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Regional Integration and regional development? - Concepts and empirical relevance

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**REGIONAL INTEGRATION AND REGIONAL DEVELOPMENT?
- CONCEPTS AND EMPIRICAL RELEVANCE**

Regional integration has altered the spatial dimensions of regional activities. The purpose of this paper is to discuss the impacts of regional integration frameworks on the regional division of labor and growth potentials and address the impacts on targets and instruments of regional policy.

The first part of the paper address's the issue from a theoretical point of view. Namely location theories and the theories of economic integration are used to develop an approach for a comprehensive analytical framework of understanding of change and development in regional systems.

Based on this framework the spatial change and the derived changes in the instruments and policy tools of regional policy are discussed in a specific context. An empirical study of the Baltic Rim is used to illuminate the theoretical concepts, developed in the first section, focusing on traditional market economies as well as the transition economies of the Baltic Rim.

The first part of the empirical analysis addresses the issue of interregional links. This part is based on trade and FDI figures for the Baltic Rim countries. Secondly long term economic growth within the region is investigated, with respect to identify distinct growth patterns within the region.

Last but not least a brief overview of the most important political and institutional determinates is introduced in an attempt to use institutional explanation in an overall understanding of the spatial dynamics in a region facing mutual changes in the 1990's. Special attention is on the impacts of the EU system with regard to the regulation of economic activities (Trade, FDI, Industrial and regional policy).

The most important systemic changes in the considered periods are: 1. the reintegration of former state trade countries into the western market system, 2. the adaptation of two former EFTA-countries to the comprehensive regional policy system of the EU, and 3. the general pressure toward deregulation and change of the west European and in particular Scandinavian welfare system.

The main result of the analysis is that the combination of spatial theory and approaches from the discipline of economic integration can contribute to a deeper understanding of regional change and regional policy in the Baltic Rim area.

Keywords: Concepts of spatial change - Regional policy - Integration and Interdependence

1. Introduction

Regional integration has altered the spatial dimensions of regional activities. The purpose of this paper is to discuss regional integration frameworks' impacts on the regional division of labor and growth potentials and on the targets and instruments of regional policy.

The theoretical foundation of regional integration is traditionally found in the disciplines of economic and political theory. With regard to the former trade theory is an important source of inspiration, with regard to the latter the roots are more mixed. In a global perspective functional thinking and focus on transaction analysis has been important. In a true regional perspective federalism and in particular neofunctionalism have been two important approaches, with strong links to real world integration initiatives. In a continental or regional perspective there seems to be strong evidence that economic and political integration and spatial proximity are close related.

Based on this assumption the next section, address the above mentioned theoretical and methodological aspects. Part three provides a brief outline of the policy-implications derived from the theoretical outline. In part four an empirical assessment of the hypothesis' regarding political, economic and spatial integration is attempted. The last two sections, part 5 and 6, contain an overall evaluation of the specific regional systems' change as well as an assessment of future development potential of the Baltic Rim Region based on the analytical framework developed.

2. Theoretical outline

This part of the analysis addresses the issue from a theoretical point of view. Location theories and the theories of economic integration are (namely) used to develop an approach for a comprehensive analytical framework of understanding of change and development in regional systems.

Usually, there is a strong correlation between geographic adjacency and strong economic ties. In economic theory this has not always been a part of mainstream economic thinking and analysis (Tichy, 1998). Concerning formal economic cooperation in regional free trade areas, customs unions or more far reaching arrangements the spatial dimension has always - at least implicit -been an important aspect (Robson 1987, Balassa 1963/73, WTO 1995). Actually, cooperative frameworks covering non contiguous areas are seldom, and the economic success of scattered trade arrangements like the European Free Trade Area has been rather limited. In the period of discriminative trade regimes the potentials of trade creation were also rather limited in Europe (Cornett eds. 1996, p.54ff). The theory of economic integration stresses among other things that competitive countries are more likely to receive benefits from regional trade agreements than complementary economies. This coincide with the fact that intra regional trade grows faster than extra regional trade in most arrangements. This also the reason why these arrangements, for a long period, have had rather limited success in third world countries with their relative strong dependence on extra regional trade with the industrialized world¹.

The increased awareness of potential gains from regional cooperation in this part of the world reflects two changes. First, the threshold economies of the new industrialized economies in Southeast Asia and parts of South America are now in a situation where some of the gains from regional economic integration are within the reach of development. Secondly, the motivation to participate in regional arrangements has changed from economic to become a mixture of economic,

strategic and political¹.

Any empirical application of concepts developed in a different environment requires an outline of the basic assumption and axioms of the involved theories and approaches. The purpose of this paper is to discuss the impacts of regional integration on regional development. Regional integration is in many respects an ambivalent notion, varying from a very general concept that describes cooperation between nations or regions, to very specific social theories of human or organizational behavior. Within the framework of this project only a brief discussion of the political and economic concepts of integration is necessary.¹

The two approaches are distinct. Economic theories of integration have their roots particularly in the field of international economics and trade theory (Balassa 1963/73, Robson 1987, Baldwin 1995), the conceptual anchors of the political theories of integration has to be found in various branches of political science (Pentland 1973, Panild 1989 & Chryssochoou 1997).

2.1 Economic Integration

The economic concepts of regional integration were originally introduced by Jacob Viner (1950) in his analysis of Customs Unions, but the concepts have been expanded in scope to cover most aspects of regional economic cooperation. The purpose of this paper is not to provide an overview of the history and the development of economic concepts of regional integration, or of the theoretical and technical refinements of the discipline¹.

Traditionally, regional economic integration takes place between relatively similar countries regarding economic development or political traditions and institutional frameworks¹. The process of economic integration between former state trade countries and the established western market economies is a different task. To some extent the internal aspects of the exercise can be compared with attempts to implement integration frameworks between the restructuring economies in Less Developed Countries. Although there has been many attempts to form regional economic associations between third world countries, their success has been rather limited².

The external perspective is simultaneously to (re)-establish links to the industrialized market economies without causing too much damage on national competitiveness.

Especially the latter seems relevant for the emerging market economies in East and Central Europe, although they to some extent are similar to frameworks of cooperation used during the existence of the *Council of Mutual Economic Assistance* (CMEA). A comparison of economic integration in various types of economic systems by Brada & Mendez (1985) showed that the ability to promote inter-member trade largely depended on the environmental factor inter-member distance. Regarding the effectiveness of integration policy, the study showed a relatively poor record for the highly institutionalized EU. The latter can partly be explained by the period of investigation, the early seventies, when most trade effects from the implementation of the Customs Union were achieved. Regarding their comparison of the CMEA with the western approaches the most interesting conclusion is:

"Thus, the combined effect of central planning and of integration policy in CMEA causes that integration grouping to under fulfill its potential by about the same amount as the EEC. Consequently, it does not seem that CMEA integration policies or the system of central planning appear to be significant greater barriers to promoting inter-member trade than do politics adopted among integrating market economies." (p. 555)

The crucial issues regarding these roads to economic integration are how to assure that they conform with especially GATT/WTO rules on nondiscrimination and equal treatment and to avoid probable adverse impacts on East and Central Europe relations to the European Union. Recent association agreements between The East and the EU have already proved the importance of these concerns as far as salient sectors of the EU are involved (European Economy 1994). Also in Western Europe the process of consolidation of the regional economic system is still in flow, and unambiguous solutions have not been found in Western Europe either, whereas Norway, Iceland and parts of central Europe, Switzerland and Liechtenstein, still have to rely on an intermediate cooperation scheme, the *EEA-agreement*, that established a European Economic Area covering the *EU* and the remaining members of *EFTA* (European Free Trade Agreement), except for Switzerland, formed according to the Stockholm convention of 1960. Since 1993, the EEA has basically provided the EFTA countries the participation in the Single European Market on equal terms.

From an economic point of view this has traditionally been addressed from a international trade and specialization perspective with major attention to the trade creation and trade diversion effects and the gains from scope and scale economics. Especially impacts on terms of trade have been considered to be important, partly for economic reasons, partly through increased influence of the involved countries in international trade negotiation. For an overview of the various EU agreements involving the WTO (Annex II, European Economy 1997, p. 235-238).

Regarding the reintegration of the former state trade economies into the western dominated market economic system the nature of the issue of complementarity and competitiveness is more complex as it is when dealing with free trade agreements between countries on different levels of development. The analysis of this topic requires a broader approach including both political and spatial aspects of integration.

2.2 Political Integration

With regard to the political theories of integration four approaches are often considered to be the classical schools in the field. They are often labeled as: the federalism, the transaction or pluralistic approach, and the functionalism and the neofunctionalism. In the seventies new variants have been added namely the so-called intergovernmentalism and transgovernmentalism, mainly taking into account the obvious changes real political integration has taken in the period (see Chryssochoou 1997, Panild 1989). The schools indicate that no common consensus with regard to a definition of integration exists. Some focus on the process of forming a regional body, others emphasize the stage of integration¹.

In particular, the neofunctionalistic approach to regional integration, often addressed as the 'theory of Western European integration', was modified and extended as the original versions failed the empirical proof, partly due to real world developments, and partly because of conceptional weaknesses and shortcomings. With regard to the importance of integrative processes for regional development this is probably the most relevant school for the topic discussed in this paper. Despite of the fact that the lack of explanatory and predictive power with regard to the political and economic trends in West European integration of this approach were criticized. The central hypothesis of the approach, the so-called 'spill over thesis', can explain why the European Community embarked on a common regional policy in the early seventies. To some extent, as it will be discussed later on, the mechanism also seems important for the analysis of development process in a spatial integrative context.

2.3 Spatial Integration

Spatial integration is not a common used phrase, but rather a kind of summarizing description of a comprehensive notion dealing with and overall assessment of regional changes. Spatial integration includes features like:

The development of specific geographical defined systems of production such as industrial district, cluster of industries or systems of innovation,

A system of urban networks defined according to specific functional links,

The availability of a relevant regional infrastructure linking the analyzed area together,

Last but not least, the intensity of intra regional flows relative to the outside flows can be considered to be the 'conditio sine non quo' whether we talk about a spatial integrated area.

In particular the last condition is restrictive. In this notion the concept of spatial integration has to be understood as the most far reaching concept of integration. In this analysis the spatial concept is not merely a consequence of the physical environment, but also the result of economic and political integration.

In a continental or regional perspective we have strong evidence that political and economic integration is 'powered' by spatial proximity and adjacency, but at the same time political and economic integration reinforce the other aspect of spatial integration, accessibility.

Figure 1 A revised concept of integration

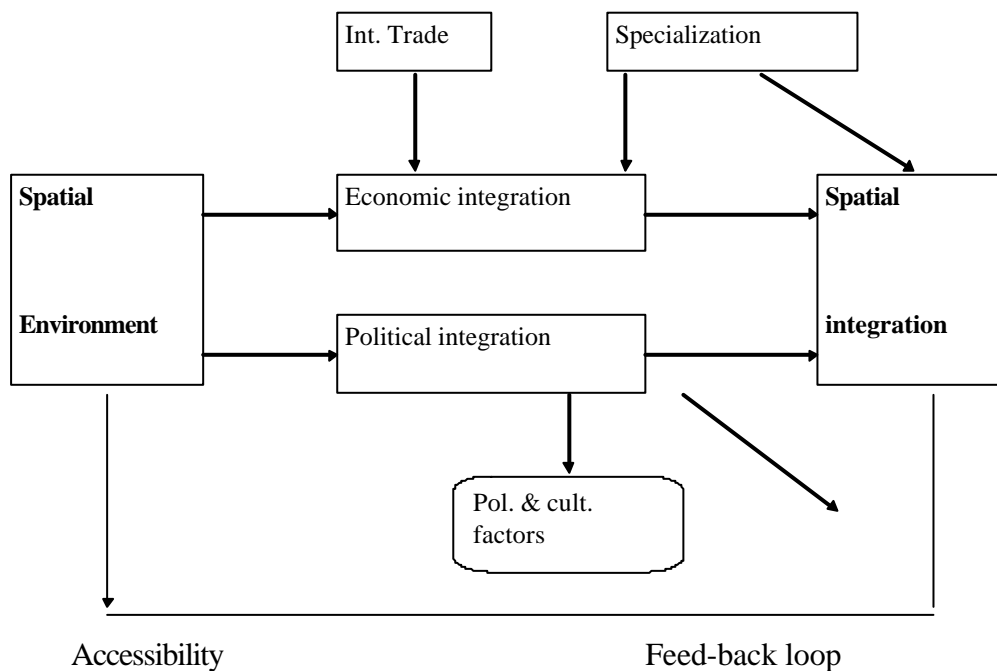


Figure 2 provides a brief summary of this approach focusing on the main factors leading toward spatial integration and the impact of this process on the future development through a feed -back mechanism reinforcing accessibility. The final result could be a kind of 'network based' (spatial) theory of integration (Gidlund 1990, p145ff).

3. Policy implications

Since the fall of the iron curtain a process of reintegration and redirection in international relations has been the most prominent feature of European economic and political development. After a tentative start economic as well as political links have intensified. After a almost abrupt change in trade and cooperation patterns in the aftermath of 1989/90, a more gradual process of reintegration took place, see figure 1.

With regard to political integration relations to NATO and the EU are the most prominent areas of action, but more adjacent means of cooperation were also attempted, i.e. *CEFTA, the Central and East European Free Trade Agreement* or the *Baltic Council*. Economic and political steps were part of a complementary process toward economic and political reintegration (Cornett & Iversen 1997).

Table 1. The Trade Regime of the Baltic Rim Countries

Title of agreement	Country, date of signature/into force	Aim/type of agreement:	WTO-status
Europe agreements (Signed and ratified)	Poland (12.12.91/1.2.94)	Association agreement providing for free trade and a forerunner to possible accession	Member since Juli 1, 1995
Europe Agreements (Signed)	Estonia Latvia Lithuania (12.6.1995) Russia	Association agreement providing for free trade and a forerunner to possible accession	Free Trade Agreement notified, June 1995 Latvia member since February 10, 1999. Estonia, Lithuania and Russia as of June 18 Observer government.
European Economic Area	Norway (1.11994)	Participation in internal market	member
EU-members	Denmark,Sweden Finland Germany	Common Market. (D & FIN members of EURO)	member

Source: European Economy (1997) & Cornett eds. (1996) & WTO (1999)

Politically this two tier strategy consists of both economic and political agreements. The later can be divided into two groups security policy (EOSC and NATO) and economic-political, namely the relations toward the EU and the major global economic organizations, i.e. WTO, IMF and the World Bank. With regard to the region considered in this analysis we have a rather scattered pattern with regard to security policy alignments¹.

In spite of the fact that economic policy alignments not are settled in all details, the picture is more clear, at least with respect to the regime for trade and other forms of economic exchange. With few exemptions mainly in the field of textile, iron and steel and agriculture the EU's trade regime toward East and Central Europe has been liberalized in all substantial aspects facilitating the participation in the European Market economic system. This means that we only have few remaining obstacles to

trade in the Baltic Rim Region, since the above mentioned restriction are in a fading out process or will become more or less obsolete if the EU reform of the Common Agricultural Policy is successful. For merchandise trade the region (with the exemption of Russia) almost constitutes a homogenous trade area.

Intensified trade relations are usually followed by closer economic ties based on a higher level of commitment, often manifested through foreign direct investment (FDI) and formal integration in the international production system¹. In an integrated area - or in a region moving toward integration - FDI can be seen as a second step toward the formation of an (spatial) integrated system of production. The first step is international trade, the third step is a change in the nature of international trade from inter to intraindustry trade.

The first two steps in this process are examined in the next section with special attention to the three aspect of integration discussed in this paper.

4. Empirical investigation

The first part of the empirical analysis addresses the issue of intra regional links. This part is based on trade and FDI figures for the Baltic Rim countries. Secondly, long term economic growth within the region is studied in order to identify distinct growth patterns within the region.

4.1 Links and notes

Networks theory and network research is closely related to the spatial aspects of society. Linking the network perspective to the political and in particular the economic aspects of integration is always a difficult task. Social and political attitudes are usually related to political actors and social groups, not necessarily to a spatial system of links and flows. The same goes for economic flows. These are mainly reported as flow or stock-data for countries or groups of countries as a whole, and can only rarely be related to specific locations.

In economic analyses, including the spatial dimension, the problem of disperse location of economic activity is often solved in a rather pragmatic way, using the national capital as location of all external trade exchange. To smaller countries this does not matter that much. For larger countries, and in particular when the models are applied on a regional level, the issue can become a considerable problem (Cornett & Iversen 1995).

Therefore, the following analysis is mainly based on national figures. The 'network system' of this article, therefore, is a rather rudimentary concept, only intended to be used as an analytical frame of reference. The purpose is mainly to stress that we are dealing with a subsystem of a larger and comprehensive economic and political system. For most of the units of analysis in this paper these external links are more important than the internal links within the region. Figure 2 illuminates the fact that for most of the Baltic Rim states external ties are stronger than intra regional flows. The only exemptions from this pattern are Estonia with regard to trade and received FDI and Lithuania, Latvia and Denmark concerning received foreign direct investment in 1997.

Figure 2 Trade and FDI of the Baltic Rim countries according to origin 1997, pct of total .

Note: No FDI for Russia available, Figures for Poland are 1995, Lithuania 1996

Source: IMF (1998) & Table 4

Due to the summarizing nature of the pattern which is reported in figure 2 one must stress that the sketched picture has to be interpreted carefully because Germany, Russia and Poland, in particular, are all part of the analyzed region with only a minor part of their economy.

Since the central purpose of this analysis is to address the issue of regional integration in a development perspective the investigation in the remaining part of this section will concentrate on economic indicators of regional integration and development. One implication of this approach is that we are not operating within the context of a real network of nodes and links in an traditional sense (Törnquist, 1990). The economic units are the nodes (countries) and the links are trade and

capital/investment relations, measured by imports and exports and foreign direct investment (FDI).

4.2 Flows

Trade flows in the Baltic Rim have suffered from the artificial economic borders between economies in the area. This does not mean that the region historically - at least not for the last hundred years - has constituted a functional internal coherent region. In the seventies and eighties the region belonged to three different economic associations, the market based EU and EFTA and the CMEA based on non-market principles. The economic border between the two former did not have major importance on trade flows for most groups of commodities. The latter was much more important, and it is mainly with regard to trade between the countries belonging to the former East block and the Scandinavian countries¹ and Germany the redirection of trade in the area took place (Cornett & Iversen 1993).

Table 2 shows that only for the smaller economies Baltic Rim region has a dominant position with regard to foreign trade. Taking the nature and the size of the German economy into account the importance of the Baltic Rim as a geographical region diminishes further. In the long run the Baltic States will probably move towards a trade pattern more similar to the Nordic countries, and find their historical place in the regional trading system (Laaser & Schrader 1992).

Table 2 Share of intra regional trade as pct. of total trade of Baltic Rim Countries since 1992

	1992	1993	1994	1995	1996	1997
Denmark	48,7	44,3	45,4	41,5	42,5	43,7
Estonia	92,0	66,8	74,1	68,0	68,8	69,8
Finland	41,7	37,5	39,4	36,5	35,2	38,0
Germany	8,6	8,8	9,1	9,4	9,3	10,3
Latvia	61,8	46,1	48,0	60,3	48,8	49,6
Lithuania	57,8	45,5	50,1	48,8	46,1	48,9
Norway	35,9	32,4	37,0	37,1	36,9	36,4
Poland	47,4	47,1	50,2	51,6	48,2	47,9
Russia	18,9	24,8	23,5	20,9	21,5	22,7
Sweden	35,5	32,6	33,1	32,7	32,2	32,9
Baltic Rim	17,9	18,0	19,0	18,9	18,9	20,1

Note: Figures based on exports to Baltic Rim countries as pct. of total exports. All figures are based on reported imports from receiving countries. Danish exports to Sweden 1992-1994 are based on Danish exports. For 1992 and 1993 some figures are missing for former state trade countries.

Source: IMF 1998

An analysis country by country proves the dominant position of Germany in the regional trading system. Germany counts for more than 30 % of both internal imports and exports. Generally speaking, shares in import and export does not vary that much except for the major exemptions of Russia (larger import share) and Poland (export share) among the bigger and Estonia and Lithuania among the smaller economies. For details see Table 3 below.

Table 3 Trade in the Baltic Rim 1997. Percentage of Total.

Export to: from:	DK	EST	FIN	D	LT	LH	N	PL	RUS	S	Total import
Denmark		0,1	0,6	4,9	0,1	0,2	1,5	0,5	0,4	2,9	11,2
Estonia	0,1		0,3	0,2	0,1	0,1	0,0	0,0	0,2	0,3	1,2
Finland	0,8	0,8		2,5	0,1	0,1	0,7	0,5	1,2	2,1	8,9
Germany	5,9	0,3	2,7		0,2	0,6	3,0	6,3	4,1	7,4	30,6
Latvia	0,1	0,0	0,0	0,2		0,1	0,0	0,0	0,2	0,3	0,9
Lithuania	0,1	0,0	0,0	0,3	0,1		0,0	0,1	0,3	0,1	1,0
Norway	1,4	0,0	0,7	5,6	0,0	0,0		0,3	0,2	3,1	11,4
Poland	0,5	0,0	0,2	5,1	0,0	0,2	0,1		0,7	0,4	7,3
Russia	0,2	0,4	1,5	6,1	0,2	0,9	0,4	1,7		0,3	11,6
Sweden	3,5	0,3	2,2	5,1	0,1	0,1	3,5	0,8	0,5		16,1
; Total export	12,5	2,0	8,1	30,1	1,1	2,4	9,3	10,0	7,7	16,8	100,0

Note: Figures based on reported imports by target country

Source: IMF (1998)

Table 4 Share of Intra regional FDI as pct. of total FDI Baltic Rim Countries (receiving countries) since 1992

	1992	1993	1994	1995	1996	1997
Denmark	1190	606	37,7	30,2	-2000,0	51,9
Estonia	-	-	590	63,5	61,6	690
Finland	440	429	70,6	10,1	14,9	23,8
Germany	-	16	-1,4	2,1	2,2	7,5
Latvia	289	409	50,1	60,8	56,0	50,4
Lithuania	-	-	-	35,8	50,8	-
Norway	-	-	6,6	52,7	15,2	5,1
Poland	-	20,1	25,7	18,6	-	-

Russia	-	-	-	-	-	-
Sweden	-	28,8	4,5	14,9	61,2	34,7

Note: Figures for West-European countries include only FDI from western countries. Sweden includes some figures for Russia, Finland includes Russia but exclusive reinvested earnings. All figures reported in national currencies and are based on Net-flow, which can cause major disturbances in some years. Figures for Denmark in 1996 are effected by heavy net outflow to the Netherlands in this particular year. German figures for 1996 are effected by huge net outflows to Denmark and Sweden. German figures do not include the Baltic States.

Source: Hedegaard & Lindström (1998), Bundesbank (1993ff)

According to the outline in section 3 foreign direct investment is used as an indicator of more formalized international integration of the economic systems. Table 4 provides an overview of FDI patterns within the region. Figures must be used very carefully due to lack of data and the methodological problems involved in the process of data collection and the periodization of the flows. Nevertheless, the Baltic Rim economies' importance for FDI in the three Baltic States is evident. This can be considered to be at least a weak indication of increased participation in the regional system of divisions of production.

Also with regard to FDI the strong position of the German economy, and in particular the non Baltic Rim part has to be taken into account. Based on GDP the Baltic Rim part of Germany counts only for 8,3 % of the German GDP in 1996¹.

4.3 Growth and development performance

The analysis of trade and FDI has proved that the transition economies of the Baltic Rim has been integrated into the regional economic system, simultaneously with disintegration of the old state-trade links. This only is a first step in a long catch-up process necessary, indicated by the huge intra-regional difference in GDP per capita within the region.

Table 5 Economic growth in the Baltic Rim Countries

	GNP per capita in US-\$ in PPP	GDP, real %change				
	1997	1995	1996	1997	1998	1999
Denmark	2345	32	32	33	24	20
Estonia	5.09	29	40	97	68	70
Finland	1966	51	36	61	50	32
Germany	2117	12	13	22	27	22
Latvia	3.97	-8	28	59	63	66
Lithuania	4.14	30	42	60	66	67
Norway	2426	38	55	34	23	23
Poland	6.51	69	61	69	61	60
Russia	428	-	-	-	-	-
Sweden	1901	39	13	18	28	22

Note: E: estimates & projections

Source: European Economy (1998a), OECD (1998) & World Bank (1999)

The disequilibrium creates a two-tier economic system. The consequence is that future development will depend on, to what extent the transition economies are able to catch-up with regard to the absolute level of economic performance and how they are able to manage the burden of external indebtedness¹ in a situation with huge investment needs and growing economic expectations of their population.

Compared to the western part of the Baltic rim the transition economies have performed significantly better concerning economic growth, but of course from a much lower level. If the catch-up with regard to economic performance persists, gravity model analysis shows a huge future potential for trade in the region (Cornett & Iversen 1998). This can probably lead to a sustainable and spatial integrated region in line with other European regions. In the short run it seems that at least the Baltic states and Poland have maintained high growth despite unfavorable macroeconomic conditions:

"The economy of the ten candidate countries in central and Eastern Europe has been negatively affected by the worsening of the international environment and the turmoil in the financial markets. Nevertheless, average growth rates have remained higher than in the EU. Over the last two years, annual GDP growth of more than 5 % was observed in Estonia, Latvia, Lithuania, Poland and Slovakia" (European Economy 1999 p.1).

5. System and system change

Since the late 1980s the Baltic Rim has been characterized by a simultaneous process of gradual and fundamental changes. The most important systemic changes in the considered period are:

the reintegration of former state trade countries into the western market system,

the adaptation of two former EFTA-countries to the comprehensive regional policy system of the EU

the general pressure towards deregulation and change of the Western European and, in particular, the Scandinavian welfare system.

For the former command economies the changes mentioned above are far more excessive than for the Scandinavian or other Western European applicant countries, internal as well as external. The first mentioned feature includes somehow both the second, the third and a wide range of other more extensive social changes. Fundamental structures of society has been altered, and the traditional system of production has disappeared rapidly. This underlines the need for a comprehensive strategy because business and industry is required to reach a level of a sustainable growth and in the longer run to keep up the economic catch-up process.

The overall policy framework for this process, sketched in figure 3 below, summarizes the spatial constraints and opportunities involved in this process.

Figure 3 Determinants of a Spatial System of Change in an Integration Perspective

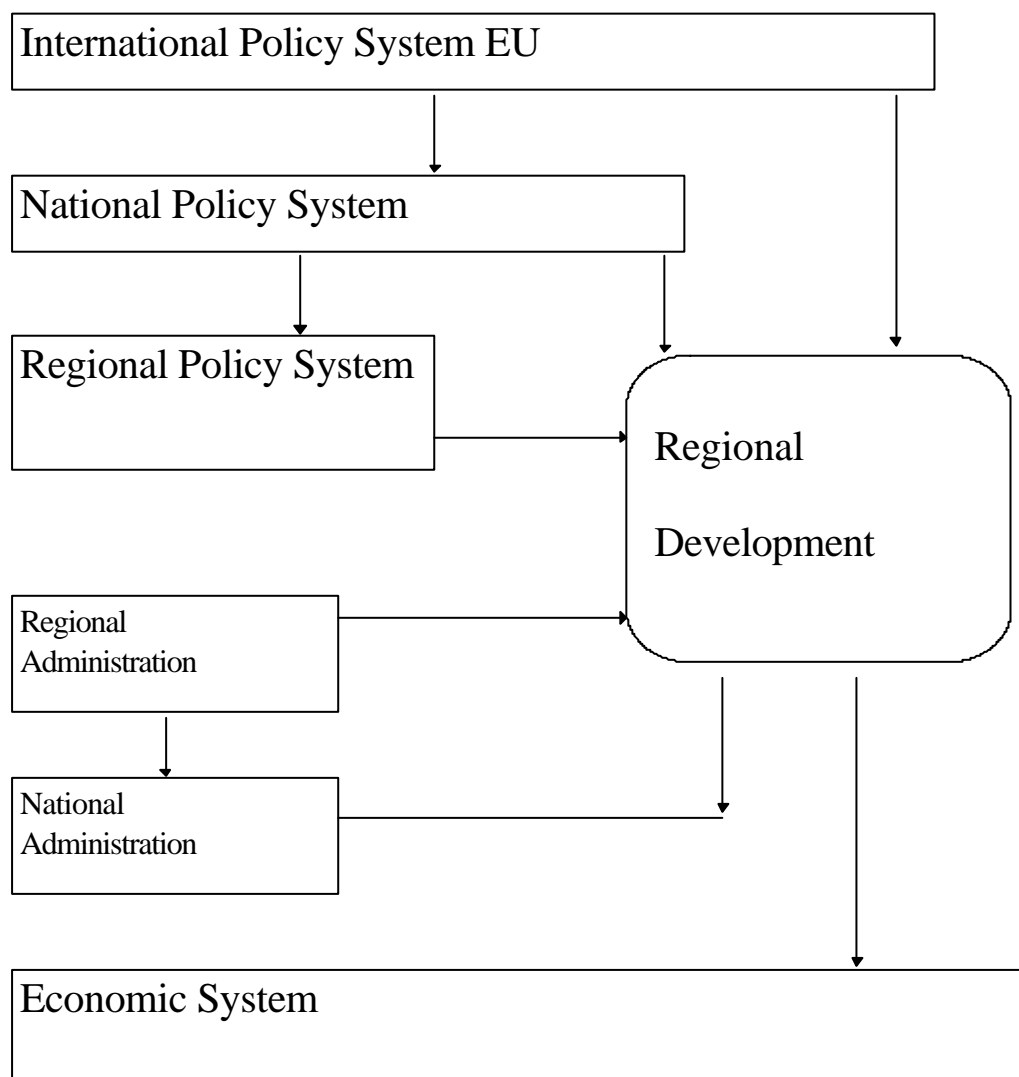


Figure 3 illuminates the basis of this approach, seeing the regional system of change as a specific result of political, economic and functional stimuli (i.e. programs and advisory bodies) in a regional and sectoral context. Using figure 3 as an analytical tool it is important to remember that the systems of change are not physical systems. They are defined as certain aspects of supply and demand side actors. The focal point are the functional links within a framework of geographical or spatial constraints to the process (compare figure 1). The systems can be defined as being partly virtual with a spatial or economic anchor, in our case the Baltic Rim Region. From a spatial integration point of view the participation in the regional system of production is a necessary condition to be fulfilled. The following section addresses these aspects.

5.1 Elements of a development strategy

Business development in this perspective has to take place within the framework of business development schemes provided by international agencies (EU), national government programmes and local and regional initiatives. In an analytical perspective the policy system can be described as a mixture of bottom-up and top-down features. In this regard, the crucial issue is the fact that effective systems still have to be established in most transition economies on the regional level. Pure regional objectives play a rather limited role in national priorities¹.

Business promotion policy within this kind of frameworks requires a wide arsenal of instruments, both targeting regional needs and the specific requirements of the industries. Cappelli n (1995, pp. 11f) distinguishes between three sets of measures:

Measures on internal capacities of firms, like promotion of the founding of new firms, vocational education, applied research and receptivity towards innovation

Measures targeted towards regional networking, namely subcontracting, business service, public private cooperation etc.

Promoting interregional network connections, like export promotion, international cooperation of firms and investment.

In particular, the last-mentioned is central in a spatial integration context. Regional policy always has to take place in a specific context, and has to be based on regional advantages or at least on an explicit strategy to create competitiveness. The crucial problem for regional development is similar to the general problem of industrial policy. *Is it possible to point the winning strategy based on scientific studies and bureaucratic decision making?* Successful result of these efforts are rather seldom also in the old market-economies. The aim of setting up development policy units in transition economies has to be more narrow, to facilitate local business and industries participation in the international division of production¹. In the longer run proactive development policy which aims the formation of sustainable industrial districts or clusters could be a target.

Industrial districts are the most visible signs of regional specialization. One of the reasons why industrial districts for many years have drawn the attention of regional scientists as well as politicians is that they have performed well with regard to growth and employment, compared to less specialized regions. The most important reason for this is probably that the older regions, at least the surviving regions, have also performed well with regard to structural adaptation. The crucial issue is whether or not the development of industrial districts is stimulated, and how these find a sustainable place in the international system of production. As mentioned earlier, increasing intra industry trade and foreign direct investment are weak indicators of the beginning of this process.

Industrial districts usually develop over a long period, and during this period specific skills and sets of knowledge become a characteristic of the area, related to the specific industry. From a regional development point of view it is important to remember, that the specific consulting and advisory bodies often found in these districts with tied links to the industry mentioned are developed as a response to the emerging needs of the industry.

Therefore, supporting measures seem to be more important when dealing with the development of a certain region, i.e. to promote that an industrial cluster (a group of firms belonging to different sectors or branches, Braunerhjelm et al. 1998) turns into an industrial district. In any case it has to be questioned whether a regional policy should focus on developing industrial districts or broader clusters of industry.

5.2 The Regional Policy Perspective

The regional policy perspective is to promote the creation of advisory bodies facilitating the process of business development. The challenge is that advisory bodies in 'old' industrial districts - to use a phrase - are 'demand driven' and not 'supply driven'. The latter is usually the case when regional policy is considered. Therefore, the advisory bodies or networks have to be considered supportive and not initiative instruments of business development policy. The problem of the economies in transition is that the old instruments have disappeared, and that traditional regional policy rarely is able to develop a system from the bottom based on supply-side instruments and public funding.

Regional policy can be defined in many ways. One concept stresses the policy as a set of instruments to achieve specific objectives in reducing regional unemployment, attaining an efficient geographical distribution of industry and employment. In line with this the provision of a more equal geographical distribution of income and living conditions are important goals (Armstrong and Taylor 1985, 176-180, Temple 1991, 225ff.). The traditional concepts - often applied in the Nordic part of the Baltic Rim (see Monnesland 1997) are probably not applicable at the current stage of economic development in the transition

Concepts of indigenous development could be a 'short cut' to stimulate sustainable regional development processes. These concepts emphasize the regions own potentials (See Hahne, U & K.v.Stackelberg 1994, 80ff.), and they have become increasingly popular since they fit the general trend towards decentralization, and coincide with budget problems in the central government in the aftermath of the first and second oil crisis. In the eighties, shifts in the ruling economic doctrines towards monetarism and neoclassical concepts reinforced this process. Supply side economics became key concepts in regional development also, and they are at least in harmony with concepts recommended by international advisory bodies for East and Central European countries.

6. Summary and perspectives

The main result of the analysis of economic indicators of the Baltic Rim region is that trade pattern within the region has been altered very fast after the dissolution of the old state-trade system after 1989/91. To some extent it seems that particularly the three Baltic States rely more on intra regional links than the Nordic countries or Poland and Russia. Concerning foreign direct investment the regional linkages seem to be of even greater relative importance. Still, it is too early to decide if these are the first weak indicators of the formation of a spatially integrated area. A precondition for the formation of an integrated sustainable region is the overcoming of frontiers of economic wealth which divide the Baltic Rim into two distinct economic regions. Indicators of economic growth provide evidence for a beginning catch-up process, but are still too weak to overcome the huge differences in economic performance within a considerable period of time.

The analytical approach developed in this paper stresses the need for a comprehensive strategy in the analysis of problems of transition in a particular region, based on the combination of spatial theory and approaches from the discipline of economic integration. This perspective may contribute to a deeper understanding of the decisive factors of regional change and regional policy in the Baltic Rim area, a region characterized by:

- the reintegration of former state trade countries into the western market system,

- the adaptation of two former EFTA-countries to the comprehensive regional policy system of the EU and

- the general pressure towards deregulation and change of the West European and in particular Scandinavian welfare system.

Concerning the regional policy implications for the region the conclusions are ambiguous. Trade and FDI are necessary, but not sufficient. Structural changes are required both internal in the transition economies and to some extent also in the old market economies as stated above. Particularly in the transition economies regional development instruments are required to form the basis of a sustainable business development policy, national as well as on the regional (county) level.

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¹ Part of the argument is that the economies of most LDC's for a long period were directed toward the industrialized world. In spite of that many countries were competing in the same market the nature of there exports (raw materials and relative simple industrial product) provided not the base for trade creation internally due to scale economics or specialization.

¹ The MERCOSUR and AFTA arrangements are the best examples in this respect.

¹ For a more specific discussion of the concept with special attention to the process of reintegration of East and Central Europe, see Cornett 1998/1999.

¹ The basic concepts of regional integration can be found in many economic textbooks. Useful and comprehensive studies are Balassa 1973 or Robson 1987. A technical and theoretical assessment of the discipline can be found in Baldwin (1995).

¹ Most Regional Economic Associations (REA) are dominated by relatively similar countries, although large internal regional differences not are unusually.

² According to Robson (1987, p.197) these attempts are usually based on the *classical approach of general trade liberalization* resulting in the formation of Free Trade Areas or Customs Unions, *complementarily agreements* (i.e. trade liberalization for certain existing industries) or *joint measures to regulate investment* in new industries aiming to exploit scale economies based on the total regional market.

¹ In a review of the state of the art of political integration theory after the first 'honey-moon' of political integration and the first major draw-backs in real world integration as well as theory-building, Charles Pentland (1973) made the attempt to formulate what he called a common denominator of political integration:

"All it seems possible to say is that international politisag integration is a process whereby a group of people, organized initially in two or more independent nation-states, come to constitute a political whole which can in some sense be described as a community" (Pentland 1973, p.21).

¹ Within the area of security policy all countries belong to the European Organization for Security and Cooperation, an successor of the Helsinki process' of detente in the 1970's. Denmark, Germany, Norway and now Poland are members of NATO. Sweden and Finland maintain a policy of nonalignment, while the Baltic states still are in an intermediate position between NATO and Russia.

¹ A good example of the later is the international specialization taking place in the textile sector. For a Danish example see Illeriis 1998.

¹ In many respects Finland is a special case due to the close economic links to the Soviet Union prior to the transition process.

¹ Another figure can illuminate the point. Export as percentage of total turnover in the German manufacturing sector was in 1996 29,7 %. In the three Baltic Rim states the figure were in Hamburg: 11,9 %, in Schleswig-Holstein 26,0 and in Mecklenburg-Vorpommern 10,6 %. (IdDW 1997, Table 4).

¹ External imbalances of the Baltic states and Poland are summarized below:

	Trade Balance (% of GDP)						Debt-export ratioin %			
	1995	1996	1997	1998F	1999F	2000F	1995	1996	1997	1998
Estonia	-18,7	-23,4	-24,1	-22 8	-20,7	-18,9	NA	36	56	

Latvia	-14,5	-15,6	-15,4	-15,4	-16,0	-16,8	31	28	27	33
Lithuania	-11,7	-11,4	-12,3	-13,9	-15,8	-16,2	25	29	27	
Poland	-1,6	-6,3	-8,5	-8,3	-8,9	-8,7	169	145	123	114

Note: E: estimates, F:forecast, figures always most recent reported.

Source: European Economy (1998a & 1998b)

¹ In Denmark and to some extent in parts of Germany (the former West), similar features are present as a consequences of changes in focus of business development policy, see Cornett et al. (1998).

¹ An example are the links developed between the Danish industrial district of Herning Ikast and production sites in the transition economies. The case also illuminates the changes taking place in the outsourcing region. The crucial feature in the later is the ability to move upwards in the vertical division of labor within in industry considered. A recent study (Illeris 1998) of the Herning Ikast areas textile industry provides a good example of, how an industrial district shifts from a production based to a knowledge and skill based competitiveness with significant impacts on traditional employment.