



# THE RĪGA CONFERENCE PAPERS

Collection of essays and articles

2012

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**Dr. Andris Spruds,**  
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The world has experienced dramatic developments in recent years. The global economic recession, the protracted euro crisis, the Arab Spring, the turmoil in Afghanistan and tensions with Iran, the Fukushima nuclear disaster and quests for energy security have been among a number of challenges and formative “game changers” with wider repercussions for global and regional stability. The Transatlantic community has been in the middle of this dynamic shift of the tectonic plates of international politics and economics. Moreover, the Baltic region and Latvia, in particular, is influenced by developments in the neighbourhood, which may contribute to both apprehension, on the one hand, and windows of opportunities, on the other, for constructive bilateral and regional engagements.

*Riga Conference Papers 2012* aim to contribute to understanding the global and Transatlantic developments and Latvia’s place there. May we consider Latvia’s economic transition to be a success story, as it is frequently referred to, and a role model for the rest of the recession-hit members of the Transatlantic community? Was the Chicago NATO summit a demonstration of the alliance’s internal strength and ability to fulfil its commitments? How to perceive the dynamic in the neighbourhood and how can Transatlantic members contribute to the political and economic modernization of Russia and Belarus? Is the verbally declared energy independence that is pursued by some of the countries in the Baltic region achievable? The publication intends to address these questions, as well as identify the challenges, explain the determinant forces behind the regional and global transformation and provide visions of possible future scenarios.

A success of the *Rīga Conference Papers 2012* was enabled by a number of joint efforts. The international body of distinguished authors have been willing to share their thoughts and contribute to the publication. The Latvian Institute of International Affairs, the Latvian Transatlantic Organisation and the Riga Rīdzene Rotary Club cooperated closely to take full advantage of the opportunities provided by the joint project. The NATO Public Diplomacy Section and the Friedrich Ebert Foundation in Riga were instrumental in providing financial support to this analytical endeavour and making it own a success story. Last but not least, this publication would be irrelevant without a reader attentive to the valuable thoughts on the international developments and eager to understand the constraints and opportunities for political and economic stability in the Transatlantic area and the Baltic Sea region.

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**Mr. Martins Bondars,**  
*Board Member in Non-Governmental  
Organization Economists Association 2010*

## **Euro: to Join or Not to Join?**

Latvia has managed to withstand the financial and economic crisis of 2008 by internal devaluation and has returned to economic growth, but this has come at a great cost. The country borrowed significant amounts from the International Monetary Fund and the European Commission compared to its GDP and pre-crisis debt levels.

Cost cuts by the government have diminished public services offered to its citizens and its economic potential has been eroded by a significant decline in population linked to emigration. At the same time, Latvia has established a deeper borrowing capacity and a stronger liquidity position to overcome potential short-term financial shocks. The country also enjoys a stable, non-partisan or like-minded government - something rarely seen in Latvia's political landscape.

While there are early signs of an economic recovery, unemployment remains high in the country. Latvia has turned into a donor nation of young and educated who leave for employment opportunities beyond its borders. As a result, some jobs in specific segments of the Latvian economy requiring skilled workers go unfilled. The country's social system is based on a solidarity principle and in its current form might not be sustainable.

Since the financial crisis swept up Latvia four years ago, the government's top priority has been to ensure country's membership in the Eurozone. Its population supported the decision to join the Euro through the EU accession referendum in 2003 and the target date for Latvia's entry into the common currency area has been set for 2014. To keep these Euro aspirations alive,

the government has maintained a prudent fiscal policy. It is also in the process of refinancing IMF and EC medium-term loans and rollover of its debt amid volatile financial markets.

There are many strong arguments for Latvia to become a fully-fledged Eurozone member as quickly as is possible: the country has a limited administrative capacity and size of economy to manage its own currency (free or managed float), a full membership would decrease transaction costs for businesses and there is a hope for investments to the nation from foreign businesses. In addition, there are national security issues related to Euro accession.

The above-mentioned arguments seemingly outweigh benefits of joining the Euro at a later stage. However,

**Latvia may want to change its plan to join the common currency in 2014, if the Eurozone experiences dramatic changes.**

To have the choice of postponing entry due to severe circumstances in the Eurozone or if EU authorities refuse Latvia's entry, Latvian authorities must think of developing a plan B that would envision how Latvia could function on its own outside the common currency area in 2014.



***H.E. Mr. Valdis Dombrovskis,***  
*Prime Minister*  
*of the Republic of Latvia*

## Why Fight for Euro?

In 2008, when Latvia became the worst victim of the global economic crisis, our story made the headlines of media all around the world. Distinguished US economist Paul Krugman famously said that “Latvia is the next Argentina”, meaning, in his opinion, the inevitable default of the small Baltic state. In 2012, after three years, an international bailout package of €7.5bn and fiscal adjustment of 17% of GDP, Latvia’s economy is back on track and in a better shape than many other EU countries. In 2012, Paul Krugman commented that since the crisis “essentially nobody has managed to regain confidence of markets, except for Latvia”.

The aim to join the eurozone has been an important part of Latvia’s strategy for overcoming the crisis. Latvia’s currency – the Latvian lats has been pegged to the euro since 2005, which essentially means that whatever happens to the euro, will happen to the lats, as well. One of the lessons we have learned is that in every crisis situation one has to have a clear exit strategy. For us the exit strategy was and still is joining the eurozone in 2014. During the crisis there was a strong internal and external pressure to devalue the Latvian currency. Me, the government and the coalition saw that in our situation it was not necessary as overheating was largely due to the excessive short-term capital inflows. In addition, for small and open economies such as the Baltics, prices are largely determined by the surrounding markets. Therefore, the benefits of devaluation would disappear very quickly and devaluation would not effectively enhance the country’s competitiveness. Instead, Latvian authorities have put in place an exit strategy that aims to join the eurozone in 2014, which, first of all meant keeping to a fixed exchange rate and focusing on measures that would allow Latvia to comply with the Maastricht criteria in due time.

The peg of the Latvian lats to the euro also means that we already have all the disadvantages of the euro without any of its advantages. We have carefully studied the experience of our neighbour Estonia, which joined eurozone on January 1, 2011 – you might say right in the middle of the debt crisis. Yet, it is clear that the benefits of the euro introduction in Estonia have clearly outweighed the few downsides. Joining the eurozone for Estonia has served as a strong signal for financial markets and investors about stability and trustworthiness of the Estonian economy, thereby improving its competitiveness in attracting FDI and creating new jobs.

We expect that joining the eurozone will bring similar effects in Latvia, as well. Even more – as our starting position is somewhat lower than that of Estonia, positive effects of the euro introduction are likely to be more manifested. Arguably, also the negative effects on inflation can be expected to be less pronounced, since unlike any other currency that has been replaced by the euro, the Latvian lats is worth more than the euro. It means that on January 1, 2014, numbers on price tags will increase, causing consumers to become more cautious and critical. Therefore, businesses will be less inclined to seek any artificial means of raising prices.

Another aspect, of course, are the practical benefits – less transaction costs for people and businesses, no need to exchange currency when traveling within the eurozone, more price-transparency. Cheaper interest rates for borrowing and servicing the state debt are another important benefit since in 2014 and 2015 Latvia will have to refinance a bulk of its IMF and EC loans. Also, introduction of the euro will put an end to all speculations about devaluation of the lats, which was an important issue during the first quarters of the crisis in 2008 and 2009. About 75% of mortgages and bank loans in Latvia are issued in euros, therefore another benefit of joining the eurozone will be reduced currency risks for borrowers and banks.

Of course, since all we hear about the euro these days is crisis, crisis and crisis, the public attitude towards the euro is becoming more negative. Nevertheless,

**if you take a close look at the situation in Europe,  
you can see that it is not a euro crisis but rather  
a crisis in some particular eurozone countries.**

Of course, we are following very closely the developments in the eurozone and we support all steps that are being taken to help countries solve their problems – for example, Latvia was one of the first countries to ratify the EU Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact).

Latvia's place is in the core of the European Union. We do not want to be a periphery or a gray zone on the EU's Eastern border. Therefore, joining the eurozone is another way of strengthening our commitment to Europe, but we want to join a monetary union that is strong and stable. In the last few years Latvia has done its part in restoring its fiscal discipline, implementing the necessary austerity measures, structural reforms and decreasing the budget deficit, which will be less than 2% this year and below 1.4% in 2013. If a country wishes to qualify for euro-membership, its economy and fiscal situation has to be in a very good shape, but the same strict rules have to apply to the euro-club countries, as well. This is a simple principle of fair and equal treatment of all the members.

**We believe in the euro and in the capability of the eurozone members to tidy their house prior to the arrival of new members.**

Currently, people in Latvia can feel much more secure about their future than residents of many other EU countries. I am sure that in the next few years Latvia along with Estonia, Lithuania, and other Baltic Sea region states will form the most stable and dynamic region in Europe and a safe place for investments.



**Karlis Bukovskis,**  
*Researcher and Deputy Director  
of the Latvian Institute of International Affairs*

## **Latvia's Austerity Model in the Context of European Austerity versus Growth Debate**

Latvia was called the “second most favoured state of German Chancellor Angela Merkel” by US Secretary of State Hillary Clinton during her short visit to Riga on 28 June, 2012. The State Secretary was referring to the Latvian economic situation and the austerity measures chosen over the last four years. From time to time, Latvia is seen as a ‘success story’<sup>1</sup> and used as an example for economic and political discipline in times of severe financial and economic problems. At the same time, there is no complete agreement among European Union members or the economist community on the efficiency of the path chosen by Latvia.

The Latvian Austerity Model is addressed widely within the current Austerity vs. Growth discussion. Socialists, social-democrats and Keynesianism supporters, including such well known economists as Paul Krugman, are among the main critics of Latvian ‘successfulness’. The Growth supporters emphasize the necessity for additional spending to fight unemployment in the first place. Investments in the economy are seen as securing both economic revival and consequently assuring the financial markets on future repayment of debts. Austerity supporters, however, see the immediate cuts in government expenditures as the core solution to the current sovereign debt problems.

For this reason, Latvia’s ability to return to growth during and after the austerity measures serves as one of the main examples for the Austerity

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<sup>1</sup> Please see for instance, Lagarde says Greece should follow Latvia example // The Athens News. – 05.06.2012. - <http://www.athensnews.gr/portal/8/56016>

protagonists. Thus, the purpose of this article is to address the successes and flaws of the Latvian Austerity Model, and its constitutive economic and political elements. Keeping in mind the potential for re-application of Latvia's approach in other countries, the paper will deal with both the most popular Austerity supporter arguments, their criticisms and will argue some specific Latvian conditions. The specifics of the Latvian Austerity Model among others include economic and political aspects, such as the timing and provision of 'politically sellable' arguments, political and psychological readiness for austerity measures and the small and flexible Latvian economy.

In the beginning, one must address the main indicators used to argue for the potential re-application of the Latvian Austerity Model in other European Union countries with excessive government spending. According to the data of the first quarter of the 2012, Latvia has become the fastest growing economy in the European Union. After experiencing the excruciating GDP fall by 21.3% in 2008-2010, 2011 showed 5.5% growth and 2012 started with 6.9% increase.<sup>ii</sup> Thus, Latvia's GDP at current prices reached slightly more than 20 billion EUR.<sup>iii</sup> Unemployment figures have also demonstrated significant improvement since 2010 when 19.8% of population was out of job<sup>iv</sup> and 15.3% of registered unemployment in March 2012.<sup>v</sup>

GDP per capita in purchasing power standards is an ambiguous number used both by supporters of the Latvian Austerity Model and supporters of the Growth model. Namely, 2011 data demonstrated that Latvia has achieved only 58% of the EU average<sup>vi</sup>, however this number is Latvia's highest achievement so far. The pre-crisis problem of high inflation was reduced by the falling internal consumption, imports and consequently prices during the crisis years. Currently the price stability is the defining element for Latvia's ability to join the European Monetary Union on January 1st, 2014. Latvia has been successfully working on fulfilment of all the other Maastricht Criteria so far.

The last but not the least argument used by the advocates of the Latvian model is the successful restructuring of the economy. Latvia's pre-crisis growth was fuelled by accessible foreign capital. This was quickly used by numerous retailers and most importantly – real estate speculators. Thus, the average

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<sup>ii</sup> Real GDP growth rate – volume. - Brussels: Eurostat, 2012. - <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115>

<sup>iii</sup> Gross Domestic Product. – Riga: Central Statistical Bureau of Latvia, 2012.

<sup>iv</sup> Unemployment Rate, by Sex. - Brussels: Eurostat, 2012. - <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsdec450&plugin=1>

<sup>v</sup> Harmonised Unemployment Rate by Sex. - Brussels: Eurostat, 2012. - <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=teilm020&tableSelection=1&plugin=1>

<sup>vi</sup> GDP per capita in PPS. - Brussels: Eurostat, 2012. - <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00114>

almost 10% GDP growth had the characteristics of a bubble. Production and export industries did not constitute the largest part of the economy and the country experienced permanent external trade deficits amounting to around 20%. Since 2010, Latvia's exports in goods have grown rapidly averaging 21%.<sup>vii</sup> Meanwhile, the trade balance in goods has remained negative almost all the time (5-6% more imports than exports 2010-2012).

Before engaging in a more detailed discussion on the Latvian specifics, one must address the measures that the Latvian Austerity Model involved and is widely criticised for. Firstly, the Latvian Austerity Model did not involve the devaluation of the national currency. The pegged exchange rate to the Euro was preserved without any changes in spite of suggestions by both classical economic textbooks and the International Monetary Fund. The Latvian Lat was not devaluated even after public discussions and lobby on the matter by influential political and economic figures, including those who claimed a significant overvaluation of the Lats at the peak of the financial crisis.

Secondly, the Latvian Austerity Model included the recent Stability supporter reasoning on macroeconomic stabilisation and the understanding that financial stability is an essential condition for economic solidity and growth. In reality Latvia hardly had any other alternatives at the time. The Latvian financial crisis started with structural economic misbalance, failing banking sector, the government's mismanagement of the economic situation, growing indebtedness of the local population in foreign currencies and a significant trade deficit (14.2% average in 2004-2008<sup>viii</sup>). Morten Hansen accurately summarizes this situation and the path chosen stating that: "With the credit freeze and ensuing recession tax revenue fell off a cliff creating a ballooning budget deficit which had no chance of market financing due to the credit freeze – a small country with a reckless fiscal policy, on the verge of default cannot borrow!"<sup>ix</sup>

In his book co-authored by Anders Åslund, Latvian Prime Minister Valdis Dombrovskis calls the austerity measures undertaken "internal devaluation – cutting public expenditures, wages, and other costs, while carrying out profound structural reforms".<sup>x</sup> The path chosen involved stabilisation of the financial sector, reducing the number of the employed in the public sector by 25% in 2011

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<sup>vii</sup> Eksports un imports pa valstu grupām. – Rīga: Central Statistical Bureau of Latvia, 2012.

<sup>viii</sup> Eksports un imports pa valstu grupām. – Rīga: Central Statistical Bureau of Latvia, 2012.

<sup>ix</sup> Hansen, M. The Latvian Economy: The Harder They Come, the Harder They Fall? – Rīga: Friedrich Bert Stiftung – Latvia, 2010. - p. 12. - [http://www.fes-baltic.lv/wp-content/uploads/2012/06/the\\_latvian\\_economy1.pdf](http://www.fes-baltic.lv/wp-content/uploads/2012/06/the_latvian_economy1.pdf)

<sup>x</sup> Åslund, A., Dombrovskis, V. How Latvia Came through the Financial Crisis. – Washington: Peterson Institute for International Economics, 2011. – p. 2.

compared to 2008<sup>xi</sup> and cutting pay for the rest. Macroeconomic stabilisation involved cutting state expenditure in the social sector, including maternity and unemployment benefits, as well as increasing the existing taxes and introducing new ones. Thus, the main critics both in Latvia and the European Union emphasize the social devastation the crisis and harsh austerity measures have left upon a part of the Latvian society. Moreover, the statistical data clearly show a gradual increase in the percentage of population at the risk of poverty or social exclusion, reaching 40.1% in 2011 – a steady increase of slightly more than 6% from 2008.<sup>xii</sup>

In spite of the quickly deteriorating living standard and growing unemployment figures, Latvians endured the austerity measures.

**Possessing something that could be called “survivors’ mentality”, the Latvian population yet again adapted to rapid transformations and quickly changing life choices.**

Throughout the history, Latvians have experienced different political and economic regimes, which in many cases have been antagonistic to each other. The necessity to adapt to different foreign and domestic rules and social principles has apparently led to emergence of self-preservation and psychological readiness to cope with economic problems individually rather than only expecting state assistance.

In addition, it should be emphasized that Latvians throughout the years of the crisis have had the option to leave the country and find employment in other countries of the European Union, which had opened their labour markets. Almost a hundred thousand people have used this “exit strategy” during the last years with more than 30 thousand only in 2011.<sup>xiii</sup> Moreover, the factor of the high level of shadow economy in the country also must not be neglected. With around 38.1%<sup>xiv</sup> of economic activity being hidden from the government account in 2010, a part of the population had a possibility to cope with the sudden income loss, and, of course, deepen the economic crisis with their activity. Finally, when discussing the specifics of the Latvian crisis, one should not forget the fundamental importance of the co-financing of private and public projects from the European Union funds. The European Regional Development Fund,

<sup>xi</sup> The number of officials working in the central government institutions was estimated around 68 thousand people in 2011. For more please see Pašlaik valsts pārvaldē mazākais nodarbināto skaits pēdējos 12 gados. – Rīga: State Chancellery of the Republic of Latvia, 26.08.2011. - <http://www.mk.gov.lv/lv/aktuali/zinas/2011gads/08/260811-vk-02/>

<sup>xii</sup> People at Risk of Poverty or Social Exclusion. - Brussels: Eurostat, 2012. - [http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=t2020\\_50&language=en](http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=t2020_50&language=en)

<sup>xiii</sup> CSP: pagaidām nevar teikt, ka 2011. gadā izbraukušo skaits sasniedzis rekordu// Delfi.lv. - 27.07.2012. - <http://www.delfi.lv/news/national/politics/pern-no-latvijas-izbraukusi-30-380-ciiveki.d?id=42543562>

<sup>xiv</sup> Ēnu ekonomika Latvijā sarukusi par vairāk nekā piektdaļu// Dienas Bizness. - 30.05.2012. - <http://www.db.lv/finanses/makroekonomika/enu-ekonomika-latvija-sarukusi-par-vairak-neka-piektadalu-372020>

the European Social Fund, the Cohesion Fund and other financial assistance facilitated the investments in the economy, in modernisation of companies, in some social programs<sup>xv</sup> and secured future growth.

When evaluating the Latvian Austerity Model and applying it to other countries one should take into account some other Latvian specifics as well. The small size of the Latvian economy and population of slightly more than 2 million allows it to adapt to changes not only structurally, but also politically more rapidly than in larger countries. The political readiness was facilitated by general responsibility towards both the country's future and foreign partners that have, e.g., provided the Latvian economy with the financial capital required at the time. Responsibility towards country's future was manifested by the ability of political parties to mobilise themselves and the social partners to concentrate on dealing with the initially apocalyptic scenarios for Latvia. Trade unions and employers' organizations were involved in the decision-making process, thus avoiding wide organized popular protests in the country.

This aspect of the Latvian Austerity Model is strictly related to yet another specific Latvian situation. It is the timing and 'politically sellable' arguments. It has been argued that "Hardship is best concentrated to a short period, when people are ready for sacrifice".<sup>xvi</sup> Not only the period of austerity measures was condensed, it was also given the image of 'temporariness'. Tax increases or reduction or suspension of some social benefits were approached in a manner of temporary measures. The clear schedule for the reversion of the "social devaluation" served as a socially calmative factor. In addition, the public was offered an understandable and practically measurable goal – Eurozone membership. This goal mobilized the public, especially in the beginning of the crisis. The Eurozone goal was also propped up with politically highly popular wage and job cuts in state bureaucracy. This way it demonstrated that there were no free-riders in the time of the national crisis and increased public's ability to accept harsh measures.

**It must be concluded that the Latvian Austerity Model evidently has been a tough and efficient solution for rather sudden financial problems, but, in no way it has been economically perfect.**

<sup>xv</sup> For instance, the Workplaces with Stipends in 2008-2010 is evaluated as a successful temporal solution to skyrocketing unemployment figures and assistance to people without job after the unemployment benefit for them expired. For more please see, Azam, M., Ferré, C., Ajwad, M. I. Did Latvia's public works program mitigate the impact of the 2008-2010 Crisis? – Washington: the World Bank, 2012. - [http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2012/07/23/000158349\\_20120723113712/Rendered/PDF/WPS6144.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2012/07/23/000158349_20120723113712/Rendered/PDF/WPS6144.pdf)

<sup>xvi</sup> Åslund, A., Dombrovskis, V. How Latvia Came through the Financial Crisis. – Washington: Peterson Institute for International Economics, 2011. – p. 3.

The macroeconomic stabilisation of the financial system was an immediate necessity. Compliance with the lending conditions set by the IMF in particular was the most evident solution when Latvia was short of money to bail out its banking sector. In addition, in early 2009, no serious politician openly claimed any alternative solutions, including non-compliance with the lender requirements.

The Latvian Austerity Model is an example of a tremendous sacrifice by Latvian people in the name of a better yet unknown future. What this paper argues, is not only the achievement of the political elite or economic approaches, but the combination of the political and economic environment characteristic to Latvia and the strength of Latvia's society. As making an omelette requires breaking the eggs, the path chosen and endured by the Latvian nation was perceived as unavoidable. Thus, when evaluating the Latvian crisis and replicating its successes in the context of the current European financial turmoil, one must be very careful about the purposes and situations on the table. Evidently, financial, economic, social and political stabilities should be regarded as mutually exclusive elements when a country is in crisis.



*Major General (ret) **Karlis Neretnieks**,  
Fellow of the Royal Swedish Academy  
of War Sciences and Former President  
of the Swedish National Defence College*

## **NATO After Chicago Summit**

The NATO Chicago summit in May 2012 in many ways looked like a success. The principle of collective defence was confirmed as the core task of the alliance. It was also declared that the development and deployment of the European part of the BMD system would continue. There will also be a more flexible approach on how to involve NATO partners in various activities, not just peace operations in remote countries. An important statement when it comes to the Baltic Sea region.

It was also declared that future enlargement of the alliance was in the cards, and that Smart Defence and the European concept of Pooling and Sharing to a large extent were two sides of the same coin. The Libya campaign was put forward as a good example of close cooperation and burden-sharing between the US and some European countries in the NATO framework. The general impression was that the Euro-Atlantic link seems to be in a reasonably good shape.

This rosy picture is misleading. Considering the US redeployment of military assets to in the Asia- Pacific region, drastic reductions of defence budgets in some of Europe's largest states and the very ambitious Russia's armament program, much of which was said in Chicago, and earlier in Lisbon, looks like cosmetics to patch over increasingly diverging views.

The US pivoting towards the Asia-Pacific is fully understandable from the US point of view. Here on-going developments in the Middle East should also be kept in mind. Europe is a quiet corner compared with other challenges that the US is facing. And why should a region with a GDP comparable, or even

larger, than that of the US, not be able to take care of its own basic security needs? One can wonder how strong a link really is if one of the partners is supposed to carry an unproportionally large part of the burden? There is a need for rethinking in Europe.

At the same time, it is important that the US seriously considers the psychological impact of withdrawing assets from Europe. Especially among those European countries that feel most concerned about recent developments. It is not so much a question of US ability to support its allies; it will still be there for the time being. Rather it is the same feeling as not seeing the police patrolling streets, although they can arrive at a crime scene on short notice.

The US being the most influential member of the alliance should therefore do its best to remind other members of the alliance's core tasks and their liabilities. But it (US) should also increase its own efforts when it comes to clearly demonstrating its resolve to help, if need be, the countries feeling that present developments are moving in the wrong direction. It is not primarily a question of keeping large forces in Europe, rather it should be different, highly visible, actions and preparations showing that the US is prepared and capable of using its power projection capabilities in case of a crisis.

**If you are not convinced that the police will arrive in time, what is the use of installing a burglar alarm – spending money on defence in the case of smaller countries?**

The ways of handling the challenges mentioned above from the Baltic point of view are discussed in Dr. Toms Rostoks's paper. Mr. Damon Wilson looks deeper into the possible effects the US pivoting towards Asia might have on European security. Europe's reluctance to bear its part of the burden when it comes to its own security is discussed by Mr Jamie Shea. Lastly, the on-going developments in the Middle East, which should concern Europe as much as they concern the US, are analysed by Mr. Giuseppe Balardetti. All these papers give a clear indication that the alliance is facing several challenges that still need to be addressed.



**Mr. Jamie Shea,**  
*Deputy Assistant Secretary General  
for Emerging Security Challenges at NATO*

## Keeping NATO Capable

A former NATO Secretary General, George Robertson, used to say that three things were important about NATO: “capabilities, capabilities, and capabilities”. He said at a time when the Alliance’s defence budgets were 30-50% higher than they are today and when NATO was less engaged in large-scale operations, such as ISAF in Afghanistan. However, in stressing the need for NATO to improve its capabilities, he put his finger on a fundamental truth; NATO’s credibility depends upon its capacity to undertake military operations successfully – whether for the collective defence of its 28 member states or to uphold their security interests on a broader global scale. The Alliance is therefore a force multiplier, which by combining the capabilities and expertise of its member states through a streamlined defence planning process, is able to deliver more punch than individual Allies or even groups of Allies could otherwise achieve.

The current financial crisis poses both a major risk and a major opportunity for the Alliance. The risk is that nations will slash their defence budgets in an uncoordinated manner and without transparency, causing NATO to lose core capabilities needed to conduct any major operation, and which will be difficult and expensive to reconstitute later on. The opportunity is that if the crisis proves to be severe and long-lasting, it will finally force the Allies to spend their resources more wisely; for instance through pooling and sharing key capabilities, such as airlift and satellite reconnaissance, and also re-prioritize their defence spending towards those capabilities that are always in demand regardless of the type of military operation. And in this respect, there is still a long way to go. Even today, after half a century of European political integration, 95% of Europe’s military units are nationally constituted and commanded, and 75% of Europe’s defence contracts are not open to international competition.

Moreover, today only eight Allies continue to possess a full-spectrum set of military capabilities; 17 have fewer than 45 000 soldiers in their armies, and five fewer than 10 000. Geographically smaller countries by their very nature, have only been able to provide limited and often niche capabilities, while the Alliance has always relied on the contributions of medium-sized Allies, as well as, of course, major powers such as, the US, first and foremost, the UK, France Germany. The danger today is that these medium-sized Allies might grow less and less capable, thereby placing an even more disproportionate burden on the few larger Allies. In this respect, it is not a good sign that in recent times the percentage of US defence spending, as a part of the overall NATO total, has gone from 50% to 77% today. This is not a sustainable form of burden-sharing.

Necessity has always been the mother of invention. But even the overwhelming pressure of the financial crisis will not by itself be sufficient to improve NATO's capability development without a clear strategy to guide the Allies in their future planning. It is clear that NATO's recent Chicago Summit has proved its value in equipping NATO with a clear road map to steer its way through the financial crisis and emerge as a leaner, but hopefully more capable, organization in the end.

The first initiative, which captured most of the attention, is Smart Defence. It involves groups of Allies coming together to share capabilities in a more cost-effective way, which not only reduces individual costs, but also provides these capabilities to NATO. Chicago delivered three particular capabilities as good examples of this approach: namely, the interim operational status of a European-wide missile defence based on US assets but with European contributions to command and, control, and basing; a long-term solution for Baltic air policing, in which Allies provide the aircraft but where the Baltic States provide additional host nation support; and a NATO intelligence surveillance and reconnaissance (ISR) capability built around the procurement of five Global Hawk drones and a data processing and training facility for ISR at Signonella in Italy. Smart Defence also comprises an initial package of just over 20 multi-national projects in areas such as training and education, spare parts and logistics. Also noteworthy in Chicago were signals from both NATO and the EU that they will endeavour to harmonize NATO's Smart Defence with the EU's similar Pooling and Sharing initiative in order to avoid duplication and increase synergies so that the assets developed in one organization bring benefit to the other.

Other Chicago initiatives, however, may prove just as important in the long run as Smart Defence which has made a good start but still has to become a part of NATO's DNA.

The first point concerns availability. If nations increase and specialize in their defence capabilities, they will rely more on those provided by other Allies.

So there has to be the presumption of availability, that these assets will be made available for NATO operations, and especially the multi-national capabilities developed under the Smart Defence label. It will also help in this respect if nations contributing to multinational capabilities to the benefit of the Alliance can also access these capabilities, or even take some of them back under national command and control for their own national operations. The more multi-purpose, the greater is the financial incentive of these nations to invest in these capabilities. At the same time, many NATO partners have participated significantly in NATO's recent operations, such as ISAF, and their personnel, equipment and doctrine have become increasingly interoperable with those of the Alliance. So it makes eminent sense to include these partners in future Smart Defence projects, as well.

Another key initiative concerns Connected Forces. Once ISAF ends in 2014, NATO may no longer have a major operation to conduct with the risk that much of the interoperability so painfully acquired in Afghanistan, as well as the ability to communicate ISAF-wide through the Afghanistan Mission Network, will be lost as nations return home and re-focus on their geographic neighbourhood and local concerns. This would then make it harder for NATO to package a new operation. Moreover, as NATO's command structure and multi-national staffs reduce as a result of financial cutbacks, the Allies will be more dependent on national HQs and force structures. Therefore, maintaining connectivity through regular exercises, computer simulating models and integrated communications will be essential if NATO is to remain an effective crisis manager able to plan operations and deploy adequate forces within days rather than months. Using NATO common funding more effectively as an incentive for nations to contribute expensive capabilities is also something to be looked at. NATO will also be bolstering its NATO Response Force and special operations forces, which are not only key instruments of immediate crisis response, but also allow Allies to achieve high level training and interact with US forces, particularly at a time when the US is withdrawing two combat brigades from Europe.

Finally, the Alliance will need to enhance its defence planning process to have a better oversight of the rapidly evolving defence plans of its individual members in order to avoid surprises and try to influence national decision-making in a way that is compatible with NATO's own capability priorities. As a part of this effort, it will need to be aware of the core capabilities that have to be protected from budget cuts because they are the force multipliers and to look at ways to invest in new capabilities, such as cyber defence and intelligence gathering, which will become more significant as threats change and non-state actors become more prominent and potentially dangerous. The dialogue with the industry, which has to provide the capabilities, will be all the more important in order to identify the most cost-effective technological

solutions – as sometimes 100% is necessary but more frequently 80% is good enough and significantly cheaper.

To conclude, the years ahead will be tough for NATO to preserve the capabilities, planning and deployment capacities, which have set the Alliance apart from other institutions when it comes to getting the job done. Nevertheless, the implementation of Chicago decisions will certainly produce an Alliance that is better value for money and is still able to effectively counter a full spectrum of security challenges it is going to face in the 21st Century.



**Mr. Damon M. Wilson,**  
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## **The Transatlantic Alliance in the Age of the Pivot**

The Obama administration's announcement of a further drawdown of US forces in Europe coupled with the (over-) hyped US 'pivot' to Asia have left many in Europe questioning the United States' interest in and commitment to Europe's security. Such US decisions against the backdrop of Europe's own financial crisis, accelerating cuts in European defense, and just as a truculent Vladimir Putin returns to the Kremlin with a vision of building a Eurasian Union, exacerbates the sense of insecurity among many of America's allies in Europe's east.

However, drawing linear conclusions from these headlines risks missing the fundamentals.

The reality is that even while Europe suffers from a lack of decisive political leadership and the malaise of the Eurozone crisis, Europe remains America's partner of choice in addressing global security challenges. The US National Security Strategy codifies as much: "Our relationship with our European allies remains the cornerstone for US engagement with the world, and a catalyst for international action." The transatlantic relationship is an essential source of stability in an unpredictable world.

**The United States has invested far too much  
in Europe's security and stability to prematurely  
declare success and withdraw.**

US forces remain a critical component of continental security. The United States, with its Canadian and European allies, must remain vigilant to hedge against a revanchist Russia, to deter worst-case security scenarios stemming

from the Eurozone crisis, to continue building the defense capacity of our closest allies, to assist partners in the western Balkans and Europe's East to meet the standards required for NATO membership, and to continue to serve as a base of operations for regional and global military operations.

True, American forces will continue their decline in Europe from 118,000 in 2001 to about 80,000 this year and an expected 70,000 in 2017. This represents a significant decline and yet US forces in Europe will still far outnumber US forces stationed elsewhere globally. Furthermore, while the United States is no doubt increasing its focus on east Asia, Europeans hardly question this development given the obvious rise of China, the lack of a stable security architecture in the region, and the economic dynamism of the Asia-Pacific.

At the same time, the most likely security challenge the United States will face in the coming decade is not in Asia, but rather in the Middle East. The situations in Syria and Iran today only underscore how real of a possibility this is. And as Libya most recently demonstrated, any security response to events in the region will be from Europe, with Europe.

Furthermore, while no doubt Asia's growth rates are eye-catching, the size of current trade and investment flows across the Atlantic continue to dwarf those across the Pacific.

In this period of so-called American disinterest, the United States has recommitted to the NATO Alliance with a new Strategic Concept and a clear policy of reassurance to our allies in the east. This policy has most notably produced contingency military plans to give credibility to NATO's Article 5 collective defense commitment, more visible military exercises in the Baltic region, and concrete advances in missile defense deployments in Poland and Romania.

But the US commitment to Europe cannot be taken for granted. The US military investment in Europe should remain strong and be made more relevant.

**The new US posture in Europe, to make sense, must focus on helping our closest allies develop the capabilities our Alliance needs to meet modern security challenges.**

The strategic review that drove US force structure decisions is designed to put the right capabilities and right activities in the right places. It is also designed to strengthen our partnership with Europe to address challenges in Europe and across the globe and acknowledges that building partnership capacity remains important for sharing the costs and responsibilities of global leadership.

American forces will be smaller and leaner, but remain agile, flexible, ready, innovative, and technologically advanced. Washington's approach has been guided by America's enduring commitment to sustaining a military presence that ensures our ability to meet our Article 5 commitments, deter aggression, and build allied and partner capacity and interoperability. We have a vested interest in maintaining the hard-won interoperability with our NATO allies and partners earned in Afghanistan, Libya, and Kosovo.

Consistent with the new NATO Strategic Concept, our force posture in Europe will adapt to meet the full range of 21st century challenges. The Pentagon aims to protect investments in the enhancements to the alliance's readiness and interoperability, which provide visible assurance of our determination to uphold our Article 5 commitments. America's new military presence in Europe will be characterized by the following:

The United States will designate a US-based Brigade Combat Team to renew America's commitment to the NATO Response Force. As a part of this commitment, the US military will also enhance multinational training at world-class military facilities in Germany with a focus on full-spectrum operations.

Rotations twice-yearly of a brigade task force from the United States to train with allied and partner units will demonstrate America's ability to deploy and operate in Europe and enhance the training opportunities for European forces while promoting interoperability. As budget pressures increase, those looking to cut costs will focus on the expenses required to deploy a brigade for training. Americans who support the alliance must help ensure we keep our commitment, while our allies should hold us to our word. At the same time, our European allies should invest resources to send more of their forces to train in the continental United States.

The United States will enhance the ability of its forward presence in Europe to address ballistic missile threats. The administration will continue to implement and grow the phased adaptive approach to missile defense in Europe – made even more viable by the announcement of interim capability for NATO missile defense at the Chicago summit. The AN/TPY-2 radar is already deployed to Turkey and transferred to NATO operational control and an Aegis ship is deployed to the eastern Mediterranean. The future basing of Aegis-BMD ships in Spain and land-based SM-3 BMD sites in Romania and Poland represent future and continued US commitment to Article 5 and European defense.

Regional special operations forces' responsiveness will be enhanced by continued partnership with the NATO Special Operations Forces Headquarters.

US is supporting the extension of NATO's Baltic Air Policing mission past 2018 to help ensure the credibility of Article 5 and Baltic sovereignty.

The establishment of the Aviation Detachment in Poland this year will facilitate exercises and training between allied aviation units in central Europe and help allies fully take advantage of their aviation capabilities.

The US military will maintain a Stryker Brigade and an Airborne Brigade in Europe to continue enhancing interoperability and institutionalize the lessons learned in places like Afghanistan, Libya, and Kosovo.

The US military involvement in Europe is changing, but it remains strong and relevant to America's Alliance commitments. The adjusted US force posture in Europe will reinforce a new focus on developing capabilities the Alliance needs to effectively meet modern security challenges. US forces in Europe will continue to invest in enhancements to NATO's readiness and interoperability, and promote the strength, adaptability, security, sovereignty, and territorial integrity of our allies and partners across Europe and Eurasia.

**Even as Europeans struggle to invest in their own defense, deep cuts in America's defense spending will not go so far as to endanger the integrity of the Atlantic alliance.**

But sustaining the transatlantic link at the core of US national security strategy requires resolve on both sides of the Atlantic to maintain the will and the capabilities to tackle together the global security challenges of today and tomorrow.



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## **The Arab Spring in Perspective: Lessons Learned for New Autumn of Nations**

### **Revolts or revolutions?**

Trying to describe whether Tunisians, Egyptians, Libyans, Yemenis and Syrians are leading popular revolts or national revolutions might sound trivial to those concerned by the tangible daily needs of the local communities: job opportunities and less interference by dysfunctional public authorities. Yet the answer will impact on the expectations from and the response to the Arab Spring events. Past revolutions, such as the British Glorious revolution, the French, the Russian and the Iranian revolutions shaped world events and changed the complex system of values that characterized societal behavior and ultimately the human history. Similarly, it is yet to be defined whether Arab masses have been fighting against a corrupt leader and his entourage or against a socio-political system borrowed from Europe, whether they are looking for a new leadership or for a new style of living. As of now, the events of the Arab Spring have not yet produced the thorough innovations required to justify the use of the word 'revolution'. Revolts in Tunisia, Egypt, Yemen, Libya, Syria and others were fueled by economic and social issues as much as by a demand for dignity, and were not initiated by a tough-provoking avant-garde search for a new Arab thought.

The successful revolutionary experiences in Central and Eastern Europe and in the Baltic region were instead based on a deep rooted cohesion of intents amongst average people, intellectuals and ruling elites.

The initial political claims were followed by demands for a new way of life that transformed the revolts against regimes into revolutions for freedom and democratization across the entire spectrum of society. A shared value system got engrained into the revolts and made the democratization process possible. The concept of the Autumn of Nations attributed to the revolutions in Central and Eastern Europe expressed the will of the newly sovereign countries to rejoin their sovereignty, while simultaneously complementing it into the broader European identity.

There has been no Autumn of Nations in Northern Africa, Middle East or Russia recently. The cultural and social system currently in place in these regions is functional for the majority of the people and respectful of their historical backgrounds.

**Revolts in Egypt, Libya or Tunisia are far from being revolutions, but they have a historical opportunity of giving legitimate governments to the Arab peoples for the first time in centuries and winning over the sense of injustice and misconceptions about themselves that many Arabs felt - at least with regards to Europe.**

The Autumn of Nations in Central and Eastern Europe or the Singing revolutions across the Baltics were completely different phenomena than the Arab Spring – and comparably the recent protests in Russia. Diverging root causes provoke the revolts and give weight to different approaches and answers.

## **The sources of the Arab outcry**

The analysis over the root causes of the Arab uprisings is complex, especially because of each country's unique situation. A shared assessment is that local regimes were not able to create proper conditions for economic stability and human fulfillment for an increasing population. The Global economic downturn, poor macroeconomic policies, which led to inflation and corruption, propelled violence against the regime incapable to respond. The kleptocratic governments that failed to pay off their inefficiencies with generous fiscal incentives – mostly derived from oil revenues - have been dismissed. Indeed, economic factors were predominant and they explain the failure of protests in Algeria, Qatar and Oman.

Revolts might also be spurred by the growing assertiveness of Muslim communities towards their governments. The examples set by previous violent mass protests in Kyrgyzstan in March 2005, the 2005 Cedar Revolution

in Lebanon and the 2009 Iranian protests, as well as by the growing role of media - Al Jazeera and blogospheres – represent two important multipliers of the recent revolts.

The most striking element of these revolts is the limited role played by the upper classes. Compared with the European revolutions in the 1990s, or even with the Rose and Orange Revolutions in Georgia and Ukraine, Arab masses have been leading the revolts and the ousting of previous regimes without any substantial support from the local elites, whose role in the revolts was weakened by the accusation of being colluded with the regimes or for having fled the country long ago.

In the post-crisis scenario, the incapability of local governments to meet the need of their people has followed a quite common path: masses ask for rather small concessions, the government crashes their aspirations, demands become more radical, the regime collapse and it is followed by a phase of uncertainty during which disputes between the different factions arise and can lead to a new authoritarianism by the most militant and extremist groups.

## **What are they looking for?**

The Arab countries are right in this phase of uncertainty. None of them has a clear path to institution building, or to the management of relations between the government and the armed forces. More in general unanimity of intent in each country is still lagging behind. After the elections in Tunisia, Libya, and Egypt, the newly elected authorities have not proved to the silent majority of their people their ability to deliver results on the two fundamental public concerns: jobs and dignity.

Economic development and human security shall be the primary goals of the newly elected leadership, as expected by their voters, many of whom cast their ballots for the first time. People leading the revolts in Tunisia and Cairo demanded more jobs, more justice, less corruption and a less intrusive government, as recognized in a report by the African Bank of Development issued in June 2012. Arab masses are looking for a new political leadership, but also for savior administrators, economists, jurists, and engineers, who could lead the country in a way that is compatible with their legitimate desires.

In this context, the Turkish model could play a significant and inspiring role. In Turkey, the dominant party has a moderate religious agenda, an efficient education system that complements the growing economy, a functional job market, proper fiscal stability and sound financial planning that enrich the vibrant middle class, public control over strategic assets to protect sensible

interests. Substantial freedom of press and broad protection of minorities are also guaranteed, despite a major setback with regard to the Kurdish minority.

A new social contract for the Arab societies could be based on the Turkish model. Nevertheless, the basis of the Turkish model resides in a united and educated middle class that is not present in Libya, for instance, and not yet in Tunisia. Moreover a distinctive national identity is not as developed amongst Egyptians or Yemenis, who tend to melt it down into their broader Arab identity.

Whether this social contract will be an inclusive one or not, a pluralistic one or not, an efficient one or not, is yet to be determined, but there are some challenges that political leaders must overcome.

First, they should avoid leaving major communities or groups outside the constitutional framework, thus growing seeds for ethnic conflicts or civil war. The sense of not sharing a national identity amongst all Libyans, Lebanese, Syrians or Bahrainis is a source of great concern. It is very hard to draw clear demarcation lines across nationalities, ethnic groups and religious minorities in the region, mostly in the Middle East and to a lesser extent in Northern Africa. In other words, political leaders should find a synthesis between the different ethnic, religious and social groups, which now demand the right to be represented and to live in a society they can identify themselves with. If it does not happen, unfortunately the next step could be another Yugoslavia or hopefully another Czechoslovakia.

Secondly, they should define a form of governance that ensures functional bureaucracy, sound administration of the public good and efficient and impartial justice. Implementing reforms for effective justice will be crucial for the credential of the local government. The abuse of power and corruption will not be eradicated overnight, but the fight is worth winning.

Thirdly, they shall promote greater regional cooperation across countries with similar backgrounds and aspirations, starting with commerce. The absence of substantial trade and mutual investments across the region is simply unsustainable vis-à-vis a rationale economic programming.

These recommendations are also highlighted in the Arab Human Development Report of 2012, which underlines the importance of 'empowerment' for the Arab masses. Empowerment is authority, responsibility and leadership, but it is also autonomy, independence and individual freedom. As a result of several decades on authoritarian regimes, and as a consequence of the absence of any hierarchy within Islam, many commentators believe that the modern Muslim communities do not support the concept of an official or authoritative view anymore, yet they remain conservative in their social and cultural behaviors.

The political and social processes now underway still have to prove successful, but some concerns already arise among commentators, thinkers and policy makers.

Muslim values and behaviors are already implemented and respected in several Arab societies. It would be naïve to believe that the sentiments of the majority of the population in favor of a more religious approach to society are new. Moreover, there is already more than one religious approach to society, eight at least – as many as the legal school of thoughts. It must be said that in Arab Muslim societies, pluralism is not a novelty. The opposing factions are disputing on whether the society needs a new interpretation of the religious phenomenon or not. Empowerment promotes diverging views on what a common future should look like, but with regard to religious matters, positions may get polarized very quickly. This process in a country without strong national sentiments and diverging views on religion, may lead to anarchy, as even reformist groups are now concerned about.

Moreover, the gap left by the intellectuals, who have not joined the revolutions, is now being filled by what can be defined as a religiously driven establishment, who puts Islam before local identities. This is definitely a response to the Arab nationalism and laicism of the past thirty years, but it has the counterintuitive problem of melting local, tribal, and national identities into a broader identity who does not respond to constitutional boundaries, in a somewhat similar process that misled Europe to the Thirty Years' war.

Nevertheless, a certain degree on instability for a limited period of time is a necessary step in the process of regenerating a country, as it was experienced in Central and Eastern Europe during the 1990s.

## **Comparing the experiences: the Arab Spring, the Singing Revolution and the Autumn of Nations**

The Arab revolts are characterized by a unique mixture of different features, some of which were not present in Central and Eastern Europe about twenty years ago.

The transformation that changed Europe from 1989 to 1992 brought a new political, economic, social and cultural system across the region. The autumn of Nations was not.

First, the Arab revolts were mostly a fight of the poor against the established order; the cultural elites - most of who were either involved

with the regimes or had abandoned the country - have not been a part of the protests. There were no Lech Walesas or Julia Timoshenkos in Tunisia, Yemen or Egypt leading the fight and then taking over the new democratic course in their country. In Europe, the common approach established by trade unions and intellectuals made it possible to give 'power to the powerless', as written by the Czech novelist, President and national hero Vaclav Havel. This union of intent made the transition rather smooth and non-violent, and also gave a long-term vision to the countries. The project of a Europe whole and free - almost immediately heralded by a forward-looking Western European leadership - was able to unite almost entirely the civil society and the political leadership in the region.

Secondly, Arab revolts stems purely from national issues and their scopes have been limited to national reforms. While Tunisians fought the Ben Ali regime alone, the leaders of the revolts in Europe fought against the broader Soviet system and its implication on their country's stance in the global arena. Political leaders in Central and Eastern Europe were a part of a broader system, the Soviet bloc, where one member was more equal than others. More and more, the system was perceived as extraneous and as imposed upon countries. Collaborators were in the country, but the engine of the system was outside and the local elites were left at the margins. The Signing Revolution in the Baltic Republics was not only a quest for independence, but a revolution of values and a transformation of principles, yet unseen in any Arab country. The USSR was not only a political adversary, but also a cultural enemy to be dismissed. Vice versa, the current Arab revolts are not against the basic structures of society, but they follow an evolutionary path aimed at reforming the country leadership and restoring the good. Actually what is emerging is a conservatory path, a search for the original Muslim social contract that some feel to have been betrayed by the previous laic regimes.

Religion, therefore, is probably the most striking different between the Arab experiences and the European revolutions of the 1990s. Interestingly, in the Russian revolts of 2011-2012, the Orthodox Church played an important role in favor of the status quo, marking the resurgence of religious nationalism in Russian politics.

Thirdly, the social and economic scenario depicts a gloomy picture, which includes a global economic downturn that impedes a speedy recovery; a small amount of skilled labor force contributing to rebuilding the country; and the cultural distance with major economic partners, Europe and North America, whose markets attract thousands of migrants. Yet, the economic frustrations that the Arab people are experiencing today are similar to those of Central and Eastern Europeans in the early nineties, when their economies opened up to global competitions. It took five to ten years to return to the Cold War

levels and a huge price was paid in terms of emigration, costly labor market transformation and security sector reforms. Moreover, the Arab cultural, religious, social and political traditions are creating larger apprehension amongst communities in Europe, compared with the strains that Polish, Romanian, and Bulgarian expatriates experienced about twenty years ago.

Another important difference lies in the diverging views on the strategic outlook of the region. The shared perspective amongst Latvians, Slovaks, or Bulgarians on where they want their country to go, combined with a strong and unmatched attractiveness of the European project - both in its NATO and EU components - contributed to unifying strategic expectations across the region. In the post-Arab Spring environment, this unity of intents is not yet there, since conflicting priorities, perceptions and animosities are still prevailing. Similarly, it must be noted that the traditional external foes - usually Israel and the United States - are left outside the picture, since demonstrators concentrated on the internal enemy, which is another striking difference with regard to the opposition movements against the USSR in Europe.

Comparably, though, the transformation processes in Central and Eastern Europe have not happened overnight. It even suffered serious setbacks in the Balkans and took twenty years to be almost concluded.

More recently, debate sparked over the possibility of similar transformation processes in Russia, following the demonstrations in 2011 and 2012. Nevertheless, the political demonstrations, which have taken place in Russia since last year, are not linked with the Arab Spring phenomena and are not rooted in the same causes. In early 1990s, the Russian society was already hit by massive protests, coups d'état and violence. Putin had an easy task in playing with the average Russians' fears of uncertainty and chaos. Global pundits and educated elites might find it easier to trade the relative wealth of today for some more substantial democracy tomorrow, yet the government control over public opinion and the lack of a common platform amongst protesters stopped the processes. The two lessons learned emerged after the protests: on the one hand, the government has to reform the political and economic patronage system engaging the potential development of a strong and stable middle class into the limit of a referential autocracy; and on the other hand, the one-party/one-man system came to an end with the tandem of Putin/Medvedev, which allows diverging views, even if in a timid and controlled way.

Even though the Russian protests marked an important moment for Russian democratic oppositions, their results were meager, as none of the objectives were achieved.

## What could Europe's reaction be?

The Arab peoples are leading this process and determining their own preferable future. They might try to convert the revolts into revolutions, and it is clear that they wish to do it only with their own intellectual resources. Meanwhile

### **Europe has to deeply revolutionize its approach to the region.**

“It is in the European interest that countries on our borders are well-governed. Neighbors who are engaged in violent conflict, weak states where organized crime flourishes, dysfunctional societies or exploding population growth on its borders all pose problems for Europe”. This assessment was written down in the European Security Strategy of 2003 and is still valid today. In this framework, the role for Europe, both in terms of its countries and of the Union, is twofold.

On the one hand, Europe should promote a comprehensive approach based on mutually beneficial agreements and on collaboration among multilateral institutions. In this context, the Three M's buzzword (Money, Market, and Mobility) must work out for both, otherwise Europe would lose its already feeble credibility. The patronizing approach towards the region by many Europeans, in Brussels as well as in many capitals, is now even more distressing for the local authorities fully legitimized by elections, yet still educated à la occidentale.

On the other hand, Europe shall re-launch its strategic partnership with the Mediterranean countries, building on a comprehensive package that includes stronger economic, social, political and cultural relations, such as:

- To encourage the strengthening of the Arab League's 'Greater Arab Free Trade Area', as the natural counterpart with European Union on economic and trade matters;
- To launch and finance the European Endowment for Democracy, to work as an instrument for political, cultural and societal engagement with Arab societies;
- To negotiate and ratify serious and profound free trade agreements in the fields of services and agriculture based on mutually beneficial conditions, similar to those signed by the United States with Jordan and Morocco;
- To collaborate on the security sector reform and joint military exercises within the NATO tailored partnership framework;

- To guarantee a proper level of insurance and financial capacity to European companies and PMI investing in the region by expanding the competences of the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) of the European Investment Bank and of the European Bank for Reconstruction and Development;
- To support private initiatives to provide training and technical education for the local population, especially the unemployed, in coordination with the World Bank initiatives;
- To encourage the creation of free or special economic zones for trade and commerce in Northern African countries.

Grand strategies, fixed conditionality, promising pledges and double standards must be forgotten. An approach based on the same conditionality as applied to Central and Eastern European countries will be a failure. Its successful implementation can be taken as an example, only if there is agreement that Northern Arab countries will once join the EU. Indeed, the whole mechanism of incentives and expectations is not applicable to countries that cannot or do not want to join the EU.

## Conclusions

The Arab Spring phenomena and their impact on global security are yet to be unveiled, but two conclusions may already be drawn and they both have implications for the transatlantic community.

The revolts in the Arab world began for economic reasons, but they might impact on the strategic balances in the region, especially if the Arab peoples develop a more assertive perception of themselves. This process is still speculative, but efforts are underway to influence it, especially by Arab and Islamic groups from the Gulf, who seek to expand their political and economic reach-out. European and North American pundits and think tanks must encourage, sustain and influence the process in order to ensure greater mutual respect and understanding, as well as a more friendly approach towards broader Euro-Atlantic strategic orientation by the Arab peoples.

### **Europeans have a great historical opportunity to finally get it right with their Arab neighbors.**

The growing numbers of local economies, paired with the huge masses of workers and immigrants that are tied to the European economies and lifestyle, impose a steadfast adaptation and political response by the European Union and its members, in order to offer what is really needed: a strong and deep economic partnership beneficial for both. A path that includes free trade

agreements and joint training is probably what Europe can really offer. Europe must not miss this chance, or others - China, Turkey and Gulf countries - are ready to take its place.

Finally, the transatlantic community and NATO have an opportunity to develop a new cluster policy with their Arab partners based on mutually agreed priorities. NATO's expertise in education and training can contribute to the development of skilled and equipped Armed Forces defending regional stability. Alliance's capabilities in cyber-defense and C4ISR can contribute to defining a new role for Armed Forces in the region. Tailored partnership with Arab partners should also be pursued. A Joint Political Declaration with the newly elected leadership of Libya, Egypt or Tunisia could represent a political success for a globally interconnected Alliance that looks at its own security, as much as to those of its partners in the region. Such a declaration, already signed with other like-minded partners – such as Australia – would be the first with an Arab state and it will be an incredible boost for the Alliance's stance in the Arab world and its contribution to regional security.



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## Baltic States and NATO

There is one thing about the Baltic States that makes them stand out among other states, namely, it is the fact that they can be discussed as examples of both success and failure at the same time. With the onset of the financial crisis in 2008, there was much talk about demise of the Baltic Tigers, although a few years earlier Lithuania, Latvia and Estonia had been regarded as examples of rapid economic growth. With double-digit economic contraction in 2009, the Baltic States could only be regarded as failures. More recently, however, there have been reasons for optimism. Even though Latvia had the worst economic performance among the Baltic three during the economic crisis, years 2011 and 2012 are marked with a return to economic growth.

Should the Baltic States be regarded as failures because of their economic performance during the crisis or should they be considered as successful examples of implementing responsible policies in order to overcome the economic downturn? There is little agreement on this issue, as well as many others. The Baltic NATO membership is not an exception, therefore this article proceeds by first outlining the main reasons of why the Baltic States' integration into NATO can be regarded as a success story, while the second part discusses some of the problems of the Baltic NATO membership. Although usually Estonia is singled out as more successful than its southern Baltic neighbours, this article takes as an initial assumption that the Baltic States have a lot in common when it comes to NATO. Some of the main challenges to the Baltic NATO membership in the years ahead are outlined in the concluding part.

## **Baltic States as a success story...**

The Baltic NATO membership is largely a success story. The three tiny Baltic republics restored their independence after the collapse of the Soviet Union and in slightly more than ten years managed to become fully-fledged members of the EU and NATO. The Baltic nations feel positive about NATO membership, although, somewhat predictably, their ethnic Russian population has less warm feelings towards the alliance. Among the Baltic political elites, there is not much disagreement about NATO membership. Even if some political parties are sceptical about NATO membership or the usefulness of participation in the ISAF mission in Afghanistan, the scepticism is either kept in opposition or seldom voiced.

The Baltic States have managed to convince the alliance partners to address their security concerns after the 2008 Russian-Georgian war and the 2009 joint Russian-Belarusian military exercise “ Zapad”, which was held near their borders. The Baltics have hosted a number of NATO military exercises over the past few years as a part of the reassurance effort. If one can believe the information made public by Wikileaks, NATO has developed contingency plans for the Baltic States. In addition, the Chicago summit saw the Baltic air policing mission extended indefinitely, and, perhaps ironically, this mission has become a model example of smart defence.

**Within NATO, the Baltic States are perceived quite positively largely because of their commitment to the alliance and substantial participation in the ISAF mission in Afghanistan.**

Even more importantly, the Baltic contribution to the ISAF mission has increased during the crisis. The Baltic States have also expressed commitment to contribute to security and development in Afghanistan after 2014, when the Afghan National Security Forces are scheduled to take full responsibility for security in the whole country. To a large extent, participation in the ISAF mission has become the defining element of the Baltic NATO membership, and the end of the mission at some point in the future can raise questions about the Baltic contribution to the alliance and shift the attention of other alliance members to the lagged defence spending in Lithuania and Latvia.

Two of the Baltic States – Estonia and Lithuania – have managed to become host nations for NATO Centres of Excellence (CoE). Estonia has hosted the NATO Cooperative Cyber Defence CoE since 2008, and a positive decision with regard to the NATO Energy Security CoE in Lithuania was taken in 2012. When countries join international organizations, they aim to get as much as possible from their membership in the particular organization. Practically, every EU member state hosts an EU agency, and there are signs that a similar way of thinking exists in NATO. Lithuania, Latvia and Estonia are small states

that share a border with Russia and are concerned about their security; therefore they have a strong interest in hosting NATO infrastructure on their land as this would strengthen the credibility of the alliance. Establishing NATO CoEs and making sure that they provide real added value to all members of the Alliance is another way of making sure that other NATO member states have a stake in security of the Baltic States.

## ...or a failure?

**If not for substantial participation in the ISAF mission in Afghanistan, Latvia and Lithuania would be widely regarded as free riders, because their defence spending is far below the required 2% of GDP.**

Until late 1990ies, the Baltic States spent a relatively small proportion of their GDP on defence. Back then, Latvia lagged behind Lithuania and Estonia with spending less than 1% of GDP on defence in 1999. It seems that it was only possible to increase defence expenditure because of the prospect of NATO membership and conditionality that came with it. Otherwise, defence spending was likely to remain low. In the run up to 2004 the Baltic States managed to get their defence expenditure close to the required 2% of GDP. However, it remained somewhat below the 2% threshold in the following years not least because of the breakneck pace of economic growth and limited ability of the Baltic militaries to absorb the rapidly increasing defence expenditures (in absolute terms).

The pattern of defence spending during the economic crisis in the Baltics reveals that the level of preparedness among the Baltic States was very varied. The Estonian defence spending decreased in real terms but was kept almost constant as percentage of GDP, while in Latvia and Lithuania defence spending contracted both in real terms and as percentage of GDP. In Latvia, defence spending decreased to 1% of GDP during the crisis, but in real terms it fell by almost a half. In Lithuania, the decrease of defence expenditure was, on the one hand, more dramatic as it fell to 0.8% of GDP, but, on the other hand, the decrease was not as dramatic as in Latvia in real terms. Estonia managed to reach the desired 2% of GDP defence spending threshold in 2012, but Latvia and Lithuania are far behind. It is far from clear if their plans to get back to the 2% mark in 2020 or 2024 will materialize. Knowing that the defence sector is not the only one to have suffered during the economic downturn, the competition for additional government allocations will be fierce in the years ahead. Of course, it may well be that Latvian and Lithuanian militaries emerge leaner and more efficient after forced austerity measures, but this is far from certain.

## Challenges ahead

There are several challenges that the Baltic States will have to face in the coming years. The most obvious challenge will be for Lithuania and Latvia to meet their NATO obligations in terms of defence spending. The Baltic States have tried to project the image as being responsible members of the alliance, who take security seriously and are willing to contribute to international security. Until now deficiencies in terms of military spending have been masked by their unwavering contribution to the ISAF mission. However, NATO presence in Afghanistan is about to wind down in the coming years, and the question of military spending will inevitably resurface. Their image will be tarnished, if the Baltic States (Lithuania and Latvia) are not able to meet the expectations of other alliance members (especially, the United States) in this respect.

The second challenge will be strengthening Baltic cooperation by moving beyond the current defence cooperation projects into joint procurement. The Baltic cooperation was facilitated by their western partners during the 1990ies when NATO membership was still a distant objective, but cooperation efforts receded after 2004. Joint projects were not abandoned, but cooperative efforts failed to move to a whole new level. However, common interests within NATO have pulled the Baltic States back together, and they are likely to jointly procure ammunition. Hopefully, it is just the beginning of joint procurement efforts. Also, the defence ministries of the Baltic States have agreed to assess the possibility of establishing joint Baltic military headquarters.

The third challenge is related to the performance of the two NATO CoEs in Lithuania and Estonia. There is little doubt that cyber security and energy security are very relevant issues not only for the Baltic States, but also for other alliance partners. However, it remains to be seen whether with the assistance of their alliance partners the Baltic States can make sure that these CoEs on energy security and cyber defence provide real added value for all NATO member states. The Baltic States already cooperate in both CoEs as sponsoring nations and it is in their interest to develop these centres into much valued instruments that enable addressing security concerns of all NATO member states.



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## Complicated Neighborhood

Nobody can choose their family to be born in. The same is true about countries' neighbors. As Edward Lucas wrote in *The Rīga Conference Papers 2011* a year ago, „Life next to an autocratic, neo-imperialist country will never be comfortable.” The Baltic countries' eastern borders are not just the borders of NATO and the EU, unfortunately so far they have also been the frontiers where democracy and authoritarianism meet. In the Freedom House *Nations in Transit 2012* report, Latvia, along with its two neighboring countries – Estonia and Lithuania – have been categorized as *Consolidated Democracies*. Two other Latvia's neighboring states – Russia and Belarus – were placed at the bottom of the rating, in the category of *Consolidated Authoritarian Regimes*. Unfortunately, the legislative amendments made in Russia and Belarus in 2012 indicate that the political elites of both countries are not going to introduce any considerable changes to the existing situation.

The amendments to the Belarusian law *On the State Security Bodies of Belarus* adopted in June stipulate that Belarusian KGB officers will have even broader authority allowing to use force with minor restrictions and freely gain access to citizens' apartments. Besides, the broad scale amnesty of imprisoned persons based on a decree issued by Alexander Lukashenka and dedicated to the Belarusian Independence Day (July 3) has not been applied to political prisoners. Many people charged with “defamation of the President” and “activities directed at undermining the image of the Republic of Belarus” remain imprisoned.

If Europe has no illusions regarding Belarus, then the recent Russian legislative initiatives aimed at restricting activities of non-governmental organizations make the life of Russia lobbyists in Europe harder. The law

adopted by Vladimir Putin in July will force non-governmental organizations engaged in political activity to register with the Justice Ministry as “foreign agents”. Besides, this summer the State Duma also passed a “defamation” law, which may restrict activities of opposition in social networks and media.

The European Union is interested in having secure and democratic states next to its borders - at least such principles have been included in the EU Neighborhood Policy objectives. However, Latvia as an EU member state has chosen to focus on economic relations with Russia and Belarus, in most cases leaving the normative foreign policy to Brussels. The EU normative foreign policy, which envisages spreading democracy, the rule of law and observation of human rights, may not be assessed as very successful in the cases of Russia and Belarus. Since the beginning of Putin’s second term of presidency, Russia has moved from making excuses for democracy problems to a “normative counter-attack”, announcing that it, similarly as China, has its own norms to follow when implementing its foreign policy, such as sovereignty and non-interference in other countries’ internal affairs.

In its turn, the reaction of Belarus to the normative criticism on EU’s part on most occasions is expressed in the form of ignoring or pointing out to a lack of consistency in the position of the EU, which, according to Belarus, applies more moderate requirements toward the countries exporting natural gas and oil.

Being the EU and NATO member states, do the Baltic countries need to worry about what is happening outside their borders? Not to mention the broad scientific discussion on whether non-democratic states can have a peaceful foreign policy, it should only be noted that, unlike Belarus, Russia’s foreign policy is capable of exerting a stronger influence on the processes in its neighboring countries. In spring 2012, Latvian security services indicated that Russia’s policy toward compatriots and the mass media under control of the Russian state authorities have a negative impact on the social integration process in Latvia. From the military point of view the border of Latvia as a NATO member state shall be respected, nonetheless the anti-NATO, anti-US and anti-democracy propaganda coming from Russia ignores this border. Latvia’s partners in NATO and the European Union should keep in mind that these are not just the Baltic countries’ frontiers – these are our common frontiers.



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## **Belarus: is Integration in the Eurasian Union a Substitute for Economic Reforms?**

Since the beginning of transition, the Belarusian economy has been dominated by the state, which produces three quarters of GDP and employs most of the labor force. State involvement in the economy—through subsidies, directed loans, price controls, or mandatory output targets—has allowed the government to maintain virtually full employment and generally stable income growth, but has hampered competition and the flow of labor and capital to new sectors.

In some respects, the state-dominated model has served the country well. Belarus avoided a deep and protracted transition recession, the enterprise sector did not suffer from breakdowns of corporate governance as experienced in the neighboring countries during mass privatization, no class of oligarchs has emerged and the distribution of income has remained relatively equal. At the same time, it is questionable whether the Belarusian model is sustainable, particularly given its dependence on relatively inexpensive energy from Russia and unhampered access to Russia's large and relatively protected market in the past. The macroeconomic instability experienced in the last two years could be viewed as a warning sign in this regard. This article examines this question in light of Belarus' policy to integrate in the Eurasian Union. Will this give the Belarusian economic model a new lease on life? Or might it even accelerate its demise?

Over the past two years, Belarus has lived through a turbulent period. As real wages grew faster than labor productivity, the profitability of the enterprise sector suffered. Because social safety nets are provided through enterprises, the state sector was not allowed to shed labor. As the government increased social expenditures and wages during the 2010 presidential elections, directed large volumes of loans to state-owned enterprises and farms and expanded the large residential construction program, macroeconomic vulnerabilities built up steadily before culminating in a balance of payments crisis in the spring of 2011. Initially, the authorities adopted various unconventional policies to mitigate the crisis without adjusting real household income and consumption levels, including by rationing foreign exchange, price and export controls and mandatory repatriation of export proceeds. However, after several months, these policies were largely abandoned and more conventional stabilization policies have been pursued since then. The exchange rate was devalued. The policy interest rates were raised. Public expenditures, in particular on directed lending programs, were curtailed, and the central bank was taken out of the directed lending business.

Both the crisis and the post-crisis stabilization coincided with the country's deepening integration in the Eurasian Economic Union. The integration process had important immediate benefits for Belarus. Some sectors most likely benefited from a greater effective rate of protection as all countries of the union adopted common external tariffs. Access to Russia's and Kazakhstan's markets was further simplified as customs borders were dismantled. Labor mobility further increased as citizens of all three countries were allowed to live and work anywhere in the union. The country's terms of trade improved significantly as prices for oil and gas consumed in Belarus were brought down to the level of Russia. The EurAsEC Anti-Crisis Fund has provided funds used by the central bank to stabilize the currency.

**Does it mean that now that Belarus is integrated in the common economic space with Russia and Kazakhstan, the country's economic model based on state ownership, full employment, directed lending and steady growth of income for all is permanently secure?**

Both the experience of the past year and the expected evolution of policies within the customs union suggest that the integration in the customs union bought some time for the Belarusian authorities to pursue reform, but did not give the current model a permanent lease on life.

Last year's crisis demonstrated that in addition to various benefits, the integration has created pressure on the Belarusian authorities to pursue more market-friendly policies. Thus, as the central bank attempted to maintain the pegged exchange rate after running out of reserves, the foreign exchange

market moved off shore, primarily to Russia, and settlements for transactions with Russian enterprises switched to the local currency, in line with the community agreements, thus hiding the real exchange rates. Price controls on food, consumer goods and petrol also turned out to be unsustainable as traders took advantage of the customs-free border with the Russian Federation. Although the list of goods subject to price controls increased during the crisis, price levels for trade-able goods were brought up towards the international equivalents.

Integration in the customs union is expected to exert further pressure on the Belarusian economy over the longer run.

**As Russia pursues liberalization policies in line with its commitments under the WTO accession, relative advantage of Belarusian enterprises from free access to the relatively protected market and high effective rate of protection will decline.**

When joining the WTO, the Russian Federation committed to reduce external tariff over time, including for a large range of agricultural products. Several service sectors will benefit from liberalization, including telecommunications, banking, insurance, transport and distribution. Some manufacturing enterprises, involved in the assembly of consumer electronics from inputs imported from South-East Asia have already suffered as their production costs increased. In the longer run, Belarusian manufacturers will also be affected by the non-symmetric treatment vis-à-vis the rest of the WTO members as Russia's WTO trading partners will effectively have free access to the Belarusian market while Belarusian manufacturers will not have free access to the WTO members' markets until the country is a fully fledged member of this organization.

Under the terms of WTO accession, the Russian Federation has also committed to provide no subsidies to local enterprises and ensure that the gas sector is commercialized. As energy prices increase in Russia, the Belarusian real sector will also be affected. Furthermore, as global energy prices soften, the country's terms of trade may worsen as the energy price discount on the international level would decline. It should not be ruled out that both Russia and Kazakhstan would continue raising domestic energy prices to the international levels over time to replenish international reserves and better target the now untargeted subsidies. The policy of transferring revenues from exports of petroleum product produced by Belarusian refineries from the Russian oil may also be more thoroughly enforced over time.

Access to capital by the state enterprise sector is also likely to become more complicated over time. After years of expanding directed lending, the government had to cut back on its directed lending programs and better

target them. Although large state owned banks continue to dominate the banking system, they are now competing with other commercial banks for depositors, including Russian state banks, which are run more commercially. They are also less able to tap central bank funding now that the central bank balance sheet was significantly weakened by the large stock of currency swaps offered to commercial banks before the last year's crisis. Gross public debt increased steadily, to around 50 per cent of GDP at end-2011, further complicating the government's ability to leverage its balance sheet to expand domestic lending programs.

As the country already went through the demographic transition and labor force is shrinking, it will be critical to increase labor productivity in order to sustain income growth over time. It is becoming increasingly clear that it will be necessary to allow state owned enterprises to shed some of the labor to enable new sectors to develop. Furthermore, easy mobility of labor force within the union of countries suffering from the Dutch disease and thus offering high wages in the non-tradable sectors would likely lead to rising emigration.

Assistance from Russia is also becoming more conditional than before. The reported conditionality under the lending program by the EurAsEC Anti-Crisis Fund to a significant extent resembles that under the previous IMF-supported program. In particular, the program requires that the authorities replenish international reserves to 2 months of imports, including by generating significant privatization revenue; reduce directed lending to 1 per cent of GDP (from around 5 per cent of GDP before the crisis) and transfer such programs to the newly established development bank; and reduce general government deficit by rationalizing expenditures and subsidies. The program targets low budget deficit and tight monetary policy. Although it may be less stringent than a potential follow up IMF program would be, the lending program is generally supportive of country's transition to a more liberal economic model.

**Overall, the coexistence of the three countries in the economic union would require greater approximation of their economic models over time.**

Although Kazakhstan and Russia are yet to reach the level of post-socialist transition of the new EU member countries, they have much more liberal economic models. At the same time, Belarus ranks at the bottom of the EBRD's transition indicators ranking. First generation reforms—including commercialization and privatization of large enterprises, liberalization of prices, opening up of the economy to external trade and introduction of effective competition policy and banking sector reform—have been significantly delayed.

To some extent the Belarusian authorities have started to work on future reforms. Positive measures include improvements in the environment for small and medium-sized enterprises, streamlining of taxation, and limited privatization. In 2010, the authorities outlined an ambitious reform agenda in Presidential Directive No. 4, which aimed to further liberalize the economy, strengthen the protection of property rights, modernize the financial sector and attract significant FDI. The initial wave of reforms led to lower de jure barriers for the private sector, to some extent reflected in the World Bank's improved Doing Business rating for Belarus. However, reforms slowed down during and after the crisis as the government had once again focused on supporting incumbent state-owned sectors. The big question that remains open is whether Belarus will be able to transit to a more competitive market-based economy avoiding a significant transition recession and large polarization of income and wealth in the economy and whether this can be achieved under the current political regime or it requires opening up the country's political model to greater competition.



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## **Upcoming Parliamentary Elections in Belarus – yet Another Chance to Consolidate EU’s Policy**

The upcoming parliamentary elections in Belarus (September 23, 2012) – most likely, vote-rigging – is going to be yet another litmus test for EU’s policy towards this country. What could be the solutions and guidelines to pass it? For the past 15 years, the 10-million autocratic state has challenged the Union’s aspirations to surround itself with a belt of democratic, stable and friendly neighbours.

**Admittedly, the failure of the EU’s efforts can be attributed not only to the manoeuvring of Alexander Lukashenko’s regime, but also to its own disunity and indecision.**

Many factors are in play, some of which can be influenced and others cannot. Still, the argument of this paper is that, by consolidating and strengthening its efforts, the EU can achieve tangible and positive results in its relations with Belarus. The tasks now are to analyze the situation, identify the possibilities and impediments and work out a coherent action plan.

Here, one might ask, whether the democratization of Belarus is really a worthwhile goal. The position of the author is that the EU should pursue it, overhauling/adapting its policy and taking a more daring, longer-term view. The situation of the Belarusian society continues to deteriorate, not least due to the unsustainable economic policy. Also, it is in the interests of the EU as a whole and all its individual neighbours to have a stable, democratic and prosperous neighbour, which does not interrupt gas supplies or endanger foreign investments. Further analysis builds on this premise.

## Background and overview of the state of play

A. Lukashenko came to power in 1994, consolidating his authoritarian regime in a few years. The EU interrupted virtually all relations with Belarus in 1997<sup>1</sup> until approximately 2004 and afterwards remained a passive observer to a great extent. Things began to change around 2004, as the newly acceding countries had much more interest in Belarus. That year, for the first time, the EU imposed a travel ban on some key supporters of the regime. In 2006, it also produced a list of potential benefits for the regime if it truly liberalizes, the famous “non-paper.”<sup>11</sup> The overall approach, however, remained that of strict conditionality – “more for more, less for less.” In the case of Belarus, it was “less”, so the EU focused its support on democratic opposition.

As this policy did not bring any results and as some of the “new” member states desired to develop economic cooperation with Belarus and lessen Russia’s influence over it, demands for constructive engagement with the regime grew within the Union. In 2008, a shift took place: the EU opted for dialogue with Lukashenko, intensified technical cooperation and even considered enticing Belarus with macro-financial assistance.<sup>12</sup> Additionally, Poland and Sweden came forward with the Eastern Partnership initiative, which, unlike the European Neighborhood Policy (ENP), included also Belarus. The EU never gave up demands for democratization, and the thaw was far from absolute. However, it gave grounds for saying that the Union was, to an extent, driven by its own (some of its members’) selfish motives. A. Lukashenko on his part freed political prisoners and made some other, half-hearted steps towards normalization of relations, which were enthusiastically welcomed by the EU.

Belarusian administration, however, did not consider liberalization seriously, which was proved by its behaviour in the last presidential elections (2010). The EU, on its part, promptly returned to the strict conditionality policy, again freezing cooperation and, in 2011, for the first time imposing direct economic sanctions, which were expanded in 2012 to cover in total

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<sup>1</sup> The EU decided, inter alia, to suspend ratification of the mutual Partnership and Cooperation Agreement (signed 1995), to severely limit all ministerial level contacts and freeze assistance programmes. See „Council Conclusions on Belarus,” 15.09.1997, Bulletin EU 9-1997, Europa portal, <http://ec.europa.eu/archives/bulletin/en/9709/p103056.htm>. The history of EU-Belarusian relations has been elaborated in more detail elsewhere, see e.g. Margarita M. Balmaceda et al., *Back From the Cold? The EU and Belarus in 2009*, ed. Sabine Fischer, Chaillot Paper No. 119 (Paris: European Union Institute for Security Studies, November 2009), <http://www.iss.europa.eu/uploads/media/cp119.pdf>

<sup>11</sup> Non-Paper „What the European Union could bring to Belarus” [November 21, 2006], [http://eeas.europa.eu/delegations/belarus/documents/eu\\_belarus/non\\_paper\\_1106.pdf](http://eeas.europa.eu/delegations/belarus/documents/eu_belarus/non_paper_1106.pdf)

<sup>12</sup> Council of the European Union, „Conclusions on Belarus”, 3041st Foreign Affairs Council meeting, Luxembourg, 25 October 2010, [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/EN/foraff/117326.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/117326.pdf)

32 enterprises close to the regime.<sup>iv</sup> Only this time is different in that there is much less unity within the EU.

**While some of the countries were quick in condemning the post-elections situation in Belarus,<sup>v</sup> others – evidently due to the pressure of economic lobbies augmented by the economic crisis – tried to prolong the détente.**

In fact, the current economic sanctions against Belarus do not affect some of the companies having most business with the EU – due to objections mainly from Latvia and Slovenia (some sources also mention Italy and Lithuania<sup>vi</sup>), which defended their own narrow economic interests.<sup>vii</sup> One can identify several groups of states: the supporters of democratization and strict conditionality (e.g. Belgium, France, Germany, Poland etc.); the moderates, trying to balance EU's current policy with their own interests (where one could currently classify Latvia, among others); and some rather marked "pragmatists", for whom the democratization of Belarus is evidently not a priority (e.g. Lithuania, Slovenia). Additionally, a sort of indifference/lack of commitment persists, both at the national and the EU level. For some reason, even the sanctions against officials are not fully enforced.<sup>viii</sup> The Union is still capable of a coherent policy towards Belarus – some economic sanctions were introduced after all. Internal disagreements, however, are a factor to consider.

## Factors to take into account

The reasons for the EU's failure to democratize Belarus stem from a conjunction of factors, some of which are internal to the EU itself and others – external. This compilation may not be exhaustive, but it does attempt to show different facets of the situation.

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<sup>iv</sup> „The EU and Belarus: A Factsheet”, 23.03.2012., European Union @ United Nations, [http://www.eu-un.europa.eu/articles/en/article\\_12009\\_en.htm](http://www.eu-un.europa.eu/articles/en/article_12009_en.htm)

<sup>v</sup> See e.g. Carl Bildt, Karel Schwarzenberg, Radek Sikorski and Guido Westerwelle [Sweden, the Czech Republic, Poland and Germany], „Lukashenko the Loser”, The International Herald Tribune, December 23, 2010, <http://www.nytimes.com/2010/12/24/opinion/24iht-edbildt24.html>

<sup>vi</sup> „Europe's Economic Sanctions As A Symbolic Gesture”, 22.06.2011., Belarus Digest, <http://belarusdigest.com/2011/06/22/europes-economic-sanctions-symbolic-gesture>; Joanna Hyndle-Hussein and Kamil Kłysiński, „Limited EU economic sanctions on Belarus”, 28.03.2012., Centre for Eastern Studies, <http://www.osw.waw.pl/en/publikacje/eastweek/2012-03-28/limited-eu-economic-sanctions-belarus>

<sup>vii</sup> Joanna Hyndle-Hussein and Kamil Kłysiński, „Limited EU economic sanctions on Belarus”.

<sup>viii</sup> George Plaschinsky, „The Reverse Effect Of EU Sanctions”, 18.01.2012., Belarus Digest, <http://belarusdigest.com/story/reverse-effect-eu-sanctions-7382>; Balázs Jarábik, „Belarus after Sanctions: The Lost Dictator”, The Rīga Conference Papers 2011, 27, [http://www.rigaconference.lv/wp-content/uploads/2011/07/Belarus-after-sanctions\\_the-lost-dictatorship.pdf](http://www.rigaconference.lv/wp-content/uploads/2011/07/Belarus-after-sanctions_the-lost-dictatorship.pdf)

### ***Belarusian domestic environment***

– The attitudes of the Belarusian society and stance of its opposition. The Belarusian society for a long time remained passive, with a weak and fragmented opposition. However, this passivity should not be taken for granted. During the last few years, as the economic situation worsened, the Belarusian “social contract” has been falling apart and wider-than-before public protests have started. It is impossible to say with certainty what Belarusians want, however, independent polls show that “as many Belarusians favour closer ties with the EU as with Russia”.<sup>ix</sup> If true, it is in fact a remarkable indicator, bearing in mind how isolated the Belarusian society has been from the West. Many Belarusian officials at lower levels are also allegedly interested in cooperation with the EU.<sup>x</sup> Perhaps, as many critics note, the opposition cannot yet provide a credible alternative; they also do not have a common approach to the upcoming elections.<sup>xi</sup> But in the long run, people are the ones who decide.

### ***Belarus’s external relations***

– ***Belarus’s relations with Russia***, arguably the main reason for Belarus to have been able to withstand the Western pressure and preserve its outdated command economy (on which a “social contract” has been based). The Belarusian relations with Russia have not been easy, sometimes escalating to open conflicts. Still, Russia is interested in supporting Lukashenko as long as he remains loyal, and the return of Vladimir Putin to power does not augur any substantial changes here. After the freeze in the EU-Belarusian relations, Russia has again emerged as one of the main supporters of the regime, e.g. lowering gas prices.<sup>xii</sup> Belarus also is a member of the ambitious Customs Union with Russia and Kazakhstan (although if Russia joins the World Trade Organization, it might also mean pressure for liberalization of the Belarusian economy). Lukashenko – like a part of the Belarusian society – in principle does not want full integration with Russia and tries to preserve Belarus’s sovereignty, and his power, also in other matters, e.g. resisting takeover of

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<sup>ix</sup> Hanna Smith, „Belarus at a crossroads”, 21. See also Balázs Jarábik, „Belarus after Sanctions: The Lost Dictator”, 30, and Vladimir Ulakhovich, „Belarus and the Eastern Partnership: Still a Long Way to Go,” *Internationale Politik und Gesellschaft* 3 (2011), 84, [http://www.eceap.eu/ul/Review\\_No3.pdf](http://www.eceap.eu/ul/Review_No3.pdf).

<sup>x</sup> Katarzyna Wolczuk, „The EU strategy on Belarus – in need of ‘smart pragmatism’”, 7.

<sup>xi</sup> Matthew Frear, „Opposition strategies for the 2012 elections in Belarus” in *Baltic Rim Economies Quarterly Review*, Special Issue on the Future of Belarus, 23.

<sup>xii</sup> Hanna Smith, „Belarus at a crossroads” in *Baltic Rim Economies Quarterly Review*, Special Issue on the Future of Belarus, 3 (Turku: University of Turku, Turku School of Economics, Pan-European Institute, June 2012), 21, <http://www.tse.fi/FI/yksikot/erillislaitokset/pei/Documents/BRE%202012/BRE%203-2012%20web.pdf>

the biggest state enterprises by Russia. More caution and in-depth analysis is needed here – as Edward Lucas rightly notes, “We know embarrassingly little about the real content of Russian-Belarusian relations.”<sup>xiii</sup>

– **Belarus’s relations with China and other third countries.** Belarus also tries to diversify its partnerships, collaborating with such states as Venezuela and courting Chinese investments. One should ask whether at some point it can become a true “third way” in Lukashenko’s attempts to balance between the West and Russia.

– **Belarus’s dependence upon the EU.** Indeed, the EU is Belarus’s biggest trading partner, accounting for 39% of its exports in 2011 (Russia – 34%).<sup>xiv</sup> It is also a potential source of new technologies (which cannot really be obtained from Russia), financial assistance and a counterweight to Russian influence. It cannot be excluded that, in its balancing between “the East” and “the West”, Belarus will try to repeat the 2008 scenario this autumn.

### *EU-related factors*

– **The capacity of the EU to reach political unity and maintain it.** As shown above, the EU remains rather divided on the issue and it needs to devote time to reach a veto-proof agreement. As shown by experience, some of the abovementioned supporters of democratization – like Poland, Sweden or Germany – could come up with new initiatives and take a strong lead. However,

**EU’s foreign policy remains a rather undeveloped sphere – member states are cautious about their sovereignty, the decision-making process is hampered by the request for unanimity, and currently the Union is also overburdened with internal matters.**

Due to the presence of some influential pro-Lukashenko groups, a veto is not unlikely in this case, and, even if an agreement is formally reached, there is no guarantee that all the member states will abide by it in practice.

– **Resources available to the EU.** At the time of a crisis and tough talks on the next multiannual financial perspective, external assistance can turn out a low-level priority. On the other hand, a well-developed policy can attract external financial resources.

<sup>xiii</sup> Edward Lucas, „What the West Gets Wrong About Belarus”, 02.05.2011., Center for European Policy Analysis, [http://cepa.org/ced/view.aspx?record\\_id=301](http://cepa.org/ced/view.aspx?record_id=301)

<sup>xiv</sup> Katarzyna Wolczuk, „The EU strategy on Belarus – in need of ‘smart pragmatism’” in Baltic Rim Economies Quarterly Review, Special Issue on the Future of Belarus, 7.

– **Expertise on Belarus.** As already noted, European policy-makers are not fully aware of all aspects of the Belarusian situation and sometimes rely on clichés like „Belarus is fundamentally pro-Russian” or „we can reach out to the population via opposition parties and NGOs”. Clarity is certainly hard to achieve with an authoritarian regime, but efforts should be made regardless of that.

– **The attitudes of other Eastern Partnership partners and EU’s image.** Until now, the EU has tried to pursue a uniform approach towards all of its partners. If Belarus is offered a separate package – as it may indeed deserve – it could undermine the Union’s credibility more broadly. On the other hand, Eastern Partnership and the ENP are in general still rather weak structures, which need to be overhauled/strengthened in either case.

## The way(s) forward?

How could the EU act in the current situation? It is up to the policy-makers to reach the final decision, and the first thing that the EU should do is to agree on a common set of principles and on how much effort they could invest into the Belarusian issue.

**If there is no agreement, sometimes it is better not to take any action – the case of the semi-sabotaged economic sanctions only demonstrated to the world, including Lukashenko, the weak points of the Union.**

If controversies escape into the public space, or if the sanctions agreed upon are not implemented in practice, it only undermines EU’s credibility and serves Lukashenko. Hopefully, those EU members that prefer unprincipled cooperation with Lukashenko regime, including some forces in Latvia, can be persuaded that reforms in Belarus will serve their medium to long-term interests. The EU should also think over different scenarios of the Belarussian elections – what is to be done in the case of further repressions or if the regime decides to grant another cosmetic concessions. Since the regime can at some point break down, a contingency plan would also be necessary for this case.

Looking at the abovementioned factors, some „do’s” and „don’ts” for the EU are already visible (many of them, in one or another form, have already been proposed by various analysts). First, do not try to engage in geopolitical games for influence with Russia. It is an often-heard argument that by isolating Belarus the EU pushes it into Russia’s arms. However, as said above, the Belarusian leader himself tries to balance between Russia and the EU, and if the EU tries to bribe him into cooperation, it will only support his current

policies – and undermine EU's established image of a „civil power”. Unless Belarus really becomes a *de jure* part of Russia, which is highly unlikely, the EU will always find a niche for itself.

Secondly, do not impose any sanctions or other measures that will harm long-term development of Belarus. If the fragile economy deteriorates even further, it can fundamentally harm the EU's image among the Belarusian society and cause wide-range social instability. However, do not give up all pressure mechanisms. When any sanctions are imposed, they must be as targeted and precise as possible to affect just the narrow interests of those engaged in repressions, with compensatory mechanisms where necessary. For instance, economic sanctions can easily also harm Belarusians at large, so a possible solution would be to offer them training or alternative social help to alleviate the impact.

Thirdly, do intensify relations with an assistance to the Belarusian society at large. Not long ago, the EU's Enlargement commissioner Štefan Füle promised to step up cooperation with civil society organizations and the political opposition, hoping that the EU thus would be able to „reach out to all Belarusian citizens”.<sup>xv</sup> He evidently did not realise that these forces were not visible to a great part of Belarusian citizens, or, even worse, were perceived negatively. To reach out, the EU should also consider liberalization of the visa regime, more opportunities for students within and outside Belarus, technical assistance to improve the living conditions of the society at large. The first two measures have gained almost universal support in the expert community, and they do not require huge resources, but the EU has yet to follow the advice. The Commission has offered Belarus negotiations on visa facilitation, but with no results. Evidently, a political solution must be found to liberalize the visa regime unilaterally at the EU level.<sup>xvi</sup> Some technical dialogue also continues<sup>xvii</sup> and could possibly be expanded in a thought-over and targeted manner to build links with lower-level officials and increase the visibility of the EU „on the ground.” A Dialogue on Modernization with Belarusian society, launched in 2012, could also be a step in the right direction. Of course, there is always a risk that technical assistance becomes, or seems to be more of

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<sup>xv</sup> Štefan Füle [European Commissioner for Enlargement and European Neighbourhood Policy], „Towards a European future for the citizens of Belarus”, Carnegie Europe event „Transforming Belarus – Ways Ahead” Brussels, 7 December 2011, SPEECH/11/861, Europa portal, <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/861&format=HTML&aged=0&language=EN&guiLanguage=en>

<sup>xvi</sup> The EU has only welcomed individual liberalization efforts by the Member States. See „ENP Package – Belarus”, MEMO/12/332, 15.05.2012., Europa portal, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/332&format=HTML&aged=0&language=EN&guiLanguage=en>

<sup>xvii</sup> „ENP Package – Belarus”, MEMO/12/332, 15.05.2012., Europa portal, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/332&format=HTML&aged=0&language=EN&guiLanguage=en>

a help to the regime, but it is also a powerful instrument. There is also some room for humanitarian aid. Finally, with the same rationale, possibly the EU could even look if Belarussian enterprises can be privatized by its companies.

Fourth, do try to attract foreign assistance. The Donors' conference in 2011, organized by Poland, has succeeded in attracting some external funding.<sup>xviii</sup> One possibility would be stepping up the already existing cooperation with the US (although it to some extent it depends on who will win in this year's presidential elections).

Although the EU's policy until now has been far from successful, it has a potential and shall not be discarded. There are both internal preconditions for success (and some Member States are truly interested in it) and external ones.

**A „third track” approach, non-partisan and oriented towards the society as a whole, would benefit Belarussians, the EU itself and it would also be harder for the regime to resist.<sup>xix</sup>**

The role of „civilian power” suites the EU well and brings sustainable results. In fact, the suggestions mentioned above do not much depend on how exactly the regime conducts the parliamentary elections – they are things that ought to be done in any case.

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<sup>xviii</sup> Warsaw International Donor Conference “Solidarity with Belarus”, 08.02.2011., Ministry of Foreign Affairs of the Republic of Poland, Polish aid, <http://www.polishaid.gov.pl/Warsaw,International,Donor,Conference,%E2%80%9CSolidarity,with,Belarus%E2%80%9D,1096.html>

<sup>xix</sup> See in particular suggestions by Anaïs Marin: Anaïs Marin, „EU–Belarus relations – which way out of the vicious circle?” in *Baltic Rim Economies Quarterly Review*, Special Issue on the Future of Belarus, 8; Anaïs Marin, „Saving What Can Be: What the Eastern Partnership Could (Still) Bring to Belarus”, *Eastern Partnership Review* 3 (Estonian Center of Eastern Partnership, 2011), 10, [http://www.eceap.eu/ul/Review\\_No3.pdf](http://www.eceap.eu/ul/Review_No3.pdf); Anaïs Marin, „How to deal with an unfriendly neighbour? Belarus in the Eastern Partnership: five steps for a paradigm shift”, 20.10.2011., Eastern Partnership Community, <http://www.easternpartnership.org/publication/politics/2011-10-20/how-deal-unfriendly-neighbour-belarus-eastern-partnership-five-steps>



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## Energy Dynamics in the Baltic Sea Region

If energy dynamics in the Baltic Sea region were an animal with symptoms, the anamnesis would include quite a variety of keywords: a puzzle, like a weather forecast, on an island, forces that be, diverse a company, aiming for the market, wires needed, generating dilemmas, who's the strongest, no friends just market and, last, but definitely not least, energy security and risks. Let me briefly dwell on some of the keywords that highlight the overall situation.

**Energy relations in the Baltic Sea Region resemble a puzzle where any single missing piece makes the picture incomplete.**

It can also be said that energy relations in the region puzzle one's mind – it is not rare to face a situation where relations between actors may indeed be understood without any difficulty. The actors – energy companies, consumers, regulatory authorities, governments – and groups of actors all have their particular interests be it new fossil or renewable generating capacities, low or high energy prices, market domination or versatility and liquidity. Some domestic markets are too small and cannot provide sufficiently lucrative incentives for investment: the solution is a bigger regional market capable of providing volumes, consumers and real trading.

A common energy market is undoubtedly one of the biggest challenges in this puzzle. While the Nordic countries are enjoying the privileges of an open and competitive electricity market, the Baltic States are only on their way there and are entertaining exercises like individual domestic markets and Baltpool, the interesting part being the unsynchronised implementation of market rules

and conditions in each of the three Baltic States. Obviously rivalry is persistent even considering the humble size of the market. Competition between the three national energy incumbents is a part of the cause of the limited market problem and at the same time can serve as a facilitator of competition on a wider Baltic and, indeed, Nordic energy market.

Another piece of the puzzle is rapprochement of energy producers and energy consumers. Physically, through wires and cables, through interconnections. The Baltic Energy Market Interconnection Plan is set to create the interface for trading electricity in the Baltic Sea region. National companies and transmission system operators make forecasts on energy demand and the necessary generation capacity to ensure that consumers get the power they need when they need and producers adjust their generation plans accordingly. Having a multitude of generating capacities in the region linked through interconnections in one energy system makes the job for TSOs and energy companies more interesting and challenging.

While the Scandinavian countries comfortably embrace their Nord Pool Spot power market and calculate the potential hidden in the water in their hydroelectric power plants, the three Baltic States are overwhelmed by domestic debates on the best ways of developing their energy sectors over the course of the next ten years. There are indeed challenges – shall natural gas dominate, shall oil shale be phased out, shall nuclear energy be introduced, or shall it be biomass, biogas and wind?

All of the above mentioned, as well as some other factors add up to the concept of energy security that plays a paramount role in the European energy policy. The significance of this concept varies among EU member states depending on their energy self-sufficiency, energy imports, availability of suppliers of primary energy resources and supply routes, ability to negotiate prices, the extent to which a country is connected with others, as well as presence and liquidity of the energy market. Russia dominates the Baltic Sea region in terms of natural gas supplies and it is quite obvious that Latvia and Lithuania are most dependent on these supplies with significant generating capacities running on gas. Other countries around the Baltic Sea have slightly more diverse energy portfolios making them less vulnerable to external influences.

**Given the diversity of situations, the development of energy sector around the Baltic Sea at times seems to resemble a typical weather forecast – intermittent clouds with occasional sunny spells and light rainfall here and there, low temperatures in the morning turning into a steamy afternoon.**

In other words, everything included but no one is sure of which parts of the forecast exactly will dominate, when and where. So, be prepared.



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## **Baltic Energy Security: a Historic Opportunity**

For the first time in modern history, the Baltic states can rely on their own actions to attain energy security. By implementing the European Union's reforms aimed at creating a unified European energy market, the political leaders of Lithuania, Estonia, and Latvia enable their countries to secure supplies of oil, natural gas, and electricity at prices determined by market forces rather than by monopolists with divergent commercial and geopolitical interests.

All three Baltic states enjoy reliable supplies of oil, although it has not always been the case. Immediately after the collapse of the USSR, Latvia became one of the world's leading oil exporting countries, from which significant volumes of Russian and Kazakhstani crude oil were exported to European markets. Significant volumes of oil exports continue to flow via Latvia's port of Ventspils, as well as to Estonia's port of Muuga in Tallinn. Lithuania, however, faced greater difficulty. It relied on the Mazekai Refinery, the Baltic region's only refinery and largest industrial concern for oil products critical to its economy and for export (via the sea terminal at Butinge). The refinery depended entirely on Russian crude oil supplied via the Druzhba Pipeline.

In July 2006, the Russian Government shut down the Druzhba Pipeline near Mazekai for unspecified repairs, crippling the refinery's operations. The cutoff occurred in the midst of a fierce battle over the refinery's privatization, as the Russian Government sought to acquire assets of a private company, Yukos, including the Mazekai Refinery. The timing and non-transparency of the shutdown seemed to have been aimed at lowering the refinery's purchase price and persuading Vilnius that it could face serious economic

and geopolitical consequences if selling Mazhekai to non-Russian investors. Russian Duma Speaker Konstanin Kosachev heightened these suspicions when noting just hours after a fire at the refinery on October 12, 2006, that “instability will continue to plague the refinery until Lithuanians finally realize which partners shall be chosen.” Rather than succumbing to such pressure, Lithuania worked with private investors to reverse Mazeikai’s export pipeline to allow to supply the refinery with non-Russian crude oil from the Butinge sea terminal. This bold tactic enabled Mazeikai to continue operating, leading to its purchase by Polish oil company PKN Orlen on December 15, 2006.

Lithuania’s experience at Mazeikai underscores two key points: energy monopolists’ pressure tactics have both commercial and geopolitical impacts; and market forces provide the most effective tools for countering such pressure. This reliance on market forces to secure Europe’s commercial and geopolitical interests lies at the heart of the European Union’s landmark Third Energy Package. Passed in 2009, this collection of regulations aims to create a unified European energy policy (?) by mandating that EU member states:

- Unbundle natural gas transit and distribution networks to reduce the monopoly power of energy companies (Russian or European);
- Diversify sources of gas supply and connect European gas grids;
- Expand gas-trading hubs; integrating gas storage facilities into gas-trading hubs; and
- Connect Baltic electricity networks to those of Nordic countries, Poland, and the EU.

The EU’s focus on markets for natural gas and electricity makes sense. Notwithstanding Lithuania’s troubles at Mazhekai, it is difficult for monopolists to restrict oil flows to European consumers, given that oil can be loaded onto tankers in a liquid form and shipped to any market in the world. Natural gas, however, must be transported either in its gaseous form via lengthy pipelines or with tankers after an expensive liquefaction process. Natural gas pipelines and liquefaction plants both require investment amounting to billions of dollars. To secure the requisite high levels of financing for such projects, the producers of natural gas insist on long-term supply contracts in Europe, which are pegged to the price of oil to lock in high prices for many years. European consumers have usually acquiesced to these demands, which restrict the development of competition among gas suppliers. As a result, Europe does not enjoy a genuine market for natural gas, and European consumers pay considerably more than if the prices of natural gas were determined by market-based competition. Indeed, in the United States, where prices are determined by the free market at trading hubs, natural gas costs four times less than in Europe.

In sharp contrast to the U.S. gas market, a single company, Russia's Gazprom, supplies 100 percent of natural gas consumed in Estonia, Latvia, Lithuania, and Finland. In addition,

**Gazprom controls the gas storage facility in Latvia that is crucial for sustaining reliable flows of natural gas during peak demand in winter, along with pipelines linking this storage facility to all three Baltic markets.**

These countries are thus isolated into an “energy island” with regard to natural gas supplies.

The Baltic states are similarly isolated from their EU allies with regard to electricity. As a Soviet-era legacy, Baltic electricity networks remain synchronized with northwest Russia's energy grid rather than integrated into the EU's system. Besides the commercial consequences of reduced competition, this situation has the geopolitical consequence of preventing Baltic economies from integrating with those of their EU allies, thereby undercutting one of the Euro-Atlantic Community's core objectives: reemergence of a united and free Europe that .

The key to eliminating these Baltic “energy islands” is to expand energy trading hubs, where prices are set according to the market forces of competition, supply, and demand – and with no political interference. The market efficiency of a hub depends on its liquidity – i.e., the degree to which a single gas trade can occur without affecting the price of subsequent trades. Liquidity at a hub requires several factors: access to diversified gas supplies through the convergence of pipelines and/or LNG terminals nearby; gas storage facilities to manage peak demand in winter; and pipelines to consumers that operate under market-friendly regulations.

During the past two and a half decades, several natural gas trading hubs have emerged around Europe's North Sea Basin. The first was the UK's National Balancing Point (NBP), which was created when the British Government privatized British Gas in December 1986 and mandated that the company release gas volumes to independent suppliers. Other nearby hubs now include the Title Transfer Facility (TTF) in the Netherlands, Zeebrugge in Belgium, PEG Nord in France, and NetConnect Germany (NCG) and Gaspool in Germany. All are competing to surpass the NBP in liquidity and become Europe's primary point for trading gas produced in the UK, Netherlands, Denmark, Norway, and Russia. They face additional competition from the Central European Gas Hub (CEGH) at the strategic junction of Gazprom's major pipelines at Baumgarten on Austria's border with Slovakia.

The liquidity of gas trading at these hubs has increased with the arrival of additional competing suppliers. Increased liquidity has allowed spot markets to emerge at each hub, where prices are set by supply and demand rather than the price of oil. Since 2008, spot prices at these hubs have converged into a single price – and thus, a single market – for the entire North Sea Basin. This is a dramatic development: it means millions of consumers in Northwestern Europe can now purchase natural gas at prices determined by the free market rather than monopolists. Consequently, both natural gas prices and monopolists' leverage have decreased.

Market pressure is now building to expand spot-market trading of energy eastward, toward the Baltic Sea. In February 2010, competition among multiple gas suppliers at North Sea gas hubs allowed the TTF to extract Gazprom's concession to allow spot-market pricing to determine 15% of Gazprom's sales price at TTF. Germany's E.ON AG quickly followed with its own demand for Gazprom to index its sales price fully to spot prices for gas. Later that month, Poland's PGNiG and Lithuania's gas utility asked Gazprom to allow some degree of market-based pricing in their own long-term contracts. Gazprom refused all of these demands, and has instead fought to stem the spread of spot-market pricing eastward in defense of its preferred pricing model, pegging natural gas to the price of oil. The Polish and Lithuanian entities replied by threatening to take Gazprom to arbitration. Gazprom Deputy CEO Aleksander Medvedev's response was chilling: "If it does come to arbitration proceedings, we are pretty confident... God help them if someone takes a risk to go to arbitration."

Market forces have nevertheless forced Gazprom to retreat from its rigid demands for long-term contracts with a non-market pricing model. Feeling the pressure from spot-market trading in the North Sea and the potential flood of cheap LNG from the United States, Gazprom agreed in early July 2012 to renegotiate its contract with E.ON: Gazprom offered a price discount in return for E.ON continuing to accept the principle of a link between the prices of natural gas and oil. According to Reuters, Sergei Komlev, head of contract structuring and price formation for Gazprom Export, stated that Gazprom was willing to make this unusual concession to protect the link between gas and oil in its pricing model. "The overall discount remained within Gazprom's set range of no more than 7-10 percent (and) the oil-linkage in this long-term contract was preserved intact," Komlev boasted. Notwithstanding Mr. Komlev's optimism, this precedent provides further momentum for spot-market pricing to extend eastward, with Poland's PGNiG now expected to renew its demand to renegotiate its contract with Gazprom, and Lithuania recently winning price concessions from Gazprom, as well.

Indeed, such monopolistic bluster is looking increasingly empty, thanks to determined political leaders with a strategic vision of bolstering free-market forces. In the Baltic region, Lithuania is leading the charge. In 2011, Lithuania adopted the EU's Third Energy Package before any other EU member state, and chose the most aggressive version. Vilnius immediately announced plans to diversify its sources of natural gas supply by contracting for a floating liquid natural gas (LNG) terminal at Klaipėda, scheduled to begin operating in 2014. Vilnius also announced it would end Gazprom's control of Lithuania's entire natural gas transit network by separating the country's internal gas distribution pipelines from its gas transmission pipelines, which import exclusively Russian gas. Gazprom retaliated in early 2011 by charging Lithuania of 15% more for natural gas than Estonia and Latvia, and then suing Lithuania at the UN's international trade arbitration tribunal. According to *Moskovskie Novosti*, Gazprom Vice President Valery Golubov explained, "Vilnius's inadequate behavior while restructuring the gas sector, and trying to separate the gas transmission pipelines from SC Lietuvos dujos" justified the price increase. Ultimately, however, Gazprom conceded to the Lithuanian Government's relentless commitment to bolster free-market forces in solidarity with the EU. In May 2012, Gazprom accepted the Lithuanian Government's pipeline unbundling plan at the Lietuvos dujos shareholders' general assembly.

Lithuania is proceeding with its aggressive implementation of the EU's Third Energy Package, ahead of all other EU member states. On July 3, 2012, the Lithuanian Government announced a tender for a new pipeline to link the Klaipėda LNG terminal with the country's natural gas transmission system. The Parliament is also debating legislation requiring Lithuania to purchase at least 25% of its natural gas as LNG at the Klaipėda terminal; this aims to prevent Gazprom from destroying the economic advantages of the Klaipėda terminal by dumping cheap gas on the Lithuanian market. Lithuania and Poland are also planning a cross-border gas pipeline of 3 to 5 BCM to facilitate free-market trading of natural gas between the two countries' national gas grids, with diversified sources of supply from LNG arriving at both Klaipėda and Poland's planned LNG terminal at Świnoujście. Taken together, these measures will provide the physical infrastructure required to develop a full-fledged gas trading hub. The regulatory and legal framework for such a hub was put in place with the establishment of the Baltpool natural gas exchange, formed under Lithuania's Law on Natural Gas, passed on August 1, 2011.

Outside Lithuania, there is progress toward spot-trading and gas hubs, but it goes slower. In Latvia, the national government is considering the construction of a large LNG terminal (for which Latvia seeks EU financial support), which is intended to serve all three Baltic markets. Latvia is also planning pipelines to link its gas grid with the networks of Lithuania and Estonia, and provide all three states with access to Latvia's crucial gas storage facility at Incukalna.

However, the Latvian Government has yet to commit to implement the EU's Third Energy Package. Consequently, Latvia's entire natural gas pipeline system and the gas storage facility at Incukalns remain unavailable for free-market trading.

In Estonia, the country's top leaders worry that as long as Latvia's Incukalns gas storage facility remains under Gazprom's control, a regional LNG terminal in Latvia would not enhance Estonia's security of crucial gas supply during winter months. Estonian Minister of Economic Development Juhan Parts outlined this reasoning in a letter leaked to the press during summer 2011, in which he expressed concern about a lack of transparency in the conditions for use of the Incukalns facility. The Estonian Government consequently directed Elering, Estonia's state-owned electricity transmission company, to develop plans for Estonia's own LNG terminal. In May 2012, Elering and the Port of Tallinn announced a joint feasibility study for an LNG terminal at Muugu harbor in Tallinn. Elering, which co-owns the Estlink electricity transmission cable connecting Estonia and Finland, is also exploring a sub-sea pipeline linking Estonia with Finland's natural gas grid. This connection, coupled with a new LNG terminal in Tallinn, would provide Estonia and Finland with their first diversified supplies of natural gas, thereby laying the foundation for another potential gas hub in the Baltic region. Momentum toward this hub accelerated on June 6, 2012, when Estonia's Parliament approved the implementation of the - EU's Third Energy Package.

The Presidents of Estonia and Lithuania appear to agree on the need to take their own steps to secure diversified natural gas supplies rather than rely on a regional LNG terminal in Latvia. Following a meeting with Estonian President Toomas Hendrik Ilves last summer, Lithuanian President Dalia Grybauskaitė announced: "We agreed with the [Estonian] president that the existence of just one terminal [in Latvia] could be risky, [as] influence could be exerted on this terminal, and it could be re-sold." Overcoming such doubt about Latvia's reliability requires Riga to confront energy monopolists, whose interests are entrenched in Latvian politics, and decide to implement the EU's Third Energy Package. If this politically difficult step is not taken, all country's smaller LNG terminals risk being undercut by monopolists' ability to dump cheap gas on Baltic markets, while the three countries would never develop an integrated pipeline and gas storage infrastructure required for formation of gas-trading hubs.

In the Baltic states, the evolution of spot markets for electricity may be more advanced than for natural gas. In keeping with the Third Energy Package's mandate to connect Baltic electricity networks with those of the Nordic states, Poland, and the rest of the EU, Estonia and Finland laid the 350 MW Estlink cable in 2007 via the 350 MW Estlink cable, which they plan to expand via

the second cable (659 MW) in 2014. Sweden and Lithuania plan to connect their electricity networks in 2016 with the 650 MW NordBalt cable. Meanwhile, Poland and Lithuania have been planning an electricity link for several years to facilitate free-market trading between the Baltic states and the rest of the EU. Additionally, Lithuania is planning to build a large nuclear power plant at Visaginas, in a joint investment with Estonia, Latvia, and Japanese industrial giant Hitachi, which will provide a new source of electricity to be traded among all three Baltic states, their Nordic neighbors, Poland, and the rest of the EU.

Estonia and Lithuania have demonstrated their intention to foster free-market trading of electricity through their participation in Nordpool, the world's largest electricity exchange, which began in Norway and is centered in the Nordic states. Estonia and Lithuania also favor disconnecting the Baltic electricity grid from that of Russia and synchronizing it with the EU system. Latvia, however, prefers to avoid significant new capital expenditures and remain integrated into the Northwest Russian grid.

It is natural that foreign monopolists and their allies within Baltic political systems would resist reforms aimed at undercutting their commercial and geopolitical leverage. However, it is equally understandable that the Baltic states would fight hard to eliminate such leverage by taking joint steps with their EU allies to bolster market forces in trade for their most strategically significant commodities. As Baltic leaders continue moving forward to establish trading hubs for natural gas and electricity, monopolists' ability to manipulate Baltic energy markets will evaporate;

**eventually the debate on whether Russia uses energy supplies for geopolitical purposes will lose its relevance, as for the first time in history the Baltic states will have achieved energy security.**

Reaching this goal, however, still requires bold decisions, especially in Riga.



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## **Shale Gas and Energy Security in the Baltic Sea Region**

The energy sector has seen exceptionally strong changes in the last few years. One of the elements, contributing to these changes, is the shale gas revolution in North America. The US, instead of becoming the largest importer of natural gas, became the largest producer of gas in the world, practically meeting its domestic needs and even considering export. The shale gas revolution has served as a catalyst for further changes in the energy sector, including a broader use of gas in the economy, limited use of coal and boost for the development of production of unconventional oil. All these changes have considerable impacts on energy security of the US and Canada, as well as their energy and climate policies, and economic development, including overcoming the recession.

**Positive effects of the shale gas revolution in North America have attracted significant interest among politicians, experts and the business community all over the world.**

The first question was whether such a revolution could be replicated elsewhere for the benefit of other nations. With this in mind, geological institutes started reviewing data and materials in their collections, the business community commenced searching for attractive sites in the world, while the most prospective areas with shale rock formations were opened by public authorities for exploration. Thus, a shale gas boom started all over the world – in China, India, the Republic of South Africa, Argentina, Mexico and Australia, just to mention some of the most prominent countries. It also came to Europe.

In the Baltic Sea region, already for several years the exploration for shale gas has been conducted in Poland, Germany, Denmark and Sweden. Other prospective areas are located in Lithuania, which has just announced a tender for licences. Shale gas formations might also exist under the Baltic Sea. However, no offshore shale gas exploration has been done anywhere in the world and currently is not considered in this region either.

The exploration is still in its early stage. Core samples are being collected and sent to laboratories for detailed analysis. Some companies have already attempted vertical and even horizontal fracking. At this moment it is still too early to make any definite assessments. More wells are needed to understand the geology of the region, while experiments with fracking need to be continued to find the optimal technological operation to extract gas from the rock. This is a time- and money-consuming process. It requires considerable knowledge and patience.

However, the prospects for shale gas production in the Baltic Sea Region remain strong. Preliminary information coming from Poland and Germany is encouraging. Shale rocks do contain gas. In some places these rocks are fairly thick, promising large amounts of hydrocarbons. The so called “sweet spots” may be present here.

Hopefully, shale gas production will start in the Baltic Sea Region in the coming years. Although broad assessment of the potential impact depends on the results of research conducted by companies (i.e. how much gas do we really have?), we may assume that this should have a considerable impact on the energy security of the whole region, as well as the energy policies (energy mix, trade in energy products, development of infrastructure) and economic situation here. There are many reasons for this.

First of all, shale gas is a domestic resource in the EU. As such, it is obvious that it is considered to be a priority from the energy security point of view.

Secondly, as regards the gas network, the whole eastern shore of the Baltic Sea is still a legacy of the old system. Finland, Estonia, Latvia and Lithuania are 100% dependent on one supply source. Poland imports ca 70% from one supplier. The diversification of supplies is an imperative from the security point of view. The three Baltic States and Finland should not remain gas islands. Security and economic considerations imply the need to connect these countries to the European network. The work on interconnectors is ongoing. The crucial link lies between Lithuania and Poland, since it will link the three Baltic States to the European gas system.

Thirdly, an important element of energy security is the functioning of a competitive, healthy market with many actors, free of monopolies. This is the

basic idea underlying the EU policies, like the 3<sup>rd</sup> liberalization package. The presence of many foreign companies in the upstream sector is a good step in this direction. In Poland, there are over 20 such companies – from North America, Europe, Asia (Japan) and Australia. Some of them have expressed interest also in the midstream and downstream sectors, depending on the development of the situation. Thus presence of shale gas will have a positive effect on the development of the gas market, dominated by a business oriented approach.

Shale gas will also contribute to the implementation of the climate policy, an issue which is very close to the hearts of all people in Northern Europe. It will allow reducing dependence on coal, as well as emissions.

**The main social challenge to shale gas production is public acceptance. Current popular views often lack scientific knowledge and are based on myths.**

This implies the need for public authorities, academic institutions and business community to provide sound evidence and information. From the environmental point of view, the shale gas production technology is not much different from the conventional and tight gas technologies used in Europe for decades. From the business and political point of view, shale gas offers a new energy resource, which to a certain extent may compete with incumbent actors and sources, as in the case of all new products appearing on the market.

There are still some years ahead until the start of commercial production of shale gas in Europe. There are good grounds to believe that this process will succeed in the Baltic Sea Region. As an unconventional resource it requires unconventional thinking and efficient administrative procedures, since the technological challenges in this sector are much greater than in the conventional one. For this reason, shale gas offers to the interested countries opportunities for cooperation—exchanging information on the procedures, regulations and practices.

Recently the Polish Ministry of Environment has undertaken a research project to assess – by the end of 2013 - the impact of the extraction of unconventional gas on the environment.

The project outcome will contribute to improving management, control and supervision of the exploration phase, prospection and possible future exploitation of unconventional hydrocarbon deposits in Poland by all authorities involved in the process. The project will also contribute to the development of efficient procedures with regard to investors willing to continue the exploitation of unconventional gas in Poland. Poland is ready to share the results with other countries interested in the development of their shale gas resources. Shale gas is a resource that will positively affect the lives of all people also in the Baltic Sea Region.

## **Latvian Institute of International Affairs (LIIA)**

*The Latvian Institute of International Affairs (LIIA) was established in 1992 as an independent non-governmental institution with the task of providing Latvia's decision-makers, opinion-makers and wider public with an expert analysis, recommendations and views on international and regional developments and foreign policy strategy and choices. Among the Latvian think tanks, LIIA is the oldest and one of the most well-known and internationally recognized institutions that conducts research, publishes publications as well as organizes lectures, seminars and conferences related to the international affairs.*

[www.lia.lv](http://www.lia.lv)

## **Latvian Transatlantic Organisation (LATO)**

*The Latvian Transatlantic Organisation (LATO) is a non-governmental organisation established in March 2000 to promote Latvia's full and active membership in NATO and to work for security and democracy in the NATO and EU Eastern neighbourhood. It unites members from different social groups in terms of age and professional interests. It has carried out various education and information activities aimed at increasing public support for NATO membership, explaining and building public awareness about principles and values that unite NATO member states.*

[www.lato.lv](http://www.lato.lv)

## **Rīga Rīdzene Rotary club**

*Rotary is a global network of community volunteers. Rotary members are business, professional and community leaders who provide humanitarian service, encourage high ethical standards, and help build goodwill and peace in the world.*

*Over 32.000 Rotary clubs in more than 200 countries and geographical areas initiate service projects to address today's challenges, including illiteracy, disease, hunger, poverty, lack of clean water, and environmental concerns.*

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