The Global and Regional Outlook in the Baltics

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I Introduction

Restoration of growth in the Baltics and their re-integration into the world economy will first and foremost depend on success in transition and the introduction of market-based economies. Open trade and other integration agreements can facilitate the process by opening up trade and investment opportunities, and locking in reforms with external anchors. But regional trading arrangements (RTAs) are also second best to unilateral trade liberalisation, and can lead to trade diversion if barriers to third countries remain high.

Since re-independence in 1992, RTAs have been important in facilitating the Baltics' integration into the world economy and their export development. As the Baltics were not yet members of the World Trade Organisation (WTO), which sets multilateral rules for trade and market access, RTAs were also important in creating initial rules for their trade relations and helped open external markets. Their integration with Europe has gradually deepened and the Baltics applied for EU membership in 1995. The large and high-income Europe was an attractive market for them, and being part of Europe was an important political goal after years under Soviet rule. Initial steps have also been taken to deepen integration among the Baltics. Trade and economic relations with other countries of the former Soviet Union (FSU) first disintegrated but are gradually being rebuilt under market principles. Apart from some trade agreements, so far no deeper integration has taken place.

This paper discusses the role of RTAs in present and future trade and foreign direct investment (FDI) performance in the Baltics. As small and open economies a major determinant of growth and transition will be trade performance. Foreign direct investment can speed transition by transferring technology and increasing savings for investment. After reviewing past

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trade and FDI performance of the Baltics, the paper discusses the role of transition policies and RTAs in fostering trade and FDI, and thereby growth and transition, in the region. The analysis is made difficult due to poor data especially on trade, but data for other economic indicators also tend to vary frequently in different sources.

Available data indicate that regional integration would in general have led to trade creation – especially with Western Europe. The RTAs with the European Union (EU) and the European Free Trade Association (EFTA) countries since 1992 are likely to have contributed to rapid reorientation of Baltic exports and increased intra-industry trade in textiles and machinery, and helped transition by requiring rapid approximation of laws to Western standards. The Agreements, however, have not yet attracted export-related FDI. FDI in general is still low in per capita terms and most of it has gone to non-tradable services. Restricted market access in agriculture, fisheries, textiles, and services in the EU, restrictive rules of origin, safeguards, and the hub-and-spoke nature of the RTAs can explain some of the disappointing FDI performance, although the need for more progress with transition and the overall policy framework are likely to be more important in this. The most liberal Baltic country – Estonia – has performed best in both trade and FDI. In Latvia and Lithuania the RTAs are likely to have promoted liberalisation of trade policiesby requiring market opening and approximation of laws to EU standards. The Baltic Free Trade Agreement (FTA) has not yet resulted in expected increases in mutual trade or FDI. Baltic trade with the FSU countries faces many non-tariff barriers and, after an initial decline, continues especially in energy, but food exports from the Baltics have also increased in recent years.

In the highly trade-dependent Baltics, future growth potential will continue to depend greatly on trade developments. First, the most important in this will remain progress with transition – maintenance of macroeconomic stability, and structural policies that promote allocative efficiency and improve incentives and legal frameworks for private sector development to attract FDI, and higher savings for investment. RTAs can play a role in promoting further liberalisation and locking in policy reforms. Second, preparation for EU membership is likely to dominate trade relations and will gradually harmonise policies within the Baltics. The preparation process would be helped by clearer timetables for EU accession and required policy reforms, better access to the EU market in sensitive products and coverage of services in the RTA with the EU – the so-called Europe Agreements. Third, intra-Baltic integration and that with other Central and Eastern European countries with Europe Agreements should be deepened within FTAs to reduce the trade and investment barriers from the EU's hub-and-spoke system of RTAs. Fourth, deeper integration with

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the FSU is not likely to offer many economic benefits, but these markets in the medium term offer large trade potential in both goods and services. Fifth, to develop FSU and other trade relations the Baltics should pursue their membership of the WTO and consider joining other broader agreements, such as the Organisation of Economic Cooperation and Development (OECD) or the planned Multilateral Agreement on Investment (MAI), that can foster further liberalisation, rule-based trade relations and increase the credibility of policy reforms.

II Trade and Foreign Investment Patterns during Transition in the Baltics

The Baltics depend on trade for a large part of their GDP, which makes trade an important engine of growth and transition to a market economy. Although trade data in general are poor and vary greatly in different sources, existing statistics (IMF) show that exports of goods and services in 1995 were three-fourths of GDP in Estonia and about one-half in Latvia (47 per cent) and Lithuania (55 per cent). The shares are higher than in many other transition countries (e.g. Hungary 29 per cent) or in small industrial countries (e.g. about 33 per cent in Finland or Sweden). Closeness to main European markets, location between Eastern and Western Europe, low wages and high skills have been the main sources of Baltic comparative advantage since re-independence (for more details see Sorsa, 1994).

After the initial collapse[2] of trade in the early 1990s, **recovery of exports** of both goods and services has been good. Both in terms of overall increase and per capita, Estonia has been the most successful in developing exports. Between 1992-1995 total exports of goods increased four-fold in Estonia, and nearly two-fold in Latvia (in nominal dollar terms). In Lithuania growth of exports between 1993 and 1995 was about 30 percent (Table 1). Exports of services have increased even more.[3] Estonia has also been the most successful in attracting **foreign direct investment** – its

2 Comparisons of levels of trade before and after transition are difficult and unreliable because of the difficult valuation problems related to trade under central planning under overvalued exchange rates. According to one estimate of pre-independence trade (Kaminski, Wang and Winters, 1996) the 1995 level of goods' exports in Estonia was 71, in Latvia 33, and in Lithuania 49 per cent of their 1991 level.

3 Baltic trade statistics are subject to many discrepancies, calling for some caution in their interpretation even after independence. Differences among various sources are large, e.g. in 1994 IMF reported exports of $1,327 million compared to 1,103 million by the World Bank (Michalopoulos and Tarr, 1996) for Estonia. All Baltics have large shares of transit trade, which may be reported differently in different sources. High inflation makes valuation difficult on an annual basis.

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cumulative per capita FDI was nearly three times that in Latvia and nearly seven times that in Lithuania. But compared to a number of other transition countries or fast growing developing countries, Estonia's FDI at $451 per capita in 1995 is still modest – by 1995 Hungary had attracted a cumulative $1,113 per capita, and the Czech Republic $512.

Table 1 Export and FDI in the Baltics during Transition, 1995

	Growth of exports of goods and services) 1995/92* (per cent in dollars)	Exports/ capita (dollars)	Export share to FSU (per cent)	Services exports in total exports (per cent)	FDI cumul. 92-95 (millions of dollars)	FDI per capita (dollars)
Estonia	300 (330)	1956	37	28	673	451
Latvia	70 (150)	822	38	39	414	164
Lithuania	30 (150)	858	52	14	228	61

* for Lithuania 1995/93 for lack of comparable 1992 data.
Source: ECE, DOT, IFS.

Trade in Goods

During the first five years of transition the **structure** of Baltic exports has been changing rapidly and reflects some of the above-mentioned comparative advantages and the restoration of more realistic relative prices[4]. Resource- and skill-intensive products now dominate exports, while imports are mainly raw materials (energy) and machinery. Both inter-industry (trade between countries with different factor endowments) and intra-industry (trade between countries with similar factor endowments) trade have increased. Some exports are "new", such as natural resources (metals, oil and wood), in the sense that they did not exist during central planning in the Baltics under distorted relative prices. Within the Soviet command system the Baltics exported machinery, light goods (food and textiles) and chemicals from imported inputs and energy (Sorsa, 1994). Wood exports now account, for example, for a quarter of Latvia's exports. Since transition Estonia has rapidly moved from being a natural resource

4 Product level data are particularly poor, which makes any detailed analysis difficult. Therefore the following assessment is by nature relatively general and based on varying sources subject to large measurement errors.

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exporter to one that exploits more its low-cost, high-skill labour force in processing activities (see below). With the increase in real wages and productivity, its structure of trade is likely to move gradually closer to that of industrial countries. Similar developments are taking place in Latvia and Lithuania, although at aslower pace. Exports from some of the "old" industries (food, textiles, machinery) have recovered, suggesting that successful restructuring may have taken place during transition and that they are exploiting past market links and know-how. A number of homogeneous, resource-intensive products such as chemicals and mineral products (oil) have remained important in Lithuania's exports (24 per cent of total exports).

Table 2 Increase in Baltic Exports of Goods by Direction between 1995 and 1993
(percentage)

	Total	EU	EFTA	Baltics	Russia	Ukraine
Estonia	140	202	160	96	4	80
Latvia	23	70	290	82	4	20
Lithuania	122	53	340	42	620	100*

* figure corresponding to 1995/1994.
Source: DOTS. In Lithuania there is a large discrepancy between DOTS and IFS data for 1993 explaining the difference in total growth between 1995 and 1993 compared to Table 1.

Since the start of transition in 1991/1992 the **direction** of the Baltics trade has changed dramatically. Europe has become their main trading partner, as the collapse of intra-FSU trade was replaced by exports to new markets (Table 2). In 1995, over 60 per cent of Estonia's, 44 per cent of Latvia's and 47 per cent of Lithuania's exports went to the EU, compared to nearly none at the start of transition. Trade with EFTA countries has been a small, although growing, share of the total (around 2 per cent). Despite the FTA, intra-Baltic trade has remained around 10 per cent of total exports. Trade with Russia and other FSU countries after the initial collapse has remained a declining share of total exports in Estonia and Latvia, but increased substantially with Lithuania. The share of Ukraine after the initial collapse has increased, but less than total trade.

The pattern of trade by direction – the EU and FSU – is quite different (Table 3), which is to be expected due to the large differences in factor endowments in these markets. Initially upon independence trade with the EU was typically of an inter-industry nature. The Baltics exchanged raw materials – their own such as wood, or re-exported such as petroleum and

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metals – against machinery and other consumer goods.[5] In 1995 resource-based goods continued to dominate Latvia's exports to the EU (wood), while Lithuania was exporting food and raw materials to the EU. Some intra-industry trade such as the processing of textiles from EU raw materials has emerged in all three. In Estonia the shift to intra-industry trade was most pronounced (about 20 per cent of total exports) – in addition to textiles, various machinery products are now processed in Estonia, that exploits its inexpensive but highly skilled labour.

Table 3 Structure of Baltic Exports (and Imports) by Direction in 1995
(percentage of total)

	Estonia				Latvia				Lithuania			
Products	EU		CIS*		EU		CIS*		EU		CIS*	
Manufactures	57	(73)	40	(38)	48	(80)	64	(40)	62	(82)	48	(27)
Textiles	18	(11)	4	(8)	16	(12)	13	(1)	19	(11)	7	(1)
Machinery	21	(37)	25	(14)	6	(35)	32	(14)	7	(40)	21	(7)
Food	9	(14)	35	(7)	3	(10)	30	(3)	16	(14)	32	(2)
Oil	5	(5)	13	(41)	1	(8)	3	(53)	6	(1)	18	(65)
Other raw materials	27	(8)	22	(14)	48	(2)	3	(4)	16	(3)	2	(6)

* Commonwealth of Independent States (CIS) includes Russia and Ukraine.
Source: COMTRADE, Estonian Statistical Yearbook (1995).

The Baltics seem to be reinforcing their past "comparative advantage" as processed food exporters to other CIS countries (fish, drinks, sweets). Other CIS exports are machinery, especially from Latvia and Lithuania, which is also likely to reflect the pre-independence trade patterns. In Estonia, part of machinery exports is various repair services for ships, trucks or trailers. Oil is still an important item from Lithuania. Some recent estimates with gravity models predict that the relative share of the FSU in total trade will increase from present levels (Cornett and Iversen, 1996).

Intra-Baltic trade is dominated by chemicals and energy, but exports of textiles and food have increased slightly in recent years. Lithuania's main export to the other Baltics is refined petroleum (35-50 per cent). Latvia exported food, textiles and other manufactures to the other Baltics, but

5 One study estimated the share of re-exports of FSU raw materials (or so-called arbitrage goods) in 1992 in total exports as 45 per cent in Estonia and about 70 per cent in the other two. In 1994 their share had already declined to 22 in Estonia and 47 in Lithuania, but remained high in Latvia at 58 per cent (Hoekman and Djankov, 1996).

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trade flows have been erratic. Food trade is likely to increase with the free intra-Baltic trade in agricultural products established in 1997.

Services and Investment

Trade in **services** has become an important element of total trade in the Baltics. Services were already important under central planning as the Baltics were among the main ports of the FSU to the West. Today the largest service exporter is Latvia. Nearly 40 per cent of total export earnings are services, compared to 28 per cent in Estonia, and only 14 per cent in Lithuania (Table 1), but services exports have grown substantially in all three countries. In Latvia main service exports were linked to transport, either by sea or land. Travel, tourism, business services and construction are also important. These activities are likely to offer high future growth potential as incentives for private sector evolve. As establishment is an important element for trade in services, the incentive framework for investment is important for further trade in this sector.

The RTAs have not generated **foreign direct investment** in export industries geared to Western markets. Most FDI has been in often non-tradable services and in industries that export to the Baltic or FSU markets (chemicals, food). In Estonia, a large share of FDI (about 30-40 per cent of inflows in 1994-95) was related to privatisation programmes (ECE, 1995). The largest investors were Finland (20 per cent), followed bySweden (19 per cent), and Russia (15 per cent) according to stock on January 1, 1996 (ECE, 1996). About half was in manufacturing (mostly chemicals and food industries), while trade and transport were the largest recipients in services. In Latvia, FDI started to increase in 1994. In Latvia as well a large part of FDI was related to the privatisation of state utilities – one large sale of telecom in 1994 accounts for most of it. Most investments (nearly 70 per cent) have been in services (mostly finance). One-tenth of the total was in food industries. The largest investors in 1996 were Denmark (26 per cent), Russia (19 per cent) , and the United States (12 per cent). Lithuania has received the least investment among the Baltics. The largest investors have been Sweden, Germany, the United States, and Russia. No sectoral breakdown is available.

III The Role of Transition Policies in the Baltic Trade and FDI Performance

While open integration agreements can create a framework for trade and investment growth, the speed of integration and the actual benefits

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from it depend crucially on progress with transition – with the introducing of market-oriented policies and with the restructuring of their economies. Progress in this has been good, but slightly different among the three Baltics. While all three have been successful in stabilising their economies, Estonia seems to be clearly ahead in structural reforms. Its trade policy framework is the most liberal among the Baltics, and it is also more advanced in privatisation and creating incentives for investment and private sector growth. This may partly explain its better export performance and success in attracting FDI.

Stabilisation Policies

Transition in the Baltics has proceeded rapidly since 1992, and all three have now successfully stabilised their economies.[6] Inflation in early 1996 was around 20-35 per cent and interest rates have declined to 16-35 per cent annually in 1995. Output growth resumed in 1994/1995 (Table 4) and was 3 per cent in Estonia and Lithuania and zero in Latvia in 1995. The return of output growth and the decline in interest rates have been slower in Latvia than in the other two, while its inflation has been the lowest. Fixed exchange rates (currency boards in Estonia and Lithuania) tend to lower interest rates when the currency is anchored to an international currency and thereby to international interest rates. Recently, external imbalances have increased in all three as imports of (especially of capital goods) have increased. However, since the deficits reflect largely private sector activities and not excessive public consumption and have been financed by FDI and other longer term capital, they have not been of much concern.

The results were achieved with slightly different policy mixes. Stabilisation in Estonia (in 1992) and later in Lithuania (1994) relied on a nominal exchange rate anchor within a currency board arrangement. In Latvia, stabilisation was initially achieved by tight monetary policy with money as the nominal anchor (tight limits on the growth of credit, and later the monetary base), but since 1994 the currency has been pegged to the Special Drawing Right (SDR) (informally). A key to success in all three was the maintenance of tight fiscal policies that helped maintain the credibility of the anchors. Recent analysis suggests that what mattered for disinflation in the Baltics was not the exchange rate policy framework (fixed or flexible exchange rates) but the policy content. Some analysts,however, attribute the larger decline in interest rates in Estonia (and also recently in Lithuania) to

6 For in-depth discussions of stabilisation in the Baltics, see Saavalainen (1995) and Citrin and Lahiri (1995).

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the larger credibility of the currency board (Saavalainen, 1995).

In the medium term, the challenge in all three Baltics is to maintain the prudence in their macroeconomic policies in the face of increasing fiscal pressures and moves away from the currency board, especially in Lithuania. This will call special attention to revenue performance. Higher foreign and especially domestic savings will also be important to finance investments to sustain the growth performance and help the Baltics catch up with Europe.

Table 4 Transition Indicators in the Baltics

	1993	1994	1995
Inflation (%)			
Estonia	36	42	29
Latvia	35	26	23
Lithuania	188	45	35
GDP (%)			
Estonia	-2.1	-0.1	3.2
Latvia	-16	2	0
Lithuania	-24	1	3.1
Current Account (% of GDP)			
Estonia	-1.4	-7.5	-5.3
Latvia	7.0	-2.4	-3.5
Lithuania	-4.6	-3.1	-2.3
Budget (Financial) Deficit (% of GDP)			
Estonia	1.4	2.9	-0.9
Latvia	1.0	-1.7	-2.7
Lithuania	2.4	-1.5	-1.8
Investment (% of GDP)			
Estonia	25	29	26
Latvia	13	19	19
Lithuania	18	19	18
Lending Rates (%)			
Estonia	27	23	16
Latvia	86	56	35
Lithuania	91	62	27

Source: IMF, International Financial Statistics.

Structural Policies

Stabilisation was accompanied by rapid liberalisation of most prices and liberal trade policies, although some controlled non-traded goods prices are still adjusting and explain part of the high inflation levels. In trade poli-

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cies, Estonia differs from its neighbours by maintaining the most liberal trade regime at zero tariffs with no quantitative restrictions (Annex Table 1). Protection of agriculture has been higher in Lithuania (average tariffs of 38 per cent) and especially in Latvia (average production weighed tariffs over 50 per cent), which may have slowed restructuring in their agricultural and food sectors. This may also explain some of the better export performance of Estonia and Lithuania (exports of foodstuffs doubled in Estonia between 1993 and 1995 and nearly tripled in Lithuania between 1992 and 1994), while Latvia's exports of food grew only moderately and remained at a low overall level. The free trade environment in Estonia is likely to have facilitated processing for export from imports at world prices. The Baltic Free Trade Agreement and to a lesser extent the Europe Agreements are likely to increase competitive pressures in agriculture in the near future.

Tariffs are also higher on industrial goods in Latvia and Lithuania. Lithuania protects a selected number of mostly domestically produced products. In Latvia effective rates of protection can be high in many industries due to dispersion of rates between inputs and final products (between zero and 15-20 per cent). The impact of protection in industry is, however, lowered by the free trade agreements among the Baltics and with EU and EFTA (see below).

Barriers in services trade, which conceptually includes establishment trade (market presence), and which are related to regulatory frameworks, barriers to foreign investment and entry and exit of firms, seem also to be the lowest in Estonia. Both Estonia and Latvia have relatively liberal laws for foreign and national investors with no restrictions to share ownership. Land ownership in Latvia is subject to some restrictions. Latvia in the Europe Agreements made some reservations on the establishment of foreign companies in some service industries in which Latvia may have a comparative advantage (ports). This may reduce efficiency gains in a sector with large future growth potential. In Lithuania, foreign investment proposals require government approval, although there are no limits to foreign ownership of shares or companies as such. Foreigners cannot own land, which can only be leased, although changes to this are planned. The conclusion of the Europe Agreement may help in liberalising laws related to establishment in Lithuania.

In a recent EBRD classification of laws fostering foreign investment in 1996, Estonia scored 4 (the maximum) in both extensiveness and effectiveness of legal rules. Latvia came second with 4 and 3 respectively, while Lithuania only received a 2 on both counts (EBRD, 1996). The weaker FDI framework in Lithuania may help explain the lower levels of FDI there.

Privatisation is the most advanced in Estonia as well. In 1995 an estimated 65 per cent of GDP was private, while in Latvia it was about 58 per cent and in Lithuania 55 per cent (EBRD, 1996). In Latvia especially, large-scale privatisation has been slow. The opening of the privatisation process for foreign investors in Estonia is likely to have helped attract foreign investment. In Latvia foreign ownership in privatised companies was only allowed at a later stage in the process (in 1996).

Restructuring of the privatised or other companies seems also the most advanced in Estonia. For many enterprises restructuring is essential if they are to be competitive in world markets. This in Estonia is likely to have been helped by open trade policies, and a functioning bankruptcy law since 1992. In Latvia restructuring has been left to owners of enterprises, which previously were dominated by former management and workers. A new bankruptcy law will enter into force in 1996 and can speed up restructuring. In Lithuania most privatisation has been left up to former managers, who have been at times unwilling to restructure the companies. A bankruptcy law has been functioning recently. Labour laws in the Baltics are relatively liberal and are not a major obstacle to restructuring.

Rapid stabilisation, price and trade reforms and the initial undervaluation of the exchange rates are likely to have helped create incentives for successful reorientation of trade to Western markets. The more liberal trade policies and more rapid progress withmarket orientation in Estonia are likely to have contributed to its better trade and FDI performance. Completion of the privatisation process, and the legal framework for private sector development and containing pressures for more protection are likely to be the main near term challenges in the Baltics in the structural policy area for continued trade and FDI performance.

A recent study by Sachs and Warner (1996) on the performance of fast-growing developing countries also noted that raising the savings rate and attracting more foreign investment are areas in which transition countries like the Baltics could do more to achieve higher growth rates. The study concluded that key elements in successful growth strategies were (i) allocative efficiency (reliance on market forces and low level of government intervention), (ii) high savings and investment rates, and (iii) openness to FDI to promote transfer of technology. On the first, the Baltics are already doing well, although protection of agriculture (especially in Latvia, but also in Lithuania) and the slow pace of privatisation and restructuring in some privatised enterprises can be of concern (especially in Lithuania). As noted above, more efforts are needed to improve private sector legal frameworks in all three but especially in Lithuania. Investments in infrastructure are needed in all three.

All three need to increase their investment and savings ratios. At present investment ratios are highest in Estonia at about 26 per cent of GDP, which is low compared to the levels of over 30 per cent in many fast-growing Asian countries. In Latvia and Lithuania they are still below 20 per cent. About one-fifth of investments in Estonia are financed by foreign investment, and much less in the other two. The domestic savings rates in Latvia and Lithuania of 15 per cent of GDP and of about 21 per cent in Estonia are low.

Competitiveness and other Future Issues

The increasing trade imbalances in the Baltics (Table 4) have at times raised concerns about competitiveness. The fixity of the exchange rates and the higher inflation than in their main trading partners have caused some observers to make statements on the potential overvaluation of the real exchange rates in the Baltics. In Lithuania, discontinuing the currency board was a topic in the recent elections.

Some recent studies on sources of inflation in the Baltics (Saavalainen, 1995, Richards and Tersman, 1995) have concluded that changes in prices mostly reflect differential productivity growth between traded and non-traded goods and price arbitrage. Prices continue to increase as administered prices adjust, and wages have increased in response to productivity increases in the traded goods sectors. The substantial initial undervaluation of the exchange rate left much room for real appreciation without undermining export performance (Saavalainen, 1995). The above studies have concluded that, provided the current prudent macroeconomic policies are continued, the inflation performance is of no concern and is only an indication of the transition process.

In Lithuania, a shift away from the currency board may be considered for political reasons to gain more flexibility in monetary policy. In any case it can be noted that while the currency board arrangement is likely to have been an important element of stabilisation, similar results were achieved initially by Latvia with a different arrangement. This suggests that the key element in maintaining a credible exchange rate policy is prudence in monetary and fiscal policies.

While any equilibrium real exchange rates are hard to estimate, some indication of the sustainability of present levels of exchange rates can be assessed by looking at a number of competitiveness indicators. Although real wages have increased in all three (Table 5), exports continue to grow and reserves are comfortable. Also, price differences withWestern Europe are still important – one study estimated Latvia's price level as 60 per cent of that in Western countries in 1995 (Richards and Tersman, 1995). Despite the wage increases, e.g. doubling in dollar terms in Estonia between 1994 and 1996, the overall level of salaries in the Baltics remains

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low compared to Western Europe, suggesting that there is still a lot of room before wage increases seriously affect competitiveness. Estonia is rapidly approaching wage levels in Central European countries (about $340 per month in the Czech Republic, Hungary and Poland). This process is part of transition and catching up with Europe. Real exchange rate appreciation is likely to continue in the future as the Baltics increase productivity. The continued decline in interest rates also suggests that markets are not considering the pegs unrealistic.

Table 5 Some Competitiveness Indicators in the Baltics

	Increase in goods exports in 1995(%)	Reserves in 1995, months of imports	Increase in average dollar wage 95/94 (%)	Increase in average dollar wage 96/95 (%)	Average dollar wage per month 1996	Interest rate (lending) latest 1996 (%)
Estonia	40	3	57	27	261	14.1 (Sept)
Latvia	34	3	34	2	190	24 (Aug)
Lithuania	33	4	42	28	165	23 (Aug)

Source: IMF.

IV The Role of Regional Integration Arrangements in the Baltic Trade and Investment Performance

In the absence of WTO membership, regional arrangements were a major determinant of the Baltics' foreign trade relations. As much of the focus of the paper is on the impact of regional integration arrangements on the Baltic trade and FDI performance at present and in the future, this part will first examine some basic issues with regional integration and determinants of or guidelines for open regionalism. Subsequently, the Baltics' RTAs are analysed in light of their economic potential for trade-creating integration and these "guidelines".

Basic Issues with Regional Integration and Determinants of Open RTAs

In recent years, the topic has been discussed extensively in numerous forums and publications (see for example, WTO, 1995, de Melo and Panagariya, 1992, de la Torre and Kelly, 1992). Globalisation and the larger role of services in GDP increasingly underline the importance of analysing RTAs in broad terms beyond static trade creation in goods to include investment and other potential dynamic benefits of integration.[7] Regionalintegration can have different degrees, ranging from simple free trade agreements to economic and political union. It is generally acknowledged that while unilateral liberalisation is the first-best policy, open regional arrangements can promote liberalisation of trade and FDI flows. But regional integration is not a panacea and its economic benefits depend on the open nature of the regional agreements, and on the policies applied by the partners. RTAs behind high tariff walls can slow down structural change and maintain inefficient activities, with dire consequences for growth.

The expected static and dynamic benefits from regional integration can be: increased allocative efficiency from more trade and competition, economies of scale and scope, foreign investment, transfer of technology and know-how. RTAs can also go beyond multilateral liberalisation in many areas. Locking in policies within an RTA can help improve policy credibility in reforming countries and prevent policy reversals. The literature[8] has developed various economic indicators for "benign" or welfare-increasing regionalism. In general, static and dynamic benefits are likely to be larger with deeper integration, removal of non-border barriers to both trade and investment and coverage of many sectors and policies (Mistry, 1996). Economic gains from integration – static and dynamic – tend to be enhanced when (i) existing mutual trade is high (less potential for trade diversion), (ii) when the partners are complementary in economic structure and when the partner's market is large (more potential for trade creation), and (iii) when the partners' tariffs are low (less potential for trade diversion). Maintenance of low trade, investment or other barriers to outsiders is a fundamental condition for open regionalism. Therefore, open regionalism is best enhanced by RTAs that (i) cover most trade and do not increase protection to third countries,[9] (ii) include deep integration (non-tariff barriers, investment barriers), (iii) include liberal rules of origin with

7 Earlier analysis of RTAs concentrated on assessing static trade effects in terms of trade diversion and trade creation. This was later refined to include models incorporating more dynamic aspects of integration such as imperfect competition leading to gains from scale economies, and increased product variety. The latest analysis is concentrated in analysing other, mostly non-border, barriers to integration which affectestablishment and entry and exit of firms (or other investment barriers). This has led to the merging of the literature on investment and trade (see Owen, 1996; UNCTAD, 1996), which better reflects the increased globalisation of the world economy.

8 See for example Michaely (1996), Shiells (1994).

9 This criterion is generally required from WTO-consistent RTAs. However, these are not enough for open regionalism as these two conditions can be fulfilled, for example, by RTAs that maintain high tariffs to third countries.

possibility for cumulation[10] among different RTAs, iv) eliminate contingency protection (anti-dumping, voluntary export restraints etc.), (v) are open to third countries, and (vi) foster low MFN duties.

Integration with the West: The Challenge of Handling Transition to Eventual EU Membership

One cornerstone of transition in the Baltics has been a gradually deepening economic integration with Western Europe. The first free trade agreements on industrial goods concluded in 1992/93 with the Nordic countries and Switzerland were replaced in 1995/1996 by a FTA with the European Union and EFTA-wide FTAs (Table 6). Integration with the EU will deepen further once the Europe Agreements[11] signed in 1995 are ratified, which is still pending in some EU members. In 1995 all three Baltics officially applied for EU membership, which will set the framework for many of their structural policies in the coming years.

Baltic relations with Europe will be dominated by eventual membership of the EU.[12] The latter has, however, refused to give the Baltics any specific timetables or conditions for membership. The EU enlargement will be discussed in more detail at the EU's Inter-Governmental Conference in 1997, whereupon the Commission is expected to submit its opinion on the applicants to the Council, which will then decide on the start of the accession negotiations. The most frequently cited conditions for accession are: progress with market reforms, especially with privatisation, introducing administrative reforms necessary to enforce private contracts, and credible macroeconomic policies (CEPR, 1992). These may also include progress with issues such as minority rights and introduction of democratic institutions.

Even in the best of circumstances, full membership is not likely during the next five to ten years. The EU has recently made clear that among the presently ten Eastern European applicants perhaps three to four may be among the first group of candidates with whom negotiations will be held.

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10 Rules of origin mean that in order to benefit from free trade among partners the product has to originate in the partner countries. This is often defined either in terms of percentage of value added or transformation of the product so that its tariff classification changes. Cumulation means that qualifying inputs can originate in the other FTAs included.

11 These subsume the FTAs and include provisions for investment, technology, approximation of laws etc.

12 The FTA with EFTA will not be discussed here. It is very similar in nature to the EU FTA – the main difference being that agricultural protection is even higher in the EFTA countries, suggesting more distortions in this trade within an FTA.

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Table 6 RTAs in the Baltics

Estonia

Agreement	Main Provisions	Rules of Origin	Safeguards
EU FTA (signed in 1994, in force since January 1995); overtook bilateral FTA with Finland and Sweden since 1992; Europe Agreement (signed June 1995), ratification pending.	Free trade in most industrial goods; EU surveillance on textiles; tariff-quotas and zero-duty quotas on agricultural products; tariff quotas on fisheries, elimination of export duties and quotas.	Baltic cumulation of origin.	Special agricultural safeguards; Estonia can use infant industry and restructuring safeguards until end-1997; general safeguards (import or export restrictions); antidumping; never used by either side.
EFTA FTA (signed in 1995; in force since July 1996); replaced bilateral FTAs from 1993.	Free trade in industrial goods, except in sensitive items (EFTA QRs); bilateral agreements in agriculture and fisheries.	Baltic-EFTA cumulation.	General safeguards (export, import); Estonia can use restructuring safeguards until mid-1999; anti-dumping; never used by either party.
Baltic FTA (signed in 1993, in force since 1994); agriculture signed in 1996, in force since January 1997); CU in 1998?	Free trade in industrial products; Latvia and Lithuania maintain some export restrictions; free trade in agricultural products.	Baltic origin cumulation.	General safeguards (EFTA model), dumping; never used by either side.
CEFTA – FTA with Czech and Slovak Republics (provisional application since July 1996); FTA with Slovenia since January 1997).	Free trade in industrial goods; Czech and Slovak Republics and Slovenia maintain QRs on selected items (until end-2000) and some export restrictions (automatic licensing until end-1996), in agriculture free trade in some goods, MFN duties on remainder.	EU-EFTA-Baltic-Bulgaria-Romania.	As above.
Ukraine FTA (signed in May 1995, in force since March 1996).	Free trade in all goods.	Cumulation with EU, other Baltics foreseen when all parties have FTAs.	As above.

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LATIA (continued)

Agreement	Main Provisions	Rules of Origin	Safeguards
EU FTA in force (signed in 1994, in force since January 1995); overtook bilateral FTAs with Finland and Sweden in force since 1992; Europe Agreement signed (June 1995), ratification pending; appled for EU membership in 1995.	Free trade in industrial goods, in Latvia 6 year transition period; Latvia to eliminate export duties in 4 years; EU zero-duty quotas in textiles, EU tariff quotas and zero-duty quotas on agricultural products, tariff quotas on fisheries.	Baltic cumulation of origin.	Special agricultural safeguards; Latvia can use infant industry and restructuring safeguards until end-1997; general safeguards (import or export restrictions); antidumping; never used by either side.
EFTA FTA (signed in 1995, in force since July 1996); replaced bilateral FTAs from 1993.	Free trade in most industrial goods, EFTA maintains QRs on sensitive products; Latvia to eliminate export duties by end-1998, bilateral agreement in agriculture.	EFTA-Baltic cumulation.	General safeguards (export, import); Latvia can use restructuring safeguards until mid-1999; antidumping; never used by either party.
Baltic FTA (signed in 1993, in force since 1994), Agriculture (provisional application since July 1996); CU by 1998?	Free trade in industrial goods, Latvia maintains some export restrictions, free trade in agricultural goods.	Baltic cumulation.	General safeguards (EFTA model), dumping; never used by either side.
CEFTA – FTA with Czech and Slovak Republics and Slovenia.	Free trade in industrial goods with QRS on selectd items, in agriculture free trade in some products, MFN duties on remainder.	EU-EFTA-Baltic-Bulgaria-Romania cumulation foreseen.	As above.
Russia MFN Agreement.	Application of MFN duties, not applied (?)		

LITHUANIA (continued)

Agreement	Main Provisions	Rules of Origin	Safeguards
EU FTA (signed in 1994, in force since January 1995), overtook bilateral FTA with Finland (since 1993) and Sweden (since 1992); Europe Agreement signed (June 1995), ratification pending; applied for EU membership, 1995.	Duty free entry to EU in most industrial goods, Lithuania to eliminate import duties and export restrictions by 2001; in EU agriculture tariff quotas zero-duty quotas in certain products; EU zero-duty quotas in textiles, agricultural products.	Baltic cumulation of origin.	One antidumping investigation on Lithuania by EU; special agricultural safeguards; Lithuania can use infant industry and restructuring safeguards until end-1997; general safeguards (import or export restrictions); anti-dumping; safeguards never used by either side.
EFTA FTA (signed in 1995, in force since January 1997).	Free trade in most industrial goods except in sensitive item QRs in EFTA; in Lithuania a transition period until end-2000, bilateral agreement in agriculture and fisheries.	EFTA-Baltic cumulation.	General safeguards (export, import); Lithuania can use restructuring safeguards within 3 years of entry into force; antidumping; never used by either party.
Baltic FTA (1994); in Agriculture in force since January 1997; CU in 1998?	Free trade in industrial goods; Lithuania maintains export restrictions on (5) goods, free trade in agriculture.	Cumulation of Baltic origin.	General safeguards (EFTA model), dumping; never used by either side.
CEFTA – FTAs with Czech and Slovak Republics (provisional application since January 1997), Poland (in force since January 1997), Slovenia (in force since January 1997).	Free trade in industrial goods: one year transition period, in agriculture free trade in some goods.	EU-EFTA-Baltic-Bulgaria-Romania foreseen.	Same as above.
Russia MFN Agreement (ratification 1995).	Application of MFN duties.		

The process will also be influenced by the EU's internal reform in decision-making in a substantially enlarged Union and on how it decides to deal with the possible costs of extending agricultural support and structural funds to new members. As there are differences in economic performance and introduction of market-based policies among the Baltic states, the eventual timetable for membership may also differ between them.

The Economic Potential

The potential benefits of closer integration with the European Union (or EFTA) can be important for relatively obvious reasons. Integration with the European Union meets many of the criteria set in the literature for trade- and growth-creating regional integration – size of market (GDP), diversity or likely complementarity in production (GDP per capita, share of agriculture in GDP), share of existing trade between partners and level of existing protection. The EU's large economic size, high incomes, high import elasticities, diversity and large share of present trade with the Baltics favour trade creation over trade diversion, and dynamic benefits from integration (Table 7). Deeper integration with a high-income large market can lead to investment creation and transfer of technology enhancing the dynamic benefits of closer integration. The level of protection in general is low in the EU (low average tariffs and few non-tariff barriers (NTBs)) except in some sensitive sectors – agriculture, textiles and clothing and perhaps steel industries. In these areas levels of existing protection can lead to trade diversion and misallocation of resources.

The Agreements

The present RTAs with Europe (Table 6) fulfill some, but not all, of the criteria set in the literature for trade- and growth-creating RTAs.[13] While providing for improved market access for Baltic exports in goods and for a gradually deepening integration, the FTAs with the Western European countries have a number of drawbacks in coverage, rules of origin, and maintenance of contingency protection, which maintain trade and investment barriers in trade between partners. For example, about

13 These are: WTO compatibility (coverage of most trade, no increase in external barriers); low MFN tariffs; liberal accession clauses; liberal rules of origin; deep integration (reduction in non-tariff and investment barriers and regulatory barriers); and limits on contingent protection (Shiells, 1995).

Table 7 Trade Creation Indicators in Baltic Regional Partners

	Size	Diversity				
	GDP (billions of 1994 dollars)	GDP/CAP (billions of 1994 dollars)	Agriculture in GDP (%)	Share of partner-trade (% of 1995 exports)	Tariffs* (% average unweighted)	Other Trade Restrictions
Estonia	**43**	**2820**	**10**		**0**	–
EU	7590	20530	2	61	A = 25	Various NTBs in sensitive
					I = 6	products
EFTA	385	33218	1	2	A = 74-82	
					I = 3-6	Various NTBs in sensitive products
other Baltics	11	1730	15-21	10	Li = 3	
					La = 10	Export restrictions in Latvia and Lithuania, specific duties
Ukraine	81	1570	39	3	12	Payments and regul. barriers
Russia	392	2650	7	13	13 (weighted)	Payments and regul. barriers
CEFTA	98	3590	6	1	8 - 14	Various NTBs in sens. products
Lithuania	**5.0**	**1350**	**21**		**10**	Export bans (skins, feathers), export tax on skins, wool, red clover seed, timber, glands). Import quotas on agriculture.
EU	7590	20530	2	47	A = 25	
					I = 3.6	Various NTBs on sensitive products
EFTA	385	33218	1	1	A = 74-62	
					I = 3-6	Various NTBs on sensitive products
Ohter Baltics	10	1587	15-21	7	E = 0	
					La = 10	
					(A = 53)	Latvian export restrictions, import restrictions
Ukraine	81	1570	39	10	12	Payments and regul. barriers
Russia	392	2650	7	14	13 (weighted)	Payments and regul. barriers
CEFTA	98	3590	6	4	8 -14	Various NTBs in sens. products

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Table 7 (continued)

	Size	Diversity				
	GDP (billions of 1994 dollars)	GDP/CAP (billions of 1994 dollars)	Agriculture in GDP (%)	Share of partner-trade (% of 1995 exports)	Tariffs* (% average unweighted)	Other Trade Restrictions
Latvia	**5.9**	**2290**	**15**		**10**	Export taxes on wood, metal, limestone Import QRs on agriculture and alcohol
EU	7590	20530	2	44	A = 25 I = 6	 NTBs on sensitive items
EFTA	385	33218	1	2	A = 74-82 I = 3-6	 NTBs on sensitive items
Other Baltics	9	1730	10-21	9	E = 0 Li = 3	 Lithuanian export restrictions
Russia	392	2650	7	14	13 (weighted)	Payments and regul. barriers
Ukraine	81	1570	39	10	12	Payments and regul. barriers
CEFTA	98	3590	6	4	8-14	Various NTBs in sens. products

* In tariffs A=agriculture, I=industry, E=Estonia, La=Latvia, Li=Lithuania.
Source: IMF Direction of Trade Statistics, World Bank Atlas, Leidy-Ibrahim (1996), various TPRs.

one-third of present Baltic exports of goods are subject to limited or conditional liberalisation in the EU (agriculture, fisheries and textiles), and services are not covered in the present FTA. This also implies that the Agreements are imbalanced, as the Baltics will liberalise market access in nearly all goods after relatively short transition periods and rapidly adopt many of the EU's laws.

Coverage

An imbalance in the Agreements on goods trade arises from partial coverage of a number of sectors by the EU – **agriculture, fisheries and services.** In agriculture and fisheries, the EU gave mostly quota-restrained concessions on a limited number of products, while the Baltics (subject to tariff quotas on some products in Latvia and Lithuania) made concessions on all products (Annex Table 2). EU concessions to the three Baltics are relatively similar. In agriculture, these are (i) "natural" products (honey, berries, plants, apple juice) with special reduced duties; (ii) dairy and meat products and some vegetables with reduced levies within increasing quotas; (iii) bovine, sheep and live animal meat quotas at reduced levies; (iv) processed agricultural products (sweets, drinks) with increasing tariff quotas; and (v) a few fisheries products with tariff quotas. All other agricultural imports are subject to full most-favoured nation (MFN) tariffs. The limited market access is reflected in low shares of trade in food products with the EU, which otherwise is a major export from the Baltics to other markets.

The FTAs are most liberal in **industrial goods** with duty-free access to Baltic exports for most goods in the EU. The exception in the EU is textiles, in which conditions also differ between the Baltics. While most textile and clothing imports from the Baltics are under surveillance, imports of most products from Latvia and Lithuania are free of duties but subject to annual quotas (to be renegotiated in 1997). Estonian textile exports to the EU have no restrictions apart from surveillance. While this is likely to lead to trade creation in the Baltics, the potential is reduced by the maintenance of restraints without clear timetables for the elimination of restrictions. Some trade diversion is possible in Latvia and Lithuania, where duties on many final products are around 15-20 per cent. Trade diversion in Estonia may only arise from origin rules.

By limiting access and reducing security of access to EU markets the restrictions may act to deter export-related FDI in the textiles sector. The FDI statistics discussed above give some support to this view. The main impact of the FTAs seems to have been an increase in intra-industry trade (processing of EU inputs for further export), which is likely to have led to important transfer of technology and know-how. As market access in other industries in the EU is free of restrictions, the restricted access in textiles coupled with rapidly increasing wages in the Baltics may speed up the shift of comparative advantage tomore skill-intensive activities. Some indication of this is already the substantially increased intra-industry trade in machinery in Estonia in 1995.

Coverage of sectors on the Baltic side is most liberal in Estonia, which offers duty-free treatment immediately to all EU exports. Latvia and Lithuania have four- and six-year transition periods respectively whereby some sectors (see Annex Table 2) will only be opened gradually to competition. This is likely to slow down transition and structural change in the protected industries in Latvia and Lithuania.

In **services**, coverage in the planned Europe Agreements is very limited at present in both partners (Annex Table 2). The limited coverage of services in the Agreements is likely to limit the trade potential of the Baltics in an area in which they are likely to be competitive in the future. Cross-border trade is only subject to a standstill commitment on new restrictions, and progressive liberalisation of cross-border supply of services will be discussed eight years after the entry into force of the Europe Agreements. Some liberalisation will take place in international maritime transport, where the agreement forbids e.g. cargo-sharing (except within the UN Liner Conference), and requires national treatment in access to ports, use of infrastructure and port facilities. A transit agreement is to be negotiated by 1999.

Establishment trade (commercial presence) in services or in other sectors is slightly more liberal (see below), although the main transport sectors are at present excluded from coverage. In addition, Lithuania has temporarily excluded many important services such as telecommunications and postal services, and Latvia some port services, in which liberalisation to foreign investors could promote rapid transfer of technology, bring large efficiency gains and the development of comparative advantages in these sectors.

Increase in Protection

At present the free trade agreements will not imply any direct increase in protection to outsiders. The question will need to be posed again when the Baltics adopt the EU's common external tariff upon EU membership. For Estonia at present levels of protection in both partners, this will necessarily mean an increase in protection. In Latvia and Lithuania, increase in protection will depend on sectors. As in many agricultural products, the overall level of protection in the Baltics is lower than that in the EU, closer integration in the longer run may lead to increased protection in the Baltics. This depends on how the EU reforms its agricultural and other policies. In the meantime, the potential for adopting the EU's common external tariff should not be used as an excuse to maintain protection in the Baltics.

By maintaining or increasing openness during the transition period to EU membership, the Baltics will help to create efficient industries that contribute to growth and trade development to other markets as well. This is reinforced by the fact that the accession process is likely to take at least ten years and in the meantime EU levels of protection may also decline. Preferential access to the EU behind high protectionist barriers may slow down transition in protected sectors.

Deep Integration

The Europe Agreements cover deepening of integration. They have important provisions on establishment that can promote competition, foreign investment and trade (Annex Table 2). The Agreements provide for national treatment in establishment and operation for companies from signatories except in air transport, inland waterways and maritime cabotage transport services. Negotiations to liberalise these sectors are foreseen. Theestablishment of Baltic nationals (the right to take up economic activities as self-employed persons) and their operation in the EU is to take place as of end 1999 and immediately for EU nationals in the Baltics. This means that EU and domestic investors are to be treated equally as far as establishment is concerned. In principle it should cover access to privatisation programmes, which Estonia and Latvia are already implementing. However, a safeguard clause allows the Baltics to exclude establishment of foreign enterprises under certain criteria until 1999, which may include privatisation programmes. As mentioned above, Latvia and Lithuania maintain temporary and permanent exceptions in some sectors (see Annex Table 2). The Agreements also provide for some investment protection clauses. Capital mobility is required for the investment and its repatriation, to which balance-of-payments safeguards do not apply. They also commit the Baltics to adopt EU rules of capital movement in the near future. The agreement is weak on labour mobility. Negotiations on further labour mobility, and mutual recognition of qualifications, are to be undertaken later.

In the Baltics many of the above benefits are already extended to all foreign investors outside the EU. The importance of the Europe Agreements for EU investors is to provide an external framework in which the rules are

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bound, which can increase security for investors. There is no reason why the Baltics should not extend investment guarantees to all investors, which is important in avoiding discrimination and ensuring efficiency in investment. This can be done to some extent by joining the planned Multilateral Agreement on Investment (MAI) under negotiation at the OECD. At present, the Baltics have bilateral investment agreements with many countries. Estonia does not discriminate between any foreign investors, while Latvia seems to restrict land ownership to countries with bilateral agreements.

Approximation of laws in the Baltics to EU standards (see Annex Table 2) in some areas has relatively tight timetables, and is likely to promote transition. For example, by the end of 1998, Estonia will adapt its laws to those of the EU in road, rail, inland waterway and air transport. Latvia and Lithuania will do so during their general four and six-year transition periods. Intellectual property protection is to be brought up to EU standards by 1999. Approximation of laws in banking, company law, financial services, competition, standards and technical rules, and the environment will be undertaken gradually. These provisions provide an important framework for modernising laws and a standstill on certain regulations, which is likely to facilitate the transition to a market economy and to EU membership.

Rules of Origin and Contingent Protection

The rules of origin in the Europe Agreements are relatively restrictive (Winters, 1992). In many sectors, 60 per cent of value added is required to benefit from the market access concessions. Cumulation of origin is allowed between the Baltics and is planned soon with all parties to Europe-wide FTAs. Strict rules of origin may act to deter investments in small markets, and discourage processing of non-EU materials, and may explain the lack of trade-related investments in the Baltics. The planned Pan-European cumulation could also change the situation in 1997 by allowing cumulation in all countries with FTAs with the EU.

The Agreements also maintain contingent protection. WTO anti-dumping and countervailing duty laws apply until the Baltics establish competition laws. At present the EU has used these provisions only once against one product from Lithuania. In addition, special safeguards are allowed in agriculture, textiles and other products that can reduce the security of the market access concessions. These have not been used, however. All this may reduce the investment and trade-creation potential of the Agreements.

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Other Drawbacks

The bilateral hub-and-spoke nature[14] of the Agreements tends to concentrate trade flows between the spoke (a Baltic) and the hub (the EU). This pattern has a tendency to marginalise the spoke economies (Baldwin, 1992), because it tends to encourage outsourcing by the hub from the spoke of certain processes and discourage investment there. Investment then tends to be concentrated in the hub country, as exports to and imports from other markets of the spoke are subject to barriers. This may partly explain the present pattern of EU intra-industry trade with the Baltics and the lack of trade-related investments. The Baltic Free Trade Agreement (see below) has reduced some of the potential marginalisation of trade in goods, but it remains in services. The marginalisation problem can be further reduced by the conclusion of free trade agreements with other Eastern European countries with Europe Agreements (CEFTA).

The Impact of the Agreements

Despite the drawbacks, the overall impact of the EU FTAs is likely to have been positive on net trade creation in the Baltics. First, the Agreements are likely to have facilitated trade re-orientation in the Baltics and contributed to export expansion. In many sensitive products – especially textiles – access to the EU without preferences would be difficult. The relatively modest levels of protection in most products in the Baltics reduce potential for trade diversion. Second, a large share of trade in manufactures is outward processing trade, especially in Estonia, but also in Latvia and Lithuania. This is likely to provide an important channel for the transfer of technology and modern management practices in the Baltics. Third, the Agreements have not led to increased foreign investments linked to better market access to the EU market. The determinants of FDI are manifold,[15] but the restrictive market access in the EU in many products, restrictive provisions in the rules of origin, and the hub-and-spoke nature of the Agreements may have contributed to this. The largest FDI inflows have been in Estonia, but they have been mostly to industries or services that do not cater to the EU market. Fourth, the conclusion of

14 Hub-and-spoke means that trade is liberalised between a large country and many small countries bilaterally. Trade between the hub and a spoke is free but subject to restrictions between the spokes.

15 Traditional motivations for FDI have been the existence of import barriers, competition in oligopolistic industries, lowering of transport or production costs, and proximity to consumers. The growing importance of services, which require presence close to consumers, can be an important determinant of investment flows.

the Europe Agreements and anticipation of EU membership are likely to have promoted progress in approximation of laws to EU standards, promoted liberalisation in the Baltics and locked in some of the reforms in the transition countries. However, the lack of specific timetables in many areas may slow down reform.

The Agreements raise a number of issues for future integration and trade relations. First, the Baltics should press for a concrete timetable for membership from the EU. This could bring further credibility to policy reforms and help attract FDI. Second, market access in the EU could be improved in sensitive products. Estonia, for example, has agreed to very ambitious goals in adjusting to various EU legal frameworks, and offered fully open access to its markets for EU goods, but was met by the EU with restrictions in several products of export interest to Estonia. While openness on its own is likely to speed up transition in Estonia and its ambitions of EU membership, there is some imbalance in the agreement. Even Latvia and Lithuania maintain less restrictions in intra-trade than the EU. Third, the EU should speed up negotiations in opening cross-border services and the removal of remaining restrictions in establishment trade. Fourth, the overall trade and investment performance of the Baltics would benefit from speedy accession to the WTO and to potential other forums such as the OECD or the planned MAI. The benefits of WTO accession are avoidance of discrimination in trade between member countries, access to a neutral system to solve disputes, and more predictable trade rules. Membership of the planned MAI can help attract FDI by increasing security of investment laws. In services, for example, liberalisation in the Baltics might be faster within the WTO framework than in the EU one.

Intra-Baltic Integration: The Necessity of Closing the Spokes

Intra-Baltic integration has been pursued in its own right and as a complement to European integration. A Baltic Free Trade Agreement in industrial goods was concluded in April 1994, which was extended to agricultural goods in 1997. A declaration of principle exists on a Baltic Customs Union by the year 1998. Several FTAs have been concluded or are in preparation with the CEFTA[16] countries (Table 6).

Economic Potential

Most of the economic arguments favouring regional integration are not

16 CEFTA membership requires the conclusion of FTAs with all CEFTA members (Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia) and WTO membership.

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met by integration among the Baltic countries. The potential for static and dynamic trade gains is reduced by their small economic size and moderate incomes (Table 7). In terms of diversity there is some differentiation between Estonia and Lithuania, agriculture being more important in the latter. Production structures are similar in the Baltics – all are textile, food and wood exporters, which can reduce potential for complementarities in trade. Trade among the Baltics is still subject to a number of non-tariff barriers (border formalities, poor transport networks, payment arrangements, some licensing requirements) which reduce trade creation potential and which may not be solved by FTAs. The differences in trade policies would favour trade creation for Latvia and Lithuania with the more liberal Estonia. For Estonia deeper integration with more protectionist partners could be trade-diverting. If integration takes place within FTAs, the risk for trade diversion is reduced by Estonia's open trade regime. The main argument favouring intra-Baltic integration is the hub-and-spoke nature of the Europe Agreements. Removing barriers between each other will reduce the distortions created by the Agreements in favour of EU enterprises vis-à-vis Baltic enterprises, reducing a potential disincentive to FDI.

The Baltic Free Trade Agreement

The Baltic Free Trade Agreement (BFTA) meets some of the criteria set for trade- and growth-creating RTAs. In terms of coverage in goods trade it is broader than the EU FTA, as all industrial and agricultural products are included without restrictions (except some temporary export restrictions from Latvia and Lithuania – see Annex Table 2). Services trade is not covered. This may work against investment and trade creation in the region. But barriers to services trade are being reduced outside the BFTA by improving regulatory frameworks for the private sector for all partners. Protection is not increased, as all three maintain existing tariff regimes. However, some protection is provided by rules of origin and safeguards (Table 6). These may reduce potential for trade and investment creation, although the safeguards or dumping clauses have not been used by the Baltics.

The weakest element in the BFTA is the lack of provisions for **deeper integration.** The agreement does not cover establishment, labour, or other forms of liberalisation of non-tariff barriers. Some of these will be addressed in the transition process or in the EU agreements. Many laws in the Baltics will be harmonised automatically in the process of EU integration. Progress with transition will gradually remove many other non-tariff barriers such as payments problems, border formalities, transport infrastructure, etc. However, the lack of deeper intra-Baltic integration may

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prevent investment and trade creation, especially in services, but also in other sectors of the economy. The hub-and-spoke distortions from the Europe Agreements will remain in services and some aspects of investment policies, unless they are addressed in multilateral agreements or unilaterally.

Experience so far in intra-Baltic trade flows confirms the lack of substantial trade creation among the Baltics. Existing statistics show that the share of intra-Baltic trade in all three has remained around 10 per cent, which suggests that it has increased in line with overall trade growth but not more. There is no clear pattern in the trade between the countries, which still partly reflects patterns inherited from central planning (large share of energy, special machinery). This is likely to reflect the lack of complementarities and the small size of the Baltic markets compared to other export opportunities for the Baltics or non-tariff barriers in intra-trade. There is, however, some indication of recent increases in trade in food and textiles products. This may be further reinforced by the extension of the BFTA to agricultural products. The existing structure of production would suggest that the more protected agricultural sectors in Latvia and Lithuania would be subject to much competition from Estonian producers that may promote competition and efficiency. Investment statistics indicate some participation of Baltic investors in each other's markets. In 1996 Estonian companies started to invest more in Latvia and to some extent in Lithuania, e.g. in 1996 there were over 400 Estonian companies established in Latvia.

The above raises a number of issues for the future. First, the Agreements could be deepened beyond market access in goods. The extension of the BFTA to agriculture was an important step. Extension of the agreement to services and establishment would remove potential discrimination between Baltics and EU companies. Some of these issues will, however, be addressed in the WTO accession process.

Second, deepening of integration towards a customs union (planned for 1998) should be resisted. There is a strong likelihood that this would result in higher protection. This naturally would depend on the level of the common external tariff (CET) chosen. Any duties for Estonia would mean higher protection. Despite having relatively moderate levels of overall protection, in many products Latvia and Lithuania have duties of 20-40 per cent compared to zero in Estonia. The cost of higher protection would have to be weighed against the likelihood of only moderate gains from trade creation in a small market. In any case, many of these benefits can already be achieved within the existing FTAs. Although the longer-term framework for trade policies will eventually be the EU's common external tariff, Estonia is better off maintaining its present open regime during

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transition as it will foster restructuring and transition to an efficient economy.

A customs union could also have high administrative costs. Any negotiation on a common external tariff, on rules for the distribution of tariff revenue or on how to distribute gains and losses from integration would require much costly time of the administration, which might be better used in other activities (e.g. reducing the isolation of the spokes). Many of the benefits of deeper integration can be achieved without a customs union. Extending the BFTA to services and establishment, or the reduction of NTBs, do not require a customs union.

Integration with the East: Gradual Re-establishment of Trade Relations

Relations with the CIS countries have been characterised by the disintegration and gradual re-establishment of trade relations. The collapse in FSU demand and payments systems, changes in relative prices, and the establishment of border barriers have redefined Baltic trade relations with their Eastern neighbours. Political concerns slowed down the ratification of basic MFN-based trade agreements with Russia, which Latvia and Lithuania have now finalised but Estonia has not. As a result Estonia is facing double the MFN duties in its exports there. Estonia's access to Ukrainian markets was improved recently by concluding a free trade agreement with Ukraine (March 1996) that covers free trade in all goods. Russia and Ukraine are potentially important markets for the Baltics for their exports and especially for transit or other service activities. However, in both markets tariffs are unlikely to be the most important barriers to trade compared to payments problems, poor trade infrastructure and slow border clearance. Most of these issues cannot be solved with RTAs.

Economic Potential

Compared to the Baltics, the size of potential Russian and Ukrainian markets is large. At present incomes are modest, reducing the economic potential from deeper integration. In terms of diversity Ukraine, with a large agricultural sector (39 per cent of GDP), is likely to be more complementary to the Baltics than Russia (agriculture only 7 per cent of GDP). But the Baltics offer other complementarities with Russia. Geography is one, as Russia's access to sea ports to Europe is limited and the Baltics offer large potential in this. Diversity therefore can offer some trade- and investment-creation potential. Trade between the parties, despite declines during the past five years, is still a large share of the total. However, potential for trade diversion with deeper integration, especially in the remaining,

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protected “old industries”, can be large, and could slow down adjustment and restructuring. The overall level of tariffs and trade restrictions in Russia and Ukraine is higher than in the Baltics (Table 6), suggesting that an FTA could lead to trade diversion, especially in Latvia and Lithuania.

The Agreements

At present the only free trade agreement with the CIS countries is between Estonia and Ukraine. This is very liberal in nature as all trade is covered (including agriculture) and there are no transition periods. The FTA implies no increase in protection. Many non-tariff barriers exist in Ukraine, which limits trade creation. These are more related to transition to a market economy than to trade policies. Deeper integration at this stage with Ukraine may not bring many benefits until transition proceeds further in Ukraine. However, exports to Ukraine seem to have increased since the FTA.

Trade relations with Russia have been governed only with regular MFN agreements in Latvia and Lithuania. Estonia has no agreement with Russia, which has led to higher duties on its exports than the MFN duties. Nevertheless, Estonia has been able to export some products to Russia. Any further trade integration is likely to lead to few benefits until Russia progresses with transition. Most trade barriers are still related to non-tariff ones. An MFN agreement between Estonia and Russia should be concluded. The main potential in trade with FSU at present is offered by transit trade via the Baltics, which can take place without trade preferences. Its development is more dependent on the development of infrastructure, investment in more efficient services, etc. Openness to investors from all sources could promote efficiency. WTO membership should reduce discrimination.

V Conclusions

Despite similar RTAs, the difference in trade and FDI performance among the Baltics highlights the importance of other factors in export and investment performance. The most prominent among these is progress with transition. Estonia stands out among the Baltics in trade, FDI and transition performance, although all three have performed well. Estonia has the most liberal trade regime, is the most advanced in developing private sector incentives, and has the highest savings rates. Regional integration agreements with Europe have been important in contributing to Baltic trade performance and are likely to remain so in the future. Trade creation

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is likely to dominate trade diversion. However, their contribution to FDI has so far been minor. In the absence of WTO membership these RTAs created a basic framework for foreign trade and economic relations for the Baltics. Their application for EU membership will form the basic framework for their future trade policies.

The RTAs with Europe are likely to have contributed to increased intra-industry trade with the Baltics and rapid approximation of laws to Western standards. Restricted market access in agriculture, fisheries, textiles, and services in the EU, restrictive rules of origin, safeguards, and the hub-and-spoke nature of the Agreements can explain some of the poor FDI performance, although the stage in transition and progress in introducing market-oriented policies are likely to be more important in this. The FTAs with the EU are likely to have promoted liberalisation of trade policies in Latvia and Lithuania. The Baltic FTA has not resulted in expected increases in trade (or investment). Trade with the FSU countries faces many non-tariff barriers and after initial decline increases, especially in energy, but food exports have also increased in recent years.

In the highly trade-dependent Baltics future growth potential will continue to depend to a large extent on trade developments. Most important will remain progress with transition – maintenance of macroeconomic stability, structural policies that promote allocative efficiency and improve incentives and legal frameworks to private sector development to attract FDI, and higher savings for investment. RTAs can continue to play a role in promoting liberalisation and locking in policy reforms. Preparation for EU membership will dominate trade relations and will gradually harmonise policies within the Baltics. The preparation process would be helped by clearer timetables for accession and policy reforms, better access in sensitive products, and coverage of services. Baltic integration and that with other Central and Eastern European countries with Europe Agreements should be deepened within FTAs to reduce the trade and investment barriers from the EU's hub-and-spoke system of RTAs. A Baltic customs union is not recommended as it would bring few benefits and have high administrative costs. Deeper integration with the FSU is not likely to offer many benefits, but in the medium term these markets offer a large trade potential in both goods and services. Although RTAs can help market access in the near term, the Baltics should consider other agreements such as the OECD's agreement on investment or the planned Multilateral Agreement on Investment that can foster further liberalisation and FDI and increase the credibility of policy reforms.

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Annex Tables

Annex Table 1 Synopsis of the Trade Regimes of the Baltics – 1996

Estonia

	Quantitative restrictions		Tariffs/Taxes	
	Imports	*Exports*	*Imports*	*Exports*
Current regime	Import restrictions are limited to those required for health and security reasons.	There are no quantitative restrictions on exports.	Zero.	Export tax of 100% applies to items of cultural value.
Other observations			Antidumping legislation has been submitted for parliamentary approval.	

Latvia

	Quantitative restrictions		Tariffs/Taxes	
	Imports	*Exports*	*Imports*	*Exports*
Current regime	Imports of sugar, grains and alcohol are subject to quotas; licensing requirements apply to imports of tobacco and sugar.		Basic rate on final goods is 20% (the MFN rate is 15%), and on inputs 1%; average production weighted tariff on agriculture is 53% (average MFN rate is 46%), and some specific rates apply. Average tariff for non-agricultural goods is 3.7%.	Export taxes apply to waste/scrap materials, round logs and art works/antiques.
Other observations			Reference prices for some imports.	The export taxes on waste/scrap metals and round logs scheduled to be eliminated by end-1998.

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Annex Table 1 (continued)

Lithuania

	Quantitative restrictions		Tariffs/Taxes	
	Imports	*Exports*	*Imports*	*Exports*
Current regime	Tariff quotas apply to import of some agriagricultural goods, alcohol, raw sugar, live pure-bred, poultry, cereals, glass bottles.	A temporary exportbans remain on 5 product categories (red clover seed, feathers and down used for stuffing, raw skins and hides, certain type of timber, and certain glands and organs).	For non agricultural products, there are 7 rates ranging from 0% to 30% most goods carry a duty between 5 and 15%, though many enter duty free, and higher rates on some foods, alcohol, and tobacco. The average tariff on non-agricultural goods is 3%. For agricultural products, tariffs range from 14% to 45% with an average of 27.5%.	A temporary export tax of 50% is levied on raw skins and hides, and certain and, certain types of wood.
Other obser-vations			Reference prices on some imports.	

Source: Leidy-Ibrahim (1996).

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Annex Table 2 Summary of Baltic-EU Europe Agreements

Estonia

Market Access	EU	Estonia
Agriculture	• Reduced duties on 15 products (honey, plants, berries, cucumbers, apple juice); some berries subject to minimumprices (Annex III). • Tariff quotas for meat (live animals, bovine meat, sheep meat); levy within quota 25 or 40 percent of regular levies (Annex IV). • Tariff quotas for 10 products; levy 40 percent of regular, increasing quantities until 1997 (pork, chicken, milk powder, cheese, potatoes, apples, sausages) (Annex V). • Tariff reductions for 41 processed agricultural products, 13 of which are subject to increasing quotas until 2000(sweets, beer, vodka, chewing gum, drinks) (Protocol 2 - Annex I, II). • Regular tariffs on other products.	• Zero duties.
Fisheries	• Tariff quotas on 6 products (duties 0-10 percent) (Annex VI). • Regular tariffs on other products.	• Zero duties.
Industrial goods	• Zero duties (textilessubject to surveillance) (Protocol 1).	• Zero duties.
Services	• Negotiations on liberalisation of cross-border services to start 8 years after ratification. International maritime transport services open access.	• Same as EU.
Investment	• National treatment in establishment of companies (except in some real estate), in 1999 for Estonian nationals, except in air transport, cabotage and inland waters.	• National treatment in all establishment except in the same 3 transport sectors as EU. Free capital and current account transfers.
Labour	• Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labour movement reviewed.	• Same as EU.
Approximation of laws		• In road, rail, inland waterways by end 1998. TRIPS by end 1999, commercial law gradually.

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Annex Table 2 (continued)

Latvia (4 year transition period)

Market Access	EU	Latvia
Agriculture	• Reduced duties on 13 products (honey, plants, roses, mushrooms, cucumbers, berries, apple juice); some berries subject to minimum prices (Annex VII).	• Some tariff reductions for 146 products, 26 of which subject to quotas (meat, cut flowers, vegerables, wheat, margarine, sausages, wine) (Annex X).
	• Tariff quotas for meat products (live bovine animals, meat, sheep meat); levy within quota 25 or 40 percent of regular (Annex VIII).	• Tariff reductions by 2000 on 127 processed agr. products (Protocol 1 - Annex III).
	• Tariff reductions for 14 products; levy 40 percent of regular, increasing quantities until 1997 (meat, milk powder, butter, cheese, tomatoes, vegetables, sausages) (Annex IX).	• Tariff quotas on 6 processed agricultural products increasing over 6 years (yogurt, bread, soups, gin) (Protocol 1 - Annex IV).
	• Tariff reductions on 10 processed agr. products; 10 of which subject to quotas increasing until 2000 (sweets, beer, vodka) (Protocol 1 - Annex II).	
	• Regular duties on other products.	• Zero duties on other products.
Fisheries	• Tariff quotas for 5 products (Annex XII). • Regular tariffs on other products.	• 6 products with tariff quotas (Annex XIII). • zero duties on other products.
Industrial goods	• Duty free quotas (Annex V) in textiles; surveillance of textiles (Protocol 1). • Zero duties on other products.	• 23 products (cement, luggage, skins, footwear, textiles, ceramics) duties to zero by 1997 (Annex II); 28 products (some footwear, machinery, electronics, furniture) duties to zero by 1997 (Annex III). • Export duties on 16 products to be eliminated by end 1998 (gypsum, hides, wood, metal scrap) (Annex IV). • Zero duties on other products.
Services	• Negotiations on liberalisation of cross-border services to start 8 years from ratification; maritime services free access.	• As EU.
Investment	• National treatment in establishment except in air transport, cabotage and inland waters; real estate, and Latvian nationals in EU.	• National treatment in esrablishment except in weapons manufacture, gambling, real estate, port infra structure ownership (until end 1988), and the 3 transport sectors. Free capital and current account transfers.
Labour	• Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labour movement reviewed.	
Approximation of laws		• In road, rail, inland waterways by end 1998. TRIPS by end 1999, commercial law gradually.

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Annex Table 2 (continued)

Lithuania (six-year transition period)

Market Access	EU	Lithuania
Agriculture	• Reduced duties for 11 products (horses, duck livers, honey, vegetables, mushrooms, berries, apple juice) Annex IX; minimum prices on berries. • Tariff quotas for meat products (live bovine, animals, bovine and sheep meat); levy 25 and 40 percent of regular (Annex X). • Tariff quotas for 10 products at increasing quantities until 1997; levy 40 percent of regular (pork, chicken, milk powder, butter, cheese, tomatoes, garlic) (Annex XI). • Tariff reductions for 12 processed agr. products (sweets, vodka); 4 of which subject to increasing quotas until 2000 (Protocol 2 - Annex I, II). • Regular duties on other products.	• Reduced duties until 2000 on 95 products (Annex XII) 15 of which subject to quotas increasing until 2000 (Annex XIII). • Reduced duties (by 2000) for 21 processed agricultural products (Protocol 2 - Annex III). • Zero duties on other products (Annex XII).
Fisheries	• Tariff quotas for 10 products (Annex XIV). • Regular duties on other products.	• Tariff reductions over 6 years for 6 products (Annex XV). • No restrictions on other products.
Industrial goods	• Duty free quotas in textiles (Annex VI). Surveillance of most textiles (Protocol 1). • Zero duties on other products.	• Footwear duty elimination in 1997 (Annex II). • Duties on 122 products to be eliminated by 2001 (metal products, plastics, wood products, footwear, appliances, electronics, furniture) (Annex III). • Duties on used cars to zero by 2001 (Annex IV). • Elimination of export duties by 2001 (hides, wood, metal scrap) (Annex V). • Zero duties on other products.

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Annex Table 2 (continued)

Lithuania

Market Access	EU	Lithuania
Services	• Negotiations on liberalisation of cross border services to start 8 years after ratification. International maritime transport services open access.	• As EU.
Investment	• National treatment in establishment of companies (except in some real estate), in 1999 for Lithuanian nationals, except in air transport, cabotage and inland waters.	• National treatment in establisment except acquisition of land, mineral deposits and natural resources; gambling, and temporarily in manuf. of alcohol, exploitation of natural resources, post and telecom, services until 2001; and in 3 transport sectors. Free capital and current account transfers.
Labour	• Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labour movement reviewed. • As EU.	
Approximation of laws		• In road, rail, inland waterways by end 2000. TRIPS by end 1999, commercial law gradually.

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