont Arenberg Palace in Brussels and decided to establish an informal group for the stimulation of international co-operation. Now known as the Egmont Group of Financial Intelligence Units, these FIUs meet regularly to find ways to cooperate, especially in the areas of information exchange, training and the sharing of expertise." Russia has established its own parallel structure for the CIS, India and China, available at <http://www.eurasiangroup.org/>. (Eurasian group on combating money laundering and financing of terrorism (EAG)).

529 Established in 1989, available at <http://www.coe.int/t/dghl/monitoring/moneyval/>.

unit FINESTO⁵³⁰, the Task Force on Organized Crime in the Baltic Sea Region⁵³¹, etc.)

The bureau's of the Minister of Regional Affairs is another separate unit within the Ministry of Internal Affairs, and its counterpart in Russia is the Ministry of Regional Development. Although there is no direct agreement between the two, a memorandum on cross-border cooperation was signed in 2011⁵³². The main cooperation format is EstLatRus⁵³³, a multilateral organization, but financing is mostly provided within the framework of ENPI⁵³⁴, an instrument of the EU Neighborhood Policy.

In the case of the Ministry of Justice, the bulk of bilateral cooperation has been transferred to the European Commission. Cooperation between courts and at other levels does exist, but often runs into huge obstacles – for example, many legal assistance requests remain unsatisfied (e.g., in cases of suspicion of money laundering, the aftermath of the cyber attacks, or the infamous *Arctic Sea* case). It should be again noted that this ministry is not directly engaged in economic relations, but it affects these relations through the shaping of the economic and political environment, by solving troublesome incidents through courts and, for example, apparatuses such as the Prison Board. Incidentally, unofficial relations between judges are excellent, and in the summer of 2011 a football match was even organized in Pskov between judges' teams.

The Ministry of Defense appears rather insignificant in terms of cooperation. On the one hand, cooperation between the Estonian and Russian Ministries of Defense and their respective structures is next to zero. This is understandable considering that Estonia and Russia belong to different defense alliances and are not members of the same armed forces control mechanisms. On the other hand, some multilateral cooperation still exists within the framework of the Treaty on Open Skies, in the NATO-Russia Council, etc. In any case, Russia plays an important role in the logic of Estonia's defense spending, which occupies quite a significant place in the budget (i.e., in the public sector of the economy).

530 Established in 2000, (National Report on Drug Situation in Estonia 2001, Prepared by Estonian Drug Monitoring Centre, National Focal Point, 2001), available at http://www.sm.ee/fileadmin/meedia/Dokumendid/Tervisevaldkond/Uuringud_ja_analuusid/EMCDDA2001.pdf.

531 Press release No 69, Estonian Ministry of Interior, (20.06.2007), available at <http://www.siseministeerium.ee/31336/?highlight=venemaa>.

532 Press release No 28, Estonian Ministry of Interior, (18.02.2011), available at <http://www.siseministeerium.ee/tana-allkirjastati-eesti-vene-piiriulese-koostoo-memorandum/>.

533 See Estonia-Latvia-Russia cross border cooperation Programme within European Neighborhood and Partnership instrument 2007-2013, available at <http://www.estlatrus.eu/eng/news>.

534 See ENPI Information and Communication Support Project, available at <http://www.enpi-info.eu/>.

The Ministries of Culture and Social Affairs are insignificant in the context of our research and, therefore, are not given a closer look – although cultural relations are one of the small number of issues that have developed relatively smoothly between the two states.

The cooperation of local governments with their Russian counterparts is hampered by one important obstacle: incompatibility. If we divide the state into three levels of administration – the state itself, regional authorities, and local governments – we see that Estonian-Russian cooperation is impeded by the problem of unequal partners. In Russia, the regional and cross-border cooperation authority is vested in the subjects of the Federation, whereas Estonia lacks an equal partner for such administrative units. The Estonian counties are virtual units; the administrations of border counties do attempt to participate in the process within their means, but they lack both the resources and the capacity to be effective. Such capacity and willingness in Estonia may be more easily found in larger local governments (e.g., the border towns Narva and Võru), but the Russian towns lack decision-making rights.

The Russian regions conduct their external affairs with strict adherence to federal guidelines and would prefer to deal with whole states as partners. For example, the Pskov Oblast would be happy to communicate directly with central institutions in Estonia (let it be noted that the Pskov Oblast and Estonia are similar in size) – but this approach, in turn, is incompatible with the expectations of the respective Estonian institutions. Thus, the problem in many respects boils down to a lack of parity and equal partnership. In spite of this, friendly ties have been established and cooperation agreements signed⁵³⁵, but the actual implementation of these has been for the most part non-existent. The best – not to say the worst – example lies in the protracted attempts to revive the shipping line between Tartu and Pskov. Officials on both sides have reiterated their goodwill and trial voyages even took place, but in reality the line has not been re-opened and is not expected to open any time soon.

2.2. *Belarusian case*

Relations between Estonia and Belarus are rather superficial compared to Estonian-Russian relations, the reason for which is mostly geographical location

535 According to the Association of Estonian Cities, as of 2009 Estonian local governments and counties had 20 instances of friendly ties at different levels with the Russian Federation (to be sure, some of them with the same subjects, e.g., Ivangorod and Saint Petersburg) out of the total of 120 friendship agreements, available at <http://portaal.ell.ee/14712>.

(the absence of a common border), although some political aspects are also involved. There is little contact at the national level. While Russia and Estonia exchanged embassies and consulates almost at the beginning of their relations, the Estonian embassy in Belarus was only opened in 2009 (there has been a consulate since 1995). Similarly, since 1995 Belarus has had a diplomatic mission in Estonia, which became an embassy in 2010. The establishment of an intergovernmental commission was on the agenda, but work on the issue has slowed in recent years.

There have been no visits by the heads of state; in 2009 the Estonian Minister of Foreign Affairs and Minister of Agriculture visited Belarus. However, several formal developments in Estonian-Belarusian relations have been taken a step further than comparable developments with Russia. For example, there is an agreement on intergovernmental cooperation between Estonia and Belarus, and the foreign treaties' database of the Ministry of Foreign Affairs indicates a total of 11 agreements⁵³⁶ (compared to 43 with Russia). There is also a memorandum of cooperation (although non-binding) between the two Ministries of Agriculture. There is an agreement between the border guards; an interesting fact in this context is that Belarus has one of the best dog training facilities in Europe and the border guards of many European countries have had their dogs trained there.

To a large extent, the role of Belarus is to provide a transit route for Russian energy resources on the way to the Baltic States, and after a quarrel with Russia, Estonia has also acquired a limited role in the export of oil to Belarus. Thus, Estonia's public sector also has a small amount of involvement in this issue. However, after Belarus joined the Customs Union, Moscow got leverage over even these small-scale interactions because it plays the leading role in the organization.

Local governments have virtually no contact with Belarus. Only one friendship agreement has been registered (Maardu-Minsk, 2000).⁵³⁷ There have been some limited contacts within the framework of cross-border projects in which Belarusian local governments participated on several occasions alongside local governments in Estonia, Latvia and Russia, but such cases are rather exceptional.

536 Database on foreign agreements (Estonian Ministry of Foreign Affairs), available at [http://vlepingud.vm.ee/et/search/?leping0nimetus=&pooled0riik_id_oper=or&pooled0riik_id\[\]=37&lep_alad0ala_id_oper=or&leping0solm_kp_start=&leping0solm_kp_end=&ajalugu0kuup_start=&ajalugu0kuup_end=&sort=leping.solm_kp&dir=asc&format=short#res](http://vlepingud.vm.ee/et/search/?leping0nimetus=&pooled0riik_id_oper=or&pooled0riik_id[]=37&lep_alad0ala_id_oper=or&leping0solm_kp_start=&leping0solm_kp_end=&ajalugu0kuup_start=&ajalugu0kuup_end=&sort=leping.solm_kp&dir=asc&format=short#res).

537 Database of partners of Estonian local governments (23.10.2009), available at <http://portaal.ell.ee/14712>.

3. Non-state actors in economic interaction with Russia and Belarus

3.1. Russian case

Relations between Estonian and Russian non-state actors are somewhat more active than between state-level actors, and the major difference between the two is that some of the former have a substantial interest in developing such relations. Due to the close geographical proximity and shared history, several strategic sectors of the Estonian economy are physically connected with partner structures in Russia, especially railways and electricity networks. At the same time, physical connections notwithstanding, in the broader transit sector and energy industry, as well as in the rest of the Estonian economy, Russia's share have been diminishing. Major companies with ties to the Russian market and economy may be conditionally divided into the following sectors: transit/logistics, the energy industry, the manufacturing industry, and tourism.

The biggest sector is transit and logistics, which includes railway and trucking companies as well as ports. The attractiveness and diversity of this sector is revealed, in particular, by the fact that it has a number of umbrella organizations – both universal (e.g., the Trade and Industry Chamber⁵³⁸ and the Employers' Confederation⁵³⁹) and specific (e.g., the Logistics and Transit Association⁵⁴⁰ and the Association of Estonian International Road Carriers⁵⁴¹).

Railways and ports form an integrated logistic chain and have the closest ties to the Russian market when compared to other sectors. Railway is practically the only segment of the Estonian economy that is mainly physically connected with Russia (there is a connection with Latvia, but no direct passenger transport as is the case with Russia). Formally, the Council for Railway Transport⁵⁴² unites on various grounds the representatives of the railways of the 15 former republics of the USSR, as well as Finland and Bulgaria. It simultaneously provides an example of the most discriminative restriction. Although the railway's daily capacity is up to 50 pairs of trains, it has for years been restricted unofficially by an internal verbal command from RZD top-officials to only 16 pairs (a pair = two-way trip of one train; 16 pairs = approximately 1000 railway wagons). It is a protectionist

measure employed by Russia to re-direct freight flow to its own ports, used in addition to differentiated freight rates. This measure is applied unofficially by means of refusing permits to a larger number of trains. In practice, however, it is a unilateral restriction imposed by the Russian Federation – which, incidentally, tends to “thaw” in winter because Estonia has a capacity for unloading fuel oil even at sub-zero temperatures (though this transit item is not very important, e.g., fuel oil on the Kirishi-Rotterdam route accounts for merely 2% of the port's turnover).

The bulk of railroad freight reaches a port sooner or later – approximately 80% of goods passing through the Port of Tallinn are of Russian origin and/or bound for Russia, and 80% of such goods are carried by rail. However, Russia's share in passenger traffic is around 1%. There is no substantial cooperation between ports, because ports as such provide only infrastructure while actual cooperation and trade is developed by operators.

The situation in international road carriage is also problem-ridden. Russia itself does not have a sufficient number of trucking companies (in Estonia there are 7,000 trucks and in Russia the number is 29,000, i.e. only four times more), but foreign companies are also not granted enough transport permits. Estonia is granted 23,000 bilateral transport permits plus 10,000 international or “third party transport permits”, the latter being a rather unique invention intended specifically for Estonia. Nevertheless, Estonia dominates cargo transportation between Estonia and Russia (at 65%), though the volume of shipments to Russia has recently declined because this spring Russia limited the use of CEMT permits⁵⁴³ for cargo transportation in Russia.⁵⁴⁴ Russia lets approximately 70 trucks a day through the border, although it has the capacity for at least 300 at the Narva border crossing point alone.

Two aspects of cooperation may be emphasized with regard to the energy industry – electricity and natural gas. In theory, shale oil may be added to the list (because shale oil deposits in North-East Estonia partly extend into Russian territory), but for all practical purposes this item has been removed from the agenda in recent years. Hydroelectric power should be another article of cooperation due to a shared body of water (the Narva River) and the hydroelectric power station located there, but this is not the case (it is customary in the case of a shared power station to also share electric power produced, but such model has not been accepted between Estonia and Russia).

538 See Estonian Chamber of Commerce and Industry, available at <http://www.koda.ee/>.

539 See The Estonian Employers' Confederation, available at <http://tooandjad.ee/>.

540 See Logistics and Transit Association, available at <http://www.transit.ee/>.

541 See Association of Estonian International Road Carriers, available at <http://www.eraa.ee/>.

542 See <http://www.sovetgt.org/default.htm> (an interesting quote on the main page of its website: “The Council for Railway Transport which unites the CIS and the Baltic States is the first real example of integration in the railway business community.” Vladimir Yakunin, Chairman of the Council).

543 See CEMT or The European Conference of Ministers of Transport is now the International Transport Forum, available at <http://www.internationaltransportforum.org/>.

544 See Information about CEMT-permits for Estonia, available at <http://www.eraa.ee/?op=body&id=717>.

The Russian and Estonian electricity networks are physically connected and belong to a joint power ring including Belarus, Russia and the three Baltic States – an organization that deals with the energy supply and security, balancing of production and consumption, transferring capabilities, and similar issues. Estonia is presently connected to the Russian network via an alternating current cable. However, in the long-term perspective Estonia plans to switch to direct current connections in major networks (as it already did in the case of Finland). This would mean a physical disconnection from Russian networks, which has been already successfully tested.

Estonia also offers an electricity transit service to Russia, which sells electricity to Latvia through Estonia. We have also acted as a go-between for Finnish electricity. Estonia consumes 8 terawatts and produces 12 terawatts of power; the surplus is sold to Finland, Latvia, and Lithuania. We sell electricity from Russia and other third countries only through exchange. The total consumption of the Baltic States is 25 terawatts, of which Latvia produces 3-4 and Lithuania 6 terawatts. Estonia also tries to avoid any possible excessive impact of Russian electricity by allowing the sale of Russian electricity only through exchange; a possible introduction of limits on the share of Russian electricity is being discussed and an introduction of import duties is possible (Finland already introduced a similar measure, ostensibly for a “compensation of costs”).

Russia's share in the natural gas industry appears to be large – 100% of imported natural gas comes from Russia – but its share in Estonia's general energy balance is 11-12%. In this regard, Estonia has greater energy independence than Belarus and/or Latvia, because the country produces electricity from its own raw materials with a gradual increase in the share of alternative energy (e.g., co-generation power plants working on non-fossil fuels). Estonia also presently lacks large chemical plants or other energy-thirsty industrial consumers that might shift the energy balance.

A rule of thumb regarding the consumption of natural gas states that 1 million people consume 1 billion cubic meters of natural gas. According to this logic there is under-consumption in Estonia, because the country consumes approximately 700 million m³. Previously the figure was 1 billion cubic meters, but in 2009 Nitrofert, a fertilizer plant, was closed and combined cycle power plants were commissioned, which reduced consumption by 300,000 m³. Earlier, *Gazprom* sold natural gas to Estonia at a discount (*Gazprom* has the exclusive right to sell natural gas, although there are several other producers as well), but it has since abandoned the practice. The price was previously approximately 30% lower, but now natural gas is sold at a competitive price according to calorie-based calculations.

In the area of oil products, Estonia has for several years (to be precise, since the Bronze Night) not received a single drop of petrol/oil products for domestic consumption, and all locally sold products are purchased from Swedish or Lithuanian producers. The transit route for these energy resources does go through Estonia, but it is not intended for Estonia or owned by Estonian companies (oil transit through Estonia is largely controlled by companies owned by Gennady Timchenko – i.e., by companies owned by people from Vladimir Putin's inner circle).

Estonian petrol retailers have significantly fewer contacts with their Russian counterparts than representatives of the above-mentioned sectors; they do not even belong to the same international associations (e.g., EUROPIA⁵⁴⁵, which unites petrol producers from the EU member-states, does not count Russia among its members). That Estonia and Latvia are the only countries in the EU without their own petroleum industry – and in contrast to Latvia, Estonia lacks even an oil pipeline – further reduces their mutual impact in the energy field.

Russia's importance for Estonian travel companies has been constantly growing. The number of tourists from the east has increased each year regardless of political tensions (after the Bronze Night several Russian media channels organized anti-Estonian campaigns, of which the most infamous was a slogan by *Regnum*, an internet portal: “Visiting Estonia = Betrayal of Motherland”). Although the Estonian and Russian travel industries compete with each other (Estonian companies want to attract Russian tourists to Estonia, while Russian companies would like to see them as domestic tourists, and the other way round), in more remote destinations they may join forces (e.g., in Japan – Japanese tourists have little interest in Tallinn or Saint Petersburg taken separately, but a combined tour of Tallinn–Saint Petersburg–Stockholm is much more attractive). Many Estonian hotels work directly with Russian travel companies, developing contacts and bringing in clients (their major partners are companies in Saint Petersburg and Moscow). All in all, Russian tourists rose to second place behind Finnish tourists – the gap is still huge (1.5 million Finland, 150,000 from Russia), but it is a telling figure nevertheless.

Russia is also the second largest trade partner for Estonia's food industry (between Latvia and Finland), although this sector is affected by several constraining factors as well. Firstly, there is no free trade agreement between Estonia and Russia. Secondly, Russia does not accept Estonian manufacturer's certificates, but instead dispatches its own controlling officers who, at their own discretion, issue to Estonian producers a permit to export products to Russia.

545 See EUROPIA, the European Petroleum Industry Association, available at <http://www.europia.com/>.

Estonian food products are in high repute in the Russian market and appeal to Russian consumers. According to producers, the problem lies in a discrepancy between words and deeds. Officially, there are no market obstacles, but problems begin with border queues, customs clearance, etc. Frequent payments are required, a company representative must be present at all times to control the process, and nothing occurs automatically or in accordance with agreements.

Russia's share in the forest industry declined drastically after Russia introduced restrictions on the export of roundwood (in the summer 2007). Timber imported from Russia (370,000 cubic meters in 2010) accounts for approximately 25% of Estonia's industry requirements, and Russia's share in roundwood is next to zero. Such constraints, however, mostly harm forest companies in North-West Russia by limiting their export opportunities. Exports are limited by export duties and quotas, and also by elementary logistics – since railway is the main mode of transportation used for timber shipments, the above mentioned 16 pairs of trains a day does not leave much space for timber shipments. Estonia exports to Russia solid wood furniture (6th place) and veneer wood furniture, but after the introduction of restrictions this sector has also realigned itself toward other markets.

In general, as relations on the non-state level are based on mutual trade, the restrictions imposed by Russia have forced Estonian companies to look to other adjacent states and to more remote markets. Electricity and natural gas are among a handful of sectors that are governed by market mechanisms rather than administrative measures. Past experience has taught the Estonian economy to cope with limited contact with Russia.

3.2. *Belarusian case*

The economies of Estonia and Belarus have weak mutual ties, to say the least. There is some cooperation in the transit sector, with Venezuelan oil as the major component (nine oil tankers have been unloaded in Estonia with oil shipped to Belarus in year 2012). However, its share in the total volume of cargo is vanishingly small (e.g., only 100,000 tons of the 37 million tons of turnover of the Port of Tallinn).

In road transportation, which is an important sector of the Belarusian economy (approximately 80% of goods carried by road between Russia and the EU pass through Belarus), Belarus also remains a minor destination for Estonia – Russian international trucking companies are issued 25,000 permits annually, while Belarusian companies are issued merely 2,500. According to

representatives of other sectors, Belarus's share in these other sectors is vastly (sometimes hundreds of times) smaller. However, companies doing business with Belarus point out several important distinctions when compared to Russia. On the one hand, Belarus wants to cooperate and offers opportunities. On the other hand, the bulk of foreign trade in Belarus is directly controlled by the state, while Russia employs only passive measures (tariffs, restrictions, etc.)

4. Political influence

One purpose of the study was to identify whether (and to what extent) economic activity and the interests of Russia and Belarus influence Estonia's policies. As this kind of influence may be difficult to measure, we used expert interviews. A total of 34 interviews have been conducted with representatives of various sectors – from politicians and public officials to entrepreneurs and the heads of professional associations. Due to the sensitive nature of these issues, both in terms of politics and economic security, the results of the interviews are presented in a generalized manner, without direct references to the persons who expressed these opinions.

4.1. *Overview of results*

Our first question to Estonian experts was whether they perceive the existence of an economic policy on the part of Russia at all, so that we may then discuss its influence. A majority of respondents gave a negative answer or expressed doubts about this question, with only 6 respondents believing that Russia has a defined policy toward Estonia. Russia's economic policy towards Estonia was most often described as "incomprehensible", "uneven", "reactive", and "*ad hoc*" behaviour.

A follow-up question about the nature of this policy – however unpredictable and hard to discern it may be – was answered in very different ways. A majority thought that such a policy represented a vague desire to preserve general control over the Estonian (economic) policy environment, to have an ability "to close the tap" and to manage bilateral trade by means of administrative measures rather than market economy mechanisms. However, almost half of the respondents thought that the reality and the described political disposition are two very different things. In general, Russian companies were considered pragmatic players that find a way to conduct their business. On the other hand, a number of experts

cited a strong counter-argument to this pragmatism – namely, the existence of an unofficial limitation on rail transportation, which is irrational in terms of foreign trade. It is true, however, that this limitation has been imposed by Russian Railways, a national rail carrier that is perceived as a political unit rather than a regular company. Furthermore, this limitation was also interpreted as Russia's desire to give a boost to its own ports and railways rather than “to punish Estonia”.

Studying the way the Russian side attempts to ensure its interests in Estonia and bring economic matters to decision-makers, we discovered a rather interesting situation. A majority of respondents denied that they or their sector are being influenced in any way whatsoever, while at the same time assuming that lobbying must be taking place. They also believed that even if influence does exist, it can't be particularly powerful – mostly due to the fact that lobbyists themselves understand the strong negative overtones associated with any articulation of Russian interests. Secondly, Russian business circles do not have any “special demands” of Estonia that would be necessary to push through complicated channels – the Estonian economic environment is clear and transparent, and Russian businesses have no big interests in Estonia either way (there is no oil refinery or pipeline, let alone other attractive big industries). Those respondents who had some opinion on the nature of Russian influence also believed that Estonia is a low-priority policy area for Russia and, therefore, does not call for any considerable effort. However, several respondents mentioned that Russia's lobbyists act with more vigor in Brussels, mostly in attempting to secure their interests by influencing the European Commission.

Very different opinions were expressed on the dynamics of bilateral economic relations and policy. Some economic sectors (e.g., tourism) emphasised a steady growth, others (e.g., the forest industry) talked about a great decline, and some (e.g., the transit sector) pointed to setbacks and instability. The major milestones signifying various stages in these dynamics included the ruble crisis of 1998 (which dealt a blow to trade), Estonia's accession to the EU in 2004 (which removed the so-called double taxation in Russian-Estonian trade), and a crisis that followed the Bronze Night in 2007 (which caused a setback further magnified by the economic crisis and Russia's long-term goal of boosting the development of its own infrastructure). However, economic relations have already recovered or are recovering from this latest setback, and the majority of respondents commented on future prospects with cautious optimism.

Almost nothing can be said about Belarusian economic policy toward Estonia. Only a few of the respondents said that perhaps there should be something along these lines (because everything important is under state control in Belarus), but

even those respondents couldn't specify this policy more precisely. The only guess was that Belarus probably seeks all kind of alternatives to Russia and any kind of partner in the European Union. Nevertheless, it is almost impossible to measure any influence on Estonia created through such vague politics, and we cannot speak about dynamics in this area.

4.2. Generalization

Russia's attempts to influence Estonia accelerated our re-orientation toward other markets. However, this readjustment was not caused by Russia's desire to push us away nor even by our “natural desire” to make business with other countries. Russia's pressure just gave us an extra push, which suited our goals and accelerated the separation. Russia's pressure is largely defined by interest groups rather than by some kind of big national policy. For example, transit has been re-directed toward Russian ports through the efforts of business circles associated with these ports, which portrayed Estonian ports as a much greater danger as a competitor than they really are. Securitizing the issue of Russian exports, these groups justified allocations from the state budget for the construction of infrastructure (which in reality is unable to satisfy Russia's needs and does not provide all the required services). On the other hand, “proper” groups have always been allowed to do business via “hostile” or competing transit routes (e.g., the transit of oil products through Estonia by the Timchenko/Gunvor group took place even in the most trying times). Moreover, it should be pointed out that Estonia has never been critically important for Russia. Their only tactical interest was in the logistics sector.

Russia attempted to preserve its influence in Estonia using the same means it employed elsewhere, with greater or lesser success:

- through big companies (which provide an incentive to keep good relations with their parent country for the sake of market preservation, social and economic stability, etc.);
- through dependence on energy (offers of cheap energy to companies and private consumers), and;
- through oligarchic interest groups (which stand behind the first two).

The only enterprise of critical size inherited from Soviet times in Estonia was Dvigatel (coincidentally, it was also the only strongpoint of the Intermovement in the aftermath of the Soviet Union's collapse), which nevertheless collapsed rather

quickly when its markets disappeared. Other bigger enterprises either managed to re-orient (e.g., Tallinn Shipyard) or closed down (e.g., a Tartu-based radio electronics enterprise that produced 'black boxes'). Many companies that are big on the local scale have never been closely tied to Russian markets (e.g., companies in the areas of shale oil chemistry or rare earth metals).

Estonia did not depend on Russian energy during Soviet times and has not come to depend on it since. Estonia has had an independent supply of electric power thanks to shale oil and Russia's monopoly on petrol and fuel oil was easy to break. Natural gas has been the only energy resource totally controlled by Russia, but its share in the Estonian energy balance is relatively small (around 10%) and the only chemical company with a significant dependence on natural gas (*Nitrofert*, a fertilizer plant) was founded at a later time and closed after Russia raised the price of natural gas for Estonia.

The rise of oligarchic interest groups in Estonia was prevented by the choice of privatization model. Estonia used the *Treuhand* model (i.e., by auction, for real money and openly; minimal encumbrance with obligations), which ensured a degree of transparency during privatization and provided the opportunity for a rapid readjustment. This model did not leave much room for the rise of oligarchs and the government was not subsequently forced to accommodate the wishes of entrepreneurs and interest groups that stood behind them.

Economically, the biggest victim of the relationship with Russia has been Estonian agriculture. A considerably large and rather critical market in Russia (Saint Petersburg and Moscow) disappeared, and the situation was further complicated by constraints from the imposition of EU regulations. However, objective trends in employment and demography enabled Estonia to overcome this setback with relative ease. At a later stage, losses were suffered by the banking sector, but the ready availability of foreign investors (e.g., the sale of *Hansapank*) took pressure off the authorities.

To sum up, because Estonia was a low-priority policy area for Russia (which introduced double taxation instead of looking for other solutions) and it managed to avoid decisions that would have increased its dependence on Russia, the political influence of Russia on Estonia based on economic considerations has remained insignificant. In other words, Russia's economic and political interests concerning Estonia are considered to be loosely defined (just a vague desire to preserve control) and relatively moderate, while pressure used to secure these interests is perceived as weak or immaterial.

The economic policy of Belarus toward Estonia was deemed virtually non-existent, with a single substantial difference – the lack of a big brother complex

(this means that Belarus does not seek control over Estonia). The influence of Belarus's economy on Estonia is marginal due to objective circumstances (distance, the absence of a shared border, etc.).

Conclusions

This study was conducted in the summer of 2011 as part of a wider pan-Baltic research project undertaken with the purpose of clarifying the economic and political relations between the Baltic States, Russia, and Belarus. The Estonian research team (Karmo Tüür and Raivo Vare) use two different research methods – generalizations of statistical databases and expert interviews. The first provided an overview of developments in bilateral economic relations after the collapse of the Soviet Union, while the second gave answers to why and how these developments took place.

Dynamics

Compared to the early 1990s, Russia's share in the Estonian foreign trade has steadily declined, with a temporary stabilization in the early 2000s. This was partly caused by the general political environment and partly by the double taxation policy that existed between the parties at that time. During this period, rapid growth occurred only in the transport and logistics sectors, due to ever increasing volumes of cargo from Russia, which was in turn because Russian export infrastructure was unable to service drastically increased export flows of raw materials. Although it led to an infusion of Russian capital into several operator companies linked to transit infrastructure, these developments did not affect other sectors of the economy.

The Russian default of 1998 was a major setback for Estonian businesses because it drove domestic prices in Russia to such low levels that imports ceased to be viable. Estonian companies withdrew from the Russian market and, in most cases, never tried to come back. Only recently have some isolated attempts to return been made (e.g., in the food industry). This was the single objective factor that constrained the development of economic cooperation, and was economic rather than a political act by Russia engineered by a political (or competing interest) group.

The next stage in Estonian-Russian economic relations (since 1999/2000) is characterized by a contradictory process in which relations between the two

states cooled down as a whole (in connection with the process of Estonia's accession to NATO and a policy pushed by the new Russian administration aimed at the restoration of its status as a great power), but at the same time a slow legal ordering of economic relations continued (in connection with the process of Estonia's accession to the EU, which was happening simultaneously).

After Estonia's accession to the EU and the subsequent abolishment of double taxation, Russian-Estonian trade volume steadily grew, reaching a peak immediately before the Bronze Night in April 2007. Amid the general economic boom, the interest of Russian investors in investing in Estonia (mostly in real estate) increased. The Bronze Night events provided Russia with a convenient excuse to re-direct transit flows to its own ports (the capacity of which had already been increased by that time) and to curb export-import operations between Russia and Estonia using administrative measures dictated by a purely political motive. In essence, this policy has continued up to the present day, although the bilateral trade volumes have been slowly recovering. Especially strong growth has recently occurred in exports from the Estonian food industry to Russia. At the same time, the development of infrastructure and a regulatory environment to facilitate trade growth has virtually stopped as a result of Russia's actions. Russia's place in the list of Estonia's trade partners has stabilized at between fourth and 10th place.

Russia's foreign economic policy towards Estonia

The nature of Russia's economic policy toward Estonia has not significantly changed in spite of the evolution of certain methods and political motivations. It may be argued that this policy has always been characterized by two factors: a) setting a low political priority for the development of economic cooperation with Estonia, and b) a desire to influence the well-being of Estonia (and, therefore, its politics) by means of various official and (predominantly) unofficial sanctions. The purpose has been to preserve Russia's influence in high-priority areas of the former Soviet Union and contemporary Russia and to achieve this goal as cheaply and as easily as possible (although this apparent easiness was based on false assumptions).

Russia attempted to preserve its influence in Estonia using the same means that it employed elsewhere with greater or lesser success: through big companies, through dependence on energy, and through oligarchic interest groups. Big Estonian enterprises either collapsed quickly (Dvigatel) or re-oriented themselves

(Tallinn Shipyard). Estonia has not been dependent on Russian energy, either during Soviet times or since, and the only energy resource that Russia has monopolized has been natural gas – but the share of this in Estonia's energy balance is relatively small (about 10%). The rise of oligarchic interest groups in Estonia was prevented by the choice of privatization model.

Contacts between Estonia and Russia

At the national/governmental level, contacts exist only on a normative level. There are no substantial working contacts or corresponding agreements (except in some rather technical areas, such as the border guard and the environment).

At the level of local government, there is a considerable interest in joint actions in the cross-border cooperation format, but this interest is hampered by administrative incompatibility. This means that different levels of authority cannot cooperate as equal partners: cooperation at the national level is not encouraged; there are some cooperation opportunities on the Russian side at the regional level, but Estonia lacks adequate regional authorities for such cooperation; Estonian local governments have the incentive to cooperate but lack a competent partner on the Russian side. "Diagonal" relations (e.g., a Russian region and the Estonian government) do not work because of the administrative and political logic.

At the non-government level (private companies), the picture is extremely mixed. There are strategic contacts in some sectors, excepting railways and natural gas, but their significance at the political level is small. We would be hard pressed to find a single sector to serve as an example of successful, problem-free cooperation. The situation in sectors varies from steep decline (e.g., the forest industry) to growth (e.g., tourism).

Political influence achieved by economic means

Russia's influence on Estonia is minimal because from the very beginning it employed the wrong instruments and proceeded from false assumptions. Estonia made a strategic choice in favor of the West, and used a liberal, open economic model – from privatization to minimal state intervention in routine economic affairs. Russia, on the contrary, set itself the strategic objective of preserving control and employed a model that had proved its effectiveness in other parts of the former Soviet Union (the reinforcement of dependency relations combined

with support for oligarchic interest groups), adding sanctions for good measure. However, these policies facilitated the withdrawal of Estonia from Russia's sphere of influence.

Therefore, when a centralized foreign policy emerged in Russia, creating the opportunity for more adequate influence, it was already too late. (The situation may change if the emphasis is shifted from economic to cultural policy, because cultural gravitation to Russia does exist.)

Belarus's foreign economic policy toward Estonia

The economic presence of Belarus in Estonia is so marginal that it is difficult to assess by either quantitative or qualitative measures. One exception is purely political – the desire to have some contact with the EU to achieve a breakthrough in relations – and another is the attempt to shield itself economically from Russia (as seen by the desire to import Venezuelan oil), but the influence of both factors on the economic and political environment in Estonia is next to zero.

Comparing the economic and political relations of Russia and Belarus with Estonia, the following generalization may be made: although both consider Estonia (and the other Baltic States) as “ours”, geographically close and relatively understandable culturally, Belarus lacks a big brother complex and has never tried to achieve or preserve a controlling influence here.

CONCLUSIONS: ADVANCING BEYOND A CONSTRUCTIVE FREEZE OR ECONOMIC "PRAGMATISM"

Andris Sprūds

Latvia's economic and political engagement with Russia and Belarus has been dynamic and has undergone an apparent transformation in the context of the global economic recession. The adopted strategy for a deliberate economization of bilateral relations with its neighbors has been frequently described as a “pragmatic” adjustment in Latvia's foreign policy. Latvia may not be perceived as an exception in the region, as economic considerations have become an important dimension and formative feature of the bilateral and regional relationships among many East Central European states. After having experienced a considerable downturn, Latvia adopted strict austerity measures, increased its competitiveness, and placed a strong emphasis on intensifying economic interaction with its neighbors. The substantial growth of trade exchange with Russia and Belarus was both a direct result of the “pragmatic” turn and a considerable catalyst for a further economization and “de-politicization” of relations.

Politics have indeed mattered, especially in Latvian-Russian relations. A number of strong political undercurrents have complemented and complicated Latvian-Russian economic interaction over the last two decades. Security concerns, humanitarian issues, and perceptions of history have been among the major aspects of contention and have contributed to periodical reversion to a state of “constructive freeze”. Symptoms of mutual interest for a more active bilateral engagement, if not political rapprochement, were demonstrated after Latvia's accession to the Euro-Atlantic organizations. The lingering border dispute was resolved in 2007. The economic recession and a wider reset and modernization agenda between the US and EU on one side and Russia on the other has contributed to further efforts to warm up Latvian-Russian political relations and intensify economic interaction. Differences in the nature of political engagement and economic asymmetries notwithstanding, Latvia's relations with Belarus have followed a somewhat a similar pattern. Likewise, the recent political challenges in the aftermath of elections in Latvia, Belarus and Russia have demonstrated an ensuing importance and somewhat burdening implications of domestic developments for bilateral relationships.

1. Increasing diversity of domestic actors

Foreign policy is usually perceived – and frequently deliberately portrayed – as a strategic, systematic and coordinated undertaking by national governmental authorities, especially those responsible for a nation's external actions. Latvia's Ministry of Foreign Affairs has been considered, as expected, a major foreign policy thinking and acting body, including with regards to the country's relations with Russia and Belarus. Some periodical divergences among government branches and coordination challenges surrounding policy synergy notwithstanding, other government institutions have generally cooperated in the implementation of the country's external policy. The Ministry of Economics and its Agency for Development and Investment, and the Ministry of Transportation have been the most instrumental state institutions responsible for facilitating economic relations such as trade, transit and investment. In the meantime, Latvia's president has played the role of a representative extension of officially adopted foreign policy strategies. Valdis Zatlers's visit to Moscow in December 2010 was not only indicative of a transformed mood in bilateral engagement, but was also in line with the "pragmatic" adjustment implemented on a governmental level.

The state visit simultaneously reflected a more widely shared leaning toward the necessity of an adjustment and economization of Latvia's foreign policy, and brought into the picture a wider range of domestic actors and interests. Although municipalities have been secondary players in bilateral political and economic settings and generally focused on practical cooperation with their regional and municipal counterparts in neighboring countries, this has gradually changed. Riga municipality took a higher profile and started to essentially contribute to the bilateral agenda after the opposition political party block "Harmony Center" became the dominant force in capital's municipality. Riga municipality not only established closer links with Moscow and St. Petersburg, but also engaged somewhat directly in business interactions, attempting to facilitate trade exchange and attract investments. Gatis Pelnens states that "there is no clear evidence of party's direct involvement in promoting Russia's interests. However, "Harmony Center's" position on such issues as joining euro-zone or the revision of terms of the bailout agreement with the IMF and EU, could strain relations between Latvia and its Western partners and that would match the interests of Russia in Latvia."

In the meantime, however, business groups have been motivated to play a more active and direct role in setting the bilateral agenda and its implementation in both the Russian and Belarusian directions. As Karlis Bukovskis indicates in his article: "All of the interviewed officials admitted that state and municipal

institutions generally have limited or assistant functions to Latvian and Russian/Belarusian businesses because of the chosen open market liberal de-regulative approach." Despite the fact that (and perhaps sometimes due to the fact that) Latvian lobbying legislation is still being developed, business groups have clearly used a variety of mechanisms to channel their interests. Latvian-Russian and Latvian-Belarusian Business Cooperation Councils have promoted their preferences for a bilateral agenda. In the meantime, the Latvian Employers Confederation and Chamber of Commerce and Industry have been vocal in defending the interests of their members domestically. Moreover, these business associations have frequently forged common positions with other important social partners, such as the Free Trade Union Confederation and the Association of Local and Regional Governments.

The debate in Latvia over EU sanctions on Belarus became something of a litmus test that discerned the increasing weight of business interests in defining the country's foreign policy choices. The debate demonstrated a variety of interest groups that Diana Potjomkina divides into "normativists" and "pragmatists". Business associations, especially the Latvian Employers Confederation, were highly vocal in lobbying against any sanctions and eventually demonstrated their influence in essentially shaping Latvia's official position to resist broad sanctions. In the process, business representatives brought the issue to the public and stepped up pressure on the government. The business sector skillfully took advantage of the recent "economization" of Latvian foreign policy discourse and found an additional formidable supporter – the Latvian President, who has emphasized the importance of the economic dimension of foreign policy. Last and not least, Latvian businesses demonstrated their relevance to bilateral partners, including on a political level. Alexander Lukashenka indirectly praised Latvia and Lithuania for its support against the EU sanctions.⁵⁴⁶ The whole process has set an important precedent and raised fundamental questions pertaining to Latvian foreign policy theory and practice, especially in the context of balancing European values and domestic economic interests. The case made it obvious that governmental authorities must not only lobby national interests externally but also defend their respective interpretation of national interests and forge compromises domestically. A two-track policy, if not policies, and two-level bargaining apparently have become a permanent trend in Latvia's foreign policy, while also revealing an increasing number of domestic players and interests involved.

Russia's and Belarus's foreign policy setting evidently differs from Latvia's. The authors pinpoint a more centralized nature of politics and a regulated

⁵⁴⁶ "Лукашенко: на Литву и Латвию оказывают давление", *Telegraf*, 5 April 2012.

business environment in both countries, especially in Belarus. However, it would be a considerable misperception to approach the Russian and even Belarusian systems, unlike Latvia's, as absolutely hierarchical and fully state-controlled systems. Although clearly observable instincts toward political centralization exist in both countries, global financial and commodity market demands, the domestic economic dynamic, and respective business interests contribute simultaneously to the formation of domestic, bilateral and international agendas. Obviously, as the result of a rather extensive privatization process and the emergence of large financial-industrial groups, this has been more observable in the case of Russia.

Russia's relations with the outside world, and particularly the former Soviet republics, in the last two decades have been caught in the crossfire between divergent national political and ideological trends, center-region problems, the ambiguous outcomes of Russia's economic reform and modernization agenda, and a variety of business interests. During the 1990s, Russian business elites essentially contributed to tilting of balance toward more accommodating relations with the West and cooperation rather than confrontation with the Baltic countries. The scope of influence of the Russian business elite varied from issue to issue, tending to have a stronger influence on the governmental policies on specific and narrower issues and to have insubstantial impact on issues generally perceived as vital to the national interests of the state.⁵⁴⁷ Although Vladimir Putin markedly subordinated the business sector further within the power vertical, the balancing between the elite's enviously guarded and implemented national strategic interests and the plurality of particular business preferences is still observable. Moreover, business interests are increasingly perceived as potential agents for the country's domestic modernization and indirect international influence, and thereby endorsed to engage actively without the state's direct oversight. Hence, the intensity of multi-level interaction between Latvia and its neighbors might only increase and make it much more difficult for central authorities in respective countries to dominate and control the substance and form of such engagements.

547 Sergey Medvedev (ed.), *Business Elites and Russia's European Policy* (Helsinki: Finnish Institute of International Affairs, 2000); Andris Spruds *Business Elite and Foreign Policy: Russian Financial-Industrial Groups and Russia's Baltic Policy, 1991-1999*. Unpublished doctoral dissertation, Krakow: Jagiellonian University, 2005.

2. Increasing diversity of engagement frameworks

The increasing diversity of state and non-state actors and the challenge of balancing a variety of interests both stems from and contributes to an increasing diversity of frameworks under which bilateral engagement between Latvia, on one side, and Russia and Belarus, on the other, takes place. Bilateral relations, especially between Latvia and Russia, have experienced a considerable institutionalization and formalization. The activities of the rather recently established bilateral Latvian-Russian and Latvian-Belarusian Intergovernmental Commissions are complemented by non-governmental Business Cooperation Councils. Moreover, in the case of Latvian-Russian interaction, a number of significant agreements have recently been negotiated and signed. Among others, the agreement on preventing double taxation was extensively worked on and eventually signed, though its ratification is still pending in Russia. It is expected that according to the agreement Russian and Latvian businesses operating in both countries will be guaranteed a stable taxation regime which will not be affected by changes in taxation policies. The Latvian-Russian declaration on cooperation in modernization, signed in June 2011, was expected to facilitate economic cooperation between both countries and include additional regulation on investment protection. The further expansion of the bilateral legal framework has been stalled, however, since both countries entered an electoral cycle in the second half of 2011.

The regional framework provides another dimension to Latvian-Russian and (to a lesser extent) Latvian-Belarusian economic interaction. During the last twenty years, the Baltic Sea region has experienced a fundamental transformation, especially in the context of an enlargement of the Euro-Atlantic institutions and a number of endeavors to institutionalize regional cooperation. However, economic cooperation through regional frameworks currently languishes. On the one hand, essentially, an EU-ization of the Baltic Sea region has been taking place. The region was the first to adopt an internal EU regional strategy in 2009.⁵⁴⁸ On the other hand, in a significant number of regional initiatives under the auspices of the Council of Baltic Sea States, a comprehensive vision and catalysts for regional political and economic cooperation are missing, Russia's participation notwithstanding. Finland initiated the Northern Dimension with the aim to promote cooperation and joint projects with Russia, as well as to establish a strong

548 European Commission, *Communication the concerning European Union Strategy for the Baltic Sea Region*, COM (2009) 248, 6 June 2009; *Action Plan: working document accompanying the Communication concerning the European Union Strategy for the Baltic Sea Region* - SEC(2009) 712, 6 June 2009, updated December 2010.

link between the ND and the EU-Russia Common Spaces.⁵⁴⁹ Partnerships have been created on public health and well-being, culture, transport and logistics, and the environment. The policies, which can be defined as “small-but-smart” and “flying-below-the-radar” of high-level EU-Russia politics, score positively in terms of mutual confidence building, yet they also reveal limitations.⁵⁵⁰ This is also the result of Russia’s preference for bilateral and increasingly pan-European interaction. However, with an increasing economic and business presence in the region, Russia may be interested in engaging more actively in regional initiatives, for instance in the energy sector.

The EU-Russia and EU-Belarus frameworks have been increasingly important in bilateral relations between Latvia on one side and Russia and Belarus on the other. The EU-ization process involves the application of a number of EU regulations in EU member countries. Among the most important of these, the Third Energy Package aims to liberalize energy markets within the EU and may have direct implications for Russian energy companies, above all *Gazprom*, in the EU, including Latvia. Notwithstanding a number of challenges for the common EU external policy after the Lisbon Treaty, the EU also provides some general frameworks for members’ external interaction with neighbors such as Russia and Belarus. Although Belarus is a part of the EU Eastern Partnership program, more recently EU-Belarus relations have been dominated by the debate over the scope and substance of sanctions against the country for the violation of human rights and democratic procedures. The formal EU-Russia framework has been much extended, with a strong emphasis on the modernization agenda of Dmitry Medvedev’s presidency.

On the one hand, Latvia has clearly benefited from an increasing multi-lateralization of relations and an advancement beyond bilateral asymmetries. Moreover, multi-lateralization has contributed to additional channels of interaction and funding, such as the Estonia-Latvia-Russia cross border cooperation program within the European Neighborhood and Partnership instrument 2007-2013. The program aims “to promote joint development activities for the improvement of the region’s competitiveness by utilizing its potential and beneficial location in the cross roads between the EU and the Russian Federation. The specific objective is to make the wider border area an attractive place for both its inhabitants and businesses through activities aimed

at improving the living standards and investment climate.”⁵⁵¹ On the other hand, some previously existing asymmetries have been replaced by the new ones, for instance in the field of trade. While Latvia as a part of the EU is bound by EU trade regulations and may not unilaterally apply protectionist measures, Russia has been in a position to apply direct and indirect protectionist measure when it deemed appropriate. Russia’s WTO membership is expected to mitigate such risks for Russia’s trading partners.

Russia was invited to join the WTO in December 2011 and its parliament ratified the membership in mid 2012. The Post-Soviet Russian economy has operated for two decades largely outside the formal, rules-based international economic system. With WTO membership Russia accepts the WTO rules of non-discrimination, intellectual property protection, dispute settlement mechanisms, and a number of other trade-related issues. All WTO members are expected to provide unconditional most-favored nations status to all other members, which must ensure equal mutual market access. Russia and its trading partners are expected to benefit from the country’s WTO accession as the Russian economy is estimated to grow by 3.3% (\$53 billion per year) in the medium term and 11% (\$177 billion) in the long term.⁵⁵² Although it is too early to expect far reaching favorable prospects from Russia’s WTO membership, it may generally contribute to a depoliticization of economic relations as political incentives would be complemented, if not replaced, by the formal and transparent rules of the organization.

Russia’s WTO membership may open additional economic and political opportunities for Russia’s relations with the Baltic countries, including Latvia. Russia has not only used import-substitution industrialization measures, but has also occasionally applied trade barriers against agricultural products (import tariffs and subsidies) and allegedly imposed instrumental sanitary and phytosanitary (SPS) regulations. Above all, Russia’s WTO membership might “normalize” Latvian exports of agricultural and fishery products to Russia while easing the import of timber from Russia for further processing. Latvia’s ports and transit business would benefit if Russia would comply with its commitment to abolish the varying domestic railway tariffs in Russia. The introduction of stricter intellectual property rights would create new opportunities for Latvia’s IT companies.⁵⁵³ Last but not least, in case of any trading disputes between Latvia

549 Pami Aalto, Helge Blakkisrud and Hanna Smith (eds.), *The New Northern Dimension of the European Neighbourhood* (Brussels: CEPS, 2008).

550 Northern Dimension Institute, Report “Coherent Northern Dimension: the Policy Priorities of the Arctic Council, the Barents Euro-Atlantic Council, the Council of the Baltic Sea States and the Nordic Council of Ministers, in comparison with the Northern Dimension objectives”, 28 October 2011.

551 See, Estonia-Latvia-Russia cross border cooperation Programme: <http://www.estlatrus.eu/eng/home/>.

552 David Tarr and Natalya Volchkova, “Foreign Economic Policy at a Crossroads” in Anders Aslund, Sergei Guriev and Andrew Kuchins (eds.), *Russia after crisis* (Washington DC: Peterson Institute for International Economics, 2010), 202-203.

553 See, for instance, Martins Vargulis, “Russia’s accession to the WTO: implications for the EU and Latvia” Analysis of the Latvian Institute of International Affairs, 19 July 2012.

and Russia a multilateral rather than bilateral dispute settling mechanism could be invoked.

The wider picture of bilateral engagement between Latvia, on the one side, and Russia and Belarus, on the other, however, has been complicated by alternative integrationist projects such as the Eurasian and Customs unions. While Russia is expected to be instrumental in defining the parameters (for instance, common external tariffs) and pace of integration, the Belarusian economy (and its partners by extension) may have to undergo a serious adjustment process. On the one hand, this integration process would bring important benefits for Belarus: access to Russia's and Kazakhstan's markets, increased labor mobility, gas and crude oil prices comparable to those in Russia, and financial support from EurAsEC Anti-Crisis Fund. On the other hand, Russia's WTO membership and further commitment to domestic liberalization may impose pressure on the currently protected Belarusian market and its domestic enterprises. While Russia's WTO commitments may effectively facilitate the access of its trading partners to the Russia-led Custom union, including Belarus, Belarusian producers will continuously encounter protectionist measures from the other WTO members. Moreover, Russian assistance for Belarus has not been without direct and indirect conditions, including a growing Russian business presence in the Belarusian economy. Belarus may already now be perceived, as Edijs Boss, puts it, as a "Russian economic offshore". According to Boss, the rather impressive performance of the "Lukashenko economy" in the 2000s "was the result of Belarus's artful functioning as an economic offshore center of the Russian Federation. Accordingly, Belarus remains dangerously dependent on the kindness of the government in Moscow." This once more implies that in Latvia's bilateral economic interaction with Russia and Belarus, respective businesses must navigate within increasingly complicated legal, economic, and political multi-level and multilateral frameworks.

3.Opportunities and risks

Both positive dynamics and opportunities, on the one hand, and controversies and perceived concerns, on the other, have appeared in the context of recent economic interaction. The economic engagement and intensification of relations between Latvia and Belarus, and especially Russia, during the regional and global economic recession has been important and welcome. It has been instrumental for a business from a small country to compensate for shrinking access to and demand from other markets. Russia has become an indispensable

economic partner for Latvia and the other Baltic states. Economically, Russia has been more important than Belarus in the whole spectrum of economic interaction: trade, transit and investment. The lesser role of Belarus in the Latvian economy notwithstanding, the country has been an imperative partner in its own right, above all in the transit sector and as a market for a number of Latvian industry sectors. As Didzis Klavins indicates, "a great growth potential... belongs to the production of pharmacy, textile and information and communications technologies that open up great opportunities for Latvian private enterprises." The question, however, may be posed of whether this apparently growing bilateral economic interdependence and indispensability may be economically and politically sustained and extended.

Andrejs Jakobsons in his chapter on general economic trends in bilateral relations re-introduces the "gravity thesis" approach, which assumes a geographically and economically predetermined scope and intensity of economic engagement between neighbors.⁵⁵⁴ Jakobsons arrives at the conclusion that the potential to intensify economic relations between Latvia and its eastern neighbors exists, though one should not overestimate its scope. Moreover, economic growth domestically, rather than the character of interstate politics or political rapprochement, will provide windows of opportunities for the expansion of economic interaction.

Though there is an existing expectation that economic interdependence may have a positive spill-over effect for bilateral political relations, apparently one may not exclude the opposite trend. Victoria Panova in her article on Russia's relations with the Baltic states pinpoints to the presence of complicated political issues as well as non-conciliatory emotions on both sides. Latvia and Russia have essentially entrapped themselves in a certain politicization of relations and have not been able to find a mutually acceptable approach to or solution to such as issues history, minority rights, democratic procedures, or strategic development in the post-Soviet space. Moreover, the considerable economic asymmetry that exists between Latvia and Russia may contribute to the sensitive and complicated task of balancing economic relations and interests with not infrequently incongruent public perceptions and respective political strategies. Furthermore, fundamental political issues may not be ignored as the Baltic countries, Russia, and Belarus somewhat represent diverging models of economic, political and international development.

The existing asymmetry and widely shared self-identification in Russia as an important regional power center in a perceived multi-polar setting implies that

⁵⁵⁴ It was dealt with by Vyacheslav Dombrovsky and Alf Vanags in Nils Muiznieks (ed.), *Latvian-Russian Relations: Domestic and International Dimensions* (Riga: Latvia University, 2006).

Russia may take the initiative in defining the direction and character of bilateral relations with Latvia. Latvia has attempted recently to facilitate a “pragmatic” foreign policy with Russia. This emanates not only from economic exigencies and business interests but also from the desire to demonstrate a “manifestation of dialogue” to its Euro-Atlantic partners. Russia, however, has at its disposal means of influence and options for soft diplomacy or pressure, economization or politicization, and a diversified or regional approach to the Baltic countries. Moreover, a definition of the Baltic direction in Russian foreign and economic policy would also correlate with a wider Russian modernization agenda and its relations with the EU.

Latvia’s economic engagement with Belarus has been considerably less politicized, at least bilaterally. Unlike in Latvia’s relations with Russia, it is Latvia that could have taken the initiative to be more active in raising political issues in the bilateral relationship with Belarus. As the result, the issue of compliance with democratic standards and human rights in Belarus has appeared on the bilateral agenda. Latvia’s position in this regard, however, has largely followed the European consensus. With a narrow opening for accelerating the engagement of the EU with Belarus in 2008-2010, a number of political and economic advancements and incentives were also observable in Latvian-Belarusian interaction. However, the widely criticized presidential elections in Belarus in December 2010 led to the return of the human rights issue, obstructed further political engagement, and impeded economic interaction.

With a wider political context in mind, a diversity of interpretations of outside investment and foreign economic presence in Latvia exists, especially with regards to Russia. Generally, as Karlis Bukovskis indicates, “the understandings and feelings toward Russia’s economic presence in Latvia are diverse, ranging from distrust and worries about a potential takeover of Latvia’s economy to seeing Russia as yet another investor with the economic potential to contribute to Latvia’s economy.” This range of approaches is partly facilitated by the difficulty of identifying accurately the size of Russia’s investments and economic presence. Russia officially is far from being a dominant partner in Latvia’s trade and investment rankings. Its share has declined from 20% of cumulative FDI in the 1990s to just 3.5% in 2010. However, the real Russia-related figures in Latvia’s economy may be considerably higher. First, some Russian companies (such as *Gazprom*) acquired valuable Latvian business assets at the beginning of the privatization process. The value of those assets has increased significantly since then. Second, Russian-related investments may arrive through third countries. As David G. Tarr and Natalya Volchkova point out, the Netherlands “enjoys a special

position in managing cross-border transactions in the fuel and gas sector” while Cyprus is “home to capital-rich Russian nationals.”⁵⁵⁵ It is not unexpected that both countries, which are major FDI source countries for Latvia, are also major investors for Russia itself.

Russian businesses have invested in a number of sectors of Latvia’s economy. Russian investments may have been instrumental in stabilizing and facilitating Latvia’s crude oil transit and natural gas business in the 1990s. Russian investments at various times were expected to contribute to the development of the real estate segment, the stabilization of the financial sector, and even the re-establishment of the car industry in Latvia. At the same time, the risk of a potential monopolization of important segments of Latvia’s economy by Russian capital may be found and concerns exist. A Russian presence in the energy sector has been considerable, and clearly complicates the implementation of liberalizing the natural gas sector. In the banking sector, attempts to attract Russian capital with slogans like “we are closer than Switzerland” are apparently an accomplishment. Scandinavian banks actively entered the Latvian financial sector after the 1998 crisis, but 10 years later were hit hard by the 2008 crisis and demonstrated a reluctance to expand in the aftermath. This vacuum has been gradually filled by Russian capital. Although the Private Bank Association is confident that “everything is alright with the arrival of Russia’s capital,” some concerns remain as bank ownership may become instrumental in increasing acquisitions of other real estate, industrial, agricultural, or infrastructure assets.⁵⁵⁶

Finally and most importantly, the character of Russian investment matters, as it has an impact on Latvia’s overall investment and business climate. The rather frequent difficulty to trace the ownership of particular investments and identify them behind offshore companies makes the investment environment fundamentally less transparent. As Arvils Zeltins indicates, Russian capital plays a role in the tendency toward an “offshorization of Latvia”. The transparency issue may also be raised in the context of the scope of corruption associated with particular investments. In the 2011 Transparency International’s “Bribe Payers Index” Chinese and Russian firms have been identified as the most likely to pay bribes while operating abroad.⁵⁵⁷ It can be implied that the companies accustomed to corrupt business practices and inside deals in their own countries “export” those corrupt routines to other countries through their business activities. This

555 David Tarr and Natalya Volchkova, “Foreign Economic Policy at a Crossroads” in Anders Aslund, Sergei Guriev and Andrew Kuchins (eds.), *Russia after crisis* (Washington DC: Peterson Institute for International Economics, 2010), 216.

556 “Russian Capital Continues to Enter the Latvian Banking Market”, Russia Briefing, 23 February 2012.

557 Transparency International “Bribe Payers Index 2011”, October 2011.

partly stems from the trend observed by Zeltins that an “important characteristic in the Russian business culture is that successful businesses within Russia nearly cannot exist without the participation of political mediators... this is perhaps the most important feature of the business culture of Russia – big business goes hand in hand with politics.”

Regardless of the validity of these transparency concerns and the need for political backing, Russian investments have also demonstrated mixed results in entirely economic and business terms. Some positive experiences notwithstanding, Russian investment may be adventurist, speculative, or short-term, as the case of *Latvijas Krajbanka* in particular demonstrates. The political and economic developments and the business culture in the former Soviet area still encourages capital to arrive in Latvia in search of either a safe political heaven or instant profits rather than as a long term business undertaking. These observations may lead to a cautioning that in the context of the existing economic asymmetries and the vulnerability of Latvian state, one cannot ignore the risks associated with particular investments. This has nothing to do with Russia’s alleged direct political influence through economic means, but rather with the “import” of non-transparent practices and an indirect gravitation toward Russia’s business model, business culture, and by extension political culture.

4. Baltic comparative perspective: commonalities and divergences

In general, the major trends of Latvia’s interaction with Russia and Belarus are comparable to those of Lithuania and Estonia. Economic engagement with the eastern partners has been dynamic and growing in recent years in terms of trade, transit, and investment volumes. Russia is perceived as an important trading partner that provides opportunities for Baltic businesses to diversify their trade directions while still ensuring access to their somewhat traditional commodity markets. Russian and Belarusian transit shipments to Baltic ports have assured operations and profits for the Baltic infrastructure. Moreover, the recently launched NATO Northern Distribution Network ensures shipments from the Baltic ports through Russia and Central Asia to Afghanistan. This has been one of the logistical endeavors that facilitates cooperation among a wider range of partners and has essentially provided a platform for “win-win” multi-national business involvement. It also has positive political implications in the region, including for mutual cooperation between the Baltic states, Belarus, and Russia.

In the process of engaging with Russia (and partly Belarus), the Baltic countries may even compete for attracting transit flows, closer business cooperation with Russian businesses, and dominant access to specific commodity market niches. Conversely, the Baltic states have demonstrated reservations about the economic presence and influence from countries that do not belong to Euro-Atlantic community organizations such as the EU or NATO. As a result, the national governments of the Baltic countries attempt to balance opportunities and risks and promote policies that may mitigate the latter. Indicatively, the governmental strategy to increase energy security, and even declarations of energy independence, have been directly aimed at lessening dependence on Russian energy supplies and reducing Russia’s presence in the energy downstream, and eventually bridging the Baltic “energy islands” with the European “energy mainland”. Moreover, engagement between the Baltic states and Russia remains rather delicate and reserved, and has been continuously complicated by the issue of minority rights in Latvia and Estonia, “history football”, and different strategic visions of (and respective activities in) the post-Soviet space. Notwithstanding less politicization of bilateral relations between the Baltic countries and Belarus, Estonia, Lithuania and Latvia have shared the criticism of human rights violations and supported the EU economic sanctions against Lukashenka regime.

In the meantime, some differences may be observable among the Baltic states in terms of political engagement, selected strategies, and specific business directions with regard to both Russia and Belarus. Estonia has chosen what some may define as a prolonged but constructive freeze in political relations.⁵⁵⁸ In contrast to the recent Latvian engagement with Russia, in the Estonian case, as Karmo Tuur indicates, “co-operation at the government level does exist, but at a very formal level. On paper, there is the Intergovernmental Commission established in 1998, which is supposed to organize such co-operation, but in reality this commission has held no meetings since 2003.” Unlike Latvia, where “pragmatism” has been associated with government’s support for business operations, Estonia’s “pragmatism” has implied a governmental distancing and “non-interference” in business operations.

In the process of bilateral interaction, the Estonian political elite has also demonstrated a considerable sensitivity to Russia’s economic presence in the country. The then Estonian Member of European Parliament Toomas Hendrik Ilves in 2005 characterized Russia’s growing presence in the Baltic infrastructure and energy sector bluntly: “Why bother to occupy them [the Baltic States]? It’s so much easier and less troublesome to simply control them... You get the same

⁵⁵⁸ Ahto Lobjakas and Martin Molder (ed.), *EU-Russia Watch*, Centre for EU-Russia Studies of University of Tartu, April 2012, 36-43.

effect if you simply control the government, access and influence in important international organizations such as NATO and the EU.”⁵⁵⁹ The Estonian energy sector, however, has been the most self sufficient and protected among the Baltics, as Estonia domestically produces around two thirds of its energy requirements. Estonia is the only country in the world that ensures power generation almost entirely from its own oil shale.⁵⁶⁰

Estonia has rather distant relations with Belarus. Unlike Latvia and Lithuania, Estonia does not have a common border with Belarus and naturally its mutual trade, transit, and investment exchange is more limited than in the case of Latvia and Lithuania. Indicatively, the Estonian embassy in Minsk was only established in 2009. Unsurprisingly, Estonia followed the EU economic sanctions without reservations or the controversial internal public debate that was seen in Latvia.

Lithuania is the Baltic state with the most intensive economic interaction with both Russia and Belarus. Political relations with Russia, however, have remained rather complicated. The continual agreement on negotiations and the functioning IGC notwithstanding, the last official meeting between Lithuanian and Russian presidents was Valdas Adamkus’s visit to Moscow in 2001. With regard to Belarus, Liudas Zdanavicius points out that “Lithuania developed the long standing strategy of so-called pragmatic selective co-operation with Belarus. In reality this means that Minsk is rewarded with political attention and advocacy from Lithuania in the EU if some democratic trends are strengthened”. Regardless of altering and sometimes challenging the political atmosphere in bilateral relations, Lithuanian businesses have been able to navigate those circumstances and advance business interests in both Russia and Belarus. As indicated in the Lithuanian chapter, one of the important characteristics of trade with Russia and Belarus is the considerable share of re-export from third countries. This demonstrates Lithuania’s favorable geographical location and inclination to become a regional transit hub in the Baltics.

At the same time, Lithuania has chosen the most vocal and non-conciliatory stance on the issue of energy security. Lithuanian authorities, and the country’s president especially, have invested considerably in the effort to achieve energy independence and the process to dismantle the perceived situation that “Lithuania does not have any chance to implement any policy that would contradict the interests of *Gazprom*.”⁵⁶¹ While Russia’s natural gas is estimated to account for

around 7% of the EU’s primary energy balance, it is more than 30% in the case of Latvia and even higher in Lithuania after the closure of the Ignalina nuclear power plant in 2009.⁵⁶² Lithuania has been a regional frontrunner for the implementation of the EU’s Third Energy Package on energy market liberalization. The adoption of TEP legislation concurred with the visit of US Secretary of State Hillary Clinton to Lithuania and agreements with US companies to participate in the prospective Lithuanian LNG in July 2011.⁵⁶³ The implementation of Lithuanian ambitions for energy independence have essentially become a litmus test for the other Baltic states in their endeavors to strengthen national energy security.

5. Recommendations

In the context of a growing diversity of state and business actors, and engagement frameworks and channels, it is increasingly difficult for a small country to be in command of their external environment and asymmetric bilateral relations. Focus clearly must be placed on the “immunization” of the domestic environment. A consolidated and robust statehood and effective institutional framework is much less exposed to the risks potentially originating from international interaction. Latvia’s internal strength and efficiency becomes an imperative prerequisite in dealing with global, regional, and bilateral issues and turning them into “opportunities” and “advantages” rather than “risks” and “threats”. This is most relevant in the case of Latvia’s (as well as Estonia’s and Lithuania’s) bilateral political and economic engagement with Russia or Belarus. In the meantime, some more detailed recommendations are provided.

First, national governments in consultation with societal groups must define the sectors of long-term strategic importance, which should be either directly owned or attentively monitored by the state. Among the sectors indicated by the authors in this research, the infrastructure, energy, and banking sectors – and partly agricultural assets and forests – still stand out as essential and instrumental in ensuring “commanding heights” and national sovereignty over the “backbone” of the economy.

Second, the monopolistic domination of any sector must be avoided. This implies strengthening anti-monopoly authorities and respective regulations. As Zeltins indicates, “Latvia’s public authorities responsible for the monitoring of

559 Liina Mäuring, Daniel Schaer. The Effects of the Russian Energy Sector on the Security of the Baltic States. *Baltic Security and Defence Review*, Vol. 8 (2006), 76.

560 Merle Maigre, “Energy Security Concerns of the Baltic States”, Analysis of the Estonian International Centre for Defence Studies, 2 March 2010, www.icds.ee

561 Tomas Janeliūnas, Arūnas Molis, Energy Security of Lithuania: Challenges and Perspectives. *Research Journal of International Studies*. Issue 5 (May 2006), 25–26.

562 Sachi Findlater and Pierre Noel, “Gas Supply Security in the Baltic States: A Qualitative Assessment”, Working Paper, University of Cambridge Electricity Policy Research Group, March 2010.

563 US State Department, “The United States and Lithuania Strengthen Energy Security Cooperation”, Media Note, 1 July 2011; *Reuters News*, “U.S. Fluor to advise on Lithuania LNG terminal” 1 July 2011.

foreign investments and economic crimes should improve their coordination both at the local level and with foreign partners, including from Russia". It is particularly important in this context to diversify, regionalize, liberalize and ensure third party access in the energy sector (above all in natural gas sector), which is currently over-exposed to Russia's supplies as well as business presence.

Third, transparency in decision-making is a must to avoid allegations of informal influence or corrupt practices. The "off-shorization of Latvia" should be reduced and precluded. Business interest groups and associations are important stakeholders in the formulation of external economic policy. However, their respective involvement and interaction with state authorities must be defined by legislation that regulates lobbyist activities. As Gatis Pelnens and Diana Potjomkina point out, a "close link between politics and economic elites allows bypassing safeguards and restrictions on an institutional level, therefore weakening the role of institutions in economic interaction and intensifying the risk of corruption." Transparent business transactions and interaction may contribute positively to bilateral relations and would reduce concern about the indirect political influence of neighboring countries.

Fourth, it is imperative to strengthen the segments and particular elements of the national economy that may contribute to achieving a comparative business advantage at the regional level. As Didzis Klavins indicates, "it is important to develop the centers of logistics in the ports of Latvia and major railway hubs... and to continue work on the arrangement of infrastructure in attracting EU funding." This would also lead to more active cooperation between the Latvian government and entrepreneurs to increase export turnover, attract investment and ensure efficient functioning of Latvia's infrastructure.

Fifth, a further Europeanization of the Latvian institutional system, legislation, and respective practices must take place. The EU provides instruments to address important domestic challenges (the TEP in energy sector, for instance) or to promote interests regionally (the EP and ENPI). These regional instruments provide opportunities to engage more actively and practically on the regional and municipality levels. Hence, a multi-lateralization of economic interaction is important.

Sixth, bilateral relations with Russia and Belarus still have a number of "windows of opportunity" to work on. The intensification of business cooperation also leads to deeper mutual interdependency. However, it is important to define the tilting point where interdependency could be transformed into dependency on Russia. In the meantime, formal engagement channels must be strengthened. As indicated by Russia's WTO membership, Russia increasingly demonstrates its understanding of the necessity to integrate into regulated and transparent frameworks.

Seventh, the "values-interests" dilemma exists and must be reconciled. Latvia naturally advances beyond the dichotomy of a "constructive freeze" or "pragmatism" in its bilateral relations with Russia and Belarus. This stems from numerous factors and leads to a multifaceted and multidimensional manifestation of mutual engagement. Latvia must follow its permanent long-term values in foreign policy thinking and formation, in harmony with the values of the Euro-Atlantic community. This does not preclude the economization of external policy and advancing economic interests. However, in this process consistency and adhering to a long-term strategy are a must to ensure the image of sustainability and the credibility of a country's external political and economic policies. Above all, in Latvia's case this depends on and correlates with the country's internal economic sustainability and political and institutional strength.

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