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**Regional Integration and Baltic Trade and Investment Performance**

Prepared by Piritta Sorsa<sup>1</sup>

Authorized for distribution by Robert Sharer

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**Abstract**

This paper analyzes the role of regional arrangements in trade and foreign direct investment (FDI) performance in the Baltics. While progress with transition is a key determinant of trade and FDI performance, regional arrangements with Western Europe have helped develop trade and transfer of technology, but have not yet led to export-related foreign direct investment toward the European Union. The main reasons for this are policy uncertainties, need for more progress with transition, and restrictions in the trade agreements, especially on the European Union side. Intra-Baltic integration has not yet led to substantial trade and FDI growth between the Baltics.

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**Author's E-Mail Address:** psorsa@imf.org

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## SUMMARY

Regional trade agreements (RTAs) with Europe have helped improve the Baltics' trade performance and provided a basic framework for their trade and economic relations, pending their membership in the World Trade Organization. However, the RTAs have attracted less export-related foreign direct investment (FDI). Restricted market access in agriculture, fisheries, textiles, and services in the European Union (EU), restrictive rules of origin, safeguards, and the hub-and-spoke nature of the Europe Agreements can explain some of the weak FDI performance, as can a country's stage in transition. Despite similar RTAs, the Baltic countries' trade and FDI performances have differed. Estonia, which has the most liberal trade regime, also has the best trade, FDI, and private sector incentive performance.

Growth in the trade-dependent Baltics will continue to depend on trade developments. Most important for this will remain progress with transition. RTAs can help in locking in policy reforms. Preparation for EU membership will dominate trade relations and will gradually harmonize the Baltic countries' policies. Such preparation would be helped by clearer accession and policy reform timetables and easier access for sensitive products and for services. Intra-Baltic integration and integration with other Central and Eastern European countries will likely bring limited economic benefits but may reduce the trade and investment barriers arising from the EU's hub-and-spoke system of RTAs. Deeper integration with the CIS would likely lead to trade diversion because of the higher trade barriers in the CIS. The Baltics should also accede to multilateral agreements such as the WTO and OECD that foster external trade liberalization and FDI and increase credibility of policy reforms.

## I. INTRODUCTION

Since 1992, regional trading arrangements (RTAs) have been important in facilitating the Baltics' integration into the world economy and their export development. As the Baltics were not members of the World Trade Organization (WTO) which sets multilateral rules for trade and market access, RTAs were also important in creating a framework for their trade relations and helped open external markets. Their integration with Europe has gradually deepened and the Baltics applied for European Union (EU) membership in 1995. Estonia was recently invited to start membership negotiations. Europe was an attractive market, and being part of Europe was an important political goal after years under Soviet rule. Steps have also been taken to deepen integration among the Baltics. Trade and economic relations with Russia and other former Soviet Union countries first disintegrated but are gradually being rebuilt under market principles.

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, trade will be a major determinant of their growth and transition performance. FDI can speed transition by transferring technology and increasing savings for investment. After reviewing past trade and FDI performance, the paper discusses the role of RTAs and transition policies 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.

The paper finds that regional integration is likely to have led to trade creation with Western Europe. The RTAs with the EU and the European Free Trade Association (EFTA) countries since 1992 are likely to have contributed to rapid reorientation of Baltic exports and increased trade in processed goods such as textiles and machinery, and helped transition by requiring rapid approximation of laws to western standards. The agreements, however, have not yet attracted much FDI to Europe-related exports, as most of it has gone to nontradable services. FDI in general is still low especially in Lithuania in per capita terms compared to a number of other transition countries. 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 need for more progress with transition is 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 liberalization of trade policies by requiring market opening and approximation of laws to EU standards. The trade creation effects of other Baltic FTAs are harder to assess for lack of detailed product specific data. There is some indication of a slight increase in intra-Baltic trade in 1996 after the entry into force of the Baltic Free Trade Agreement (BFTA). Baltic trade with Russia and other former Soviet Union countries faces many nontariff barriers and, after an initial decline, continues especially in energy, but food exports from the Baltics have also increased in recent years.

In the 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. Open RTAs can play a role in promoting further liberalization and locking in policy reforms. Second, preparation for EU membership is likely to dominate trade relations and will gradually harmonize policies within the Baltics. Third, trade creation potential in intra-Baltic trade can be limited but intra-Baltic and Baltic-Eastern European integration could 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 Russia and other former Soviet Union countries is likely to lead to trade diversion due to the higher protection levels there, but these markets in the medium-term offer large trade potential in both goods and services. To develop Russia and other former Soviet Union countries and other trade relations the Baltics should pursue their membership of the WTO and other international agreements.

## 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 show that trade openness in 1996 defined as the ratio of exports and imports to GDP was 80 percent in Estonia, 50 percent in Latvia and 30 percent in Lithuania (IMF, 1997). Apart from Estonia, the Baltic ratios are low compared to other small open economies. For example, the trade openness ratios for the Czech and Slovak Republics were over 60 percent. In a number of small Southeast Asian countries, these ratios can be 100–300 percent. This suggests that the share of trade in GDP in Latvia and especially Lithuania could still grow further.<sup>2</sup> 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 start of transition (for more details see Sorsa, 1994).

After the initial collapse<sup>3</sup> of trade in the early 1990s, **recovery of exports** of both goods and services has been good. Both in terms of the overall increase and per capita,

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<sup>2</sup>For a discussion of these ratios, see Havrylyshyn and Al-Atrash (1997). Their data show that the Baltics' trade/GDP ratios are below potential.

<sup>3</sup>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 percent, in Latvia 33 percent, and in Lithuania 49 percent of their 1991 level.

Estonia has been the most successful in developing exports. Between 1992–96 total exports of goods increased fourfold in Estonia, and nearly twofold in Latvia (in nominal dollar terms). In Lithuania growth of exports between 1993 and 1996 was about 62 percent (Table 1). Exports of services have increased even more—over fivefold in Estonia and about fourfold in the other two.<sup>4</sup> Estonia has also been the most successful in attracting FDI—its cumulative per capita FDI in 1996 was nearly twice that in Latvia and nearly five times that in Lithuania (Table 1). However, compared to Hungary, for example, Estonia’s cumulated FDI at US\$538 per capita in 1996 is still modest. By 1996 Hungary had attracted a cumulative US\$1,306 per capita of FDI.

### A. 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 restoration of more realistic relative prices.<sup>5</sup> Resource- and skill-intensive products now dominate exports, while imports are mainly raw materials such as energy, and machinery. 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 a natural resource exporter to one that exploits more its low-cost, high-skill labor force in processing activities (see below). With the gradual 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 a slower 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 percent of total exports).

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<sup>4</sup>Baltic trade statistics are subject to many discrepancies calling for some caution in their interpretation even after independence. Differences among various sources are large, for example, in 1994 IMF reported exports of US\$1,327 million compared to US\$1,103 million by the World Bank (Michalopoulos and Tarr, 1996) for Estonia. All the Baltics have large shares of transit trade, which may be reported differently in different sources. High inflation makes valuation also difficult on an annual basis.

<sup>5</sup>Product level data is 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.

Since the start of transition in 1991–92 the **direction** of the Baltics' trade has changed dramatically. Europe has become their main trading partner, as the collapse of intra-Baltics, Russia, and other former Soviet Union countries (BRO) trade was replaced by exports to new markets (Table 2). In 1996, over 51 percent of Estonia's, 44 percent of Latvia's and 33 percent 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 total (around 2 percent). The share of intra-Baltic trade has fluctuated in Estonia and Lithuania around 10–12 percent, and has increased to that level in Latvia in recent years. No substantial increase in this trade has yet taken place after the conclusion of the FTA in 1994, although 1996 data points to an increase of a few percentage points. Trade with Russia and other former Soviet Union countries after the initial collapse has remained a declining share of total exports in Estonia and Latvia, but has increased in Lithuania. The share of Ukraine in all three after the initial collapse has slightly increased.

The product pattern of trade by direction—the EU and Russia and other former Soviet Union countries—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 (trade in products reflecting the partners' different factor endowments). The Baltics exchanged raw materials—their own such as wood, or re-exported such as petroleum and metals—against machinery and other consumer goods.<sup>6</sup> 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. Trade related to processing of goods such as textiles and clothing from EU raw materials has emerged in all three. In Estonia the shift to processing-trade was most pronounced (about 20 percent of total exports)—in addition to textiles, various machinery products are now processed in Estonia that exploit its low-cost but highly skilled labor.

In exports to other BRO countries, the Baltics continue past export patterns as processed food exporters (fish, drinks, sweets). Other BRO 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 in Lithuania's exports. Some recent estimates with gravity models predict that in the longer run the relative share of the BRO in total trade will again 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 percent). Latvia exported food, textiles and other manufactures to

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<sup>6</sup>One study estimated the share of re-exports of BRO raw materials (or so-called arbitrage goods) in 1992 in total exports as 45 percent in Estonia and about 70 percent 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 percent (Hoekman and Djankov 1996).

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

### **B. 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 Soviet Union to the West. Today the largest service exporter is Latvia. In 1996 over 40 percent of total export earnings were services compared to 35 percent in Estonia, and only 20 percent 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 development 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 **FDI** in export industries geared to Western markets. Most FDI has been in, often nontradable, services and in industries that export to the Baltic or Russia and other former Soviet Union countries markets (chemicals, food). In Estonia, a large share of FDI (about 30–40 percent of inflows in 1994–95) was related to privatization programs (ECE 1996). Largest investors were Finland (20 percent), followed by Sweden (19 percent), and Russia (15 percent), based on the stock as of January 1, 1996. About half was in manufacturing (mostly chemicals and food industries) exporting to non-EU markets, 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 privatization of state utilities. Most investments (nearly 70 percent) have been in services (mostly finance and utilities). One-tenth of total was in food industries. Largest investors in 1996 were Denmark (26 percent), Russia (19 percent), and the United States (12 percent). Lithuania has received the least FDI among the Baltics. Largest investors have been Sweden, Germany, the United States, and Russia. No sectoral breakdown is available.

### **III. 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. Thereafter, the Baltics' RTAs are analyzed in light of their economic potential for trade creating integration and these "guidelines."



### **A. Basic Issues with Regional Integration and Determinants of Open RTAs**

In recent years, the topic has been discussed extensively in numerous fora and publications (see for example, WTO, 1995; de Melo and Panagariya, 1992; de la Torre and Kelly, 1992). Globalization and the larger role of services in GDP increasingly underline the importance of analyzing RTAs in broad terms beyond static trade creation in goods to include investment and other benefits of integration.<sup>7</sup> Regional integration can have different degrees, ranging from simple free trade agreements to economic and political union. It is generally acknowledged that while nondiscriminatory (unilateral or multilateral) liberalization is the first best policy, open regional arrangements can promote liberalization of trade and FDI flows.<sup>8</sup> But regional integration is not a panacea and its economic benefits depend on external openness of regional agreements, and on the policies applied by the partners. RTAs behind high tariff walls can slow structural change and maintain inefficient activities with dire consequences for growth.

The expected 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 liberalization in many areas. Locking in policies within an RTA can help improve policy credibility in reforming countries and prevent policy reversals. The literature<sup>9</sup> 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 nonborder 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

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<sup>7</sup>Earlier analysis on RTAs concentrated on assessing static trade effects in terms of trade diversion and trade creation. This was later refined to include models incorporating other aspects of integration such as imperfect competition leading to gains from scale economies, and increased product variety. The latest analysis is concentrating in analyzing other, mostly nonborder, barriers to integration, which effects establishment and entry and exit of firms (or other investment barriers). This has on the one hand led to the merging of the literature on investment and trade (see Owen, 1996 and UNCTAD, 1996), which better reflects the increased globalization of the world economy.

<sup>8</sup>The use of RTAs as stepping stones to broader global liberalization has been discussed for example by Havrylyshyn (1997); Krugman (1993); and Lawrence (1995 and 1996).

<sup>9</sup>See, for example, Michaely (1996) and Shiells (1995).

and do not increase protection to third countries;<sup>10</sup> (ii) include deep integration (nontariff barriers, investment barriers); and (iii) include liberal rules of origin with possibility for cumulation<sup>11</sup> among different RTAs; (iv) eliminate contingent protection (antidumping, voluntary export restraints, etc.); (v) are open to third countries; and (vi) foster low most-favored-nation (MFN) duties.

## **B. Integration with the West**

An important element 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 1995–96 by a FTA with the European Union and EFTA-wide FTAs (Table 4). Integration with the EU will deepen further once the Europe Agreements<sup>12</sup> signed in 1995 will be 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. In 1997, the EU gave Estonia the green light to start accession negotiations with the next round of applicants.

Baltic relations with Europe will be dominated by eventual membership in the EU.<sup>13</sup> The latter has, however, not given the Baltics any specific timetables or conditions for membership. Even for Estonia the process may take several years, and for Latvia and Lithuania it is even more uncertain. Most frequently cited conditions for accession are progress with market reforms, especially with privatization; 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. The green light given for Estonia suggests that in the EU's view these would have been better fulfilled in Estonia than in the other two Baltics. Even in the best of

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<sup>10</sup>This criteria 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.

<sup>11</sup>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.

<sup>12</sup>These take over the FTAs and include provisions for investment, technology, approximation of laws, etc.

<sup>13</sup>The FTA with EFTA will not be discussed here. It is very similar in nature with the EU FTA—main difference being that agricultural protection is even higher in the EFTA countries suggesting more distortions in this trade within an FTA.

circumstances, the accession process for the Baltics is likely to take 5 to 10 years. The process will also be influenced by the EU's internal reform in decision making in a substantially enlarged Community, and on how it decides to deal with the possible costs of extending agricultural support and structural funds to new members.

### **The economic potential**

The potential benefits of closer integration with the EU (or EFTA) can be important for relatively obvious reasons. Integration with the EU meets many of the criteria set in the literature for trade and growth creating regional integration—large size of market (GDP), diversity or likely complementarity in production (differences in GDP per capita or in share of agriculture in GDP), high share of existing trade between partners and relatively level existing protection in most except a few sensitive goods such as agriculture and textiles (Table 5). A priori these characteristics favor trade creation over trade diversion (Table 5). Deeper integration with a high income large market can also lead to investment creation and transfer of technology enhancing the benefits of closer integration.

### **The agreements**

The present RTAs with Europe (for a summary see Table 4) fulfill some, but not all, of the criteria set in the literature for trade- and growth-creating RTAs.<sup>14</sup> 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 one-third of present Baltic exports of goods are subject to limited or conditional liberalization 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 liberalize market access in nearly all goods after relatively short transition periods and adopt rapidly many of the EU's laws.

### **Coverage**

An imbalance in the agreements on goods trade arises by the 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 in 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)

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<sup>14</sup>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 nontariff and investment barriers and regulatory barriers); and limits on contingent protection (Shiells, 1995).

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 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 (Table 3). However, trade diversion potential in agricultural goods can be large due to the high protection levels in the EU and some of the Baltics.

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 textiles 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 percent. 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 above discussed FDI statistics give some support to this view, as most FDI has gone to nontradable services or to industries geared to BRO markets. The main impact of the FTAs seems to have been an increase in trade related to processing of EU inputs for further export, which is likely to have led to important transfer of technology and knowhow. As market access in other industries in the EU is free of restrictions, the restricted access in textiles coupled with rapidly increasing real wages in the Baltics, may speed the shift of comparative advantage to more skill-intensive activities. Some indication of this is already the substantially increased processing 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) such as selected consumer goods will only be opened gradually to competition. This is likely to slow 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 liberalization of cross-border supply of services will be discussed eight years after the entry into force of the Europe Agreements. Some liberalization will take place in

international maritime transport, where the agreement forbids for example, cargo-sharing (except within the United Nations Liner Conference), and requires national treatment in access to ports, use of infrastructure and port facilities. 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 main transport sectors are presently excluded from the coverage. In addition, Lithuania has temporarily excluded many important services such as telecommunications or postal services, and Latvia some port services, in which liberalization to foreign investors could promote rapid transfer of technology, bring large efficiency gains and development of comparative advantages in these sectors.

### **Increase in protection**

At present, the FTAs 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 and common agricultural policy upon EU membership. For Estonia, adopting the EU's protection levels necessarily will mean an increase in protection. In Latvia and Lithuania, protection may increase in some 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 will reform its agricultural and other policies, which is being discussed within the EU and will be taken up in the WTO in 1999. In the interim period (which as noted above could easily exceed 5–10 years), 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, the Baltics during the transition period to EU membership will help in creating 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 several years and in the meantime EU levels of protection may also decline as WTO negotiations, especially in agriculture, resume in 1999. 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 in establishment, that can promote competition, foreign investment and trade (Annex Table 2). The agreement provides for national treatment in establishment and operation for companies from signatories except in air transport, inland waterways and maritime cabotage transport services. Negotiations to liberalize these sectors are foreseen. Establishment of Baltic nationals (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 privatization

programs, 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 privatization programs. 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 their repatriation, to which balance of payments (BOP) 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 labor mobility. Negotiations on further labor 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 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. 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, Estonia will, by end-1998, 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 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 modernizing laws and a standstill on certain regulations, which is likely to facilitate the transition to market economy, and towards 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 percent 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 origin rules 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 antidumping 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 these may reduce

the investment and trade creation potential of the agreements by increasing uncertainty of market access.

### **Other**

The bilateral hub-and-spoke nature<sup>15</sup> of the agreements tends to concentrate trade flows between the spoke (a Baltic country) and the hub (the EU). This pattern has a tendency to marginalize 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 trade with the Baltics in processing of EU raw materials and lack of EU trade-related investments. The BFTAt (see below) has reduced some of the potential marginalization of trade in goods, but it remains in services. The marginalization problem can be further reduced by the conclusion of FTAs with other Eastern European countries with Europe Agreements.

### **The impact of the agreements**

Despite the drawbacks, the overall impact of the EU FTAs is likely to have resulted in net trade creation in the Baltics. First, the agreements are likely to have facilitated trade reorientation in the Baltics. 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,<sup>16</sup> 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 the Europe Agreements and anticipation of EU membership are likely to have promoted progress in approximation of laws to EU standards, promoted liberalization in the Baltics and locked in

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<sup>15</sup>Hub-and-spoke means that trade is liberalized 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 (see Havrylyshyn, 1997).

<sup>16</sup>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.

some of the reforms in the transition countries. However, the lack of specific timetables in many areas may slow down reform.

The RTAs raise a number of issues for future integration and trade relations. First, Latvia and Lithuania should press for a more 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 the 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 towards 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 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 potentially other fora such as the OECD. 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. In services, for example, liberalization in the Baltics might be faster within the WTO framework than in the EU one. However, more important may be progress with private sector incentives such as stable and transparent regulatory frameworks, and privatization (see below).

### **C. Intra-Baltic Integration**

Intra-Baltic integration has been pursued on its own right and as a complement to European integration. A Baltic FTA 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 under preparation with the Central European Free Trade Agreement (CEFTA)<sup>17</sup> countries. These are summarized in Table 4.

#### **Economic potential**

Most of the economic arguments favoring regional integration are not 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 5). 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 nontariff barriers (border formalities, poor transport networks,

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<sup>17</sup>CEFTA membership requires the conclusion of FTAs with all CEFTA members (Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia) and WTO membership.



payments arrangements, some licensing requirements) which reduce trade creation potential and which may not be solved by FTAs. The differences in protection levels would favor trade creation for Latvia and Lithuania with the more liberal Estonia from an FTA. 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. Similar concerns apply to the CEFTA integration.

### **The agreement**

The 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 FTA by improving regulatory frameworks for 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 4). These may reduce potential for trade and investment creation by affecting stability of incentives, although the safeguards or dumping clauses have not been used by the Baltics. In practice, rules of origin may also be ineffective, if smuggling takes place.

The weakest element in the BFTA is the lack of provisions for **deeper integration**. The agreement does not cover establishment, labor, or other forms of liberalization of nontariff barriers. Some of these will be addressed in the transition process or in the EU agreements. Many laws in the Baltics will be harmonized automatically in the process of EU integration. Progress with transition will gradually remove many other nontariff barriers such as payments problems, border formalities, transport infrastructure, etc. However, the lack of deeper intra-Baltic integration may prevent investment and trade creation, especially in services, but also in other sectors of the economy. The hub-and-spoke distortions from the EU agreements will remain in services and some aspects of investment policies, unless they are addressed in multilateral agreements or unilaterally.

Whether intra-Baltic trade has led to trade creation or trade diversion is too early to assess with existing data. Trade creation could be expected if Latvia and Lithuania, for example, increased imports from the less protectionist Estonia, or trade diversion if their mutual trade increased in protected products. Existing statistics show that the share of intra-Baltic trade in all but Latvia has fluctuated around 10–12 percent in recent years. In Latvia, trade with the other Baltics has increased more steadily. Data for 1996 indicate some increase in Baltic exports in all three.

There is no clear product pattern in the trade between the countries, which is still partly reflecting those 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 nontariff 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 FTA to agricultural products in 1997. 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. However, it may also lead to increased agricultural subsidies in Latvia and Lithuania, and to trade diversion in their intra-trade in these products.

Investment statistics indicate some participation of Baltic investors in each others markets. In 1996 Estonian companies started to invest more in Latvia and to some extent in Lithuania, for example, in 1996 there were over 400 Estonian companies established in Latvia.

The above raises a number of issues for the future, which suggest that pending EU membership the Baltics should pursue integration within FTAs. First, while economic arguments point to relatively small potential for trade creation, risks for trade diversion may also be modest as overall protection levels, except in a few sensitive goods, are moderate. To improve trade creation potential the agreements could be deepened beyond market access in goods. The extension of the Baltic FTA to agriculture was one step. Disciplines on subsidies could also be added. Extension of the agreement to services and establishment would remove potential discrimination between Baltics and EU companies.<sup>18</sup> Second, the main argument favoring intra-Baltic (or Baltic-CEFTA) integration is not economic, but the hub-and-spoke nature of the EU agreements. Removing barriers within the Baltics will reduce the potential distortions created by the EU agreements in favor of EU enterprises vis-à-vis Baltic enterprises reducing a potential disincentive to FDI.

Third, deepening of integration towards a customs union (planned for 1998) should be resisted. Whether this would result in higher protection 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 Latvia and Lithuania in many products have duties of 20–40 percent compared to zero in Estonia. Many of the potential benefits from increased intra-Baltic trade can already be achieved within the existing FTAs. Especially Estonia is better off maintaining its present open regime during transition as it will foster restructuring and transition to an efficient economy. Estonia's start of accession negotiations with the EU should reduce incentives for a Baltic customs union. As the longer-term framework for trade policies is likely to be the EU's common external tariff, a customs union is unlikely to be needed as an intermediate step.

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 of costly time of the administration,

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<sup>18</sup>Some of these issues will, however, be addressed in the WTO accession process.

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 reduction of NTBs does not require a customs union.

#### **D. Integration with the East**

Relations with Russia and other former Soviet Union countries have been characterized by disintegration and gradual reestablishment of trade relations. The collapse in Russia and other former Soviet Union countries demand and payments systems, changes in relative prices, and establishment of border barriers have redefined Baltic trade relations with their Eastern neighbors. Political concerns slowed the ratification of basic MFN-based trade agreements with Russia, which Latvia and Lithuania have now finalized 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 by concluding a free trade agreement with Ukraine (March 1996) that covers free trade in all goods (Table 4). 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 (Table 5) which could favor trade creation. However, at present incomes are modest reducing the economic potential from deeper integration. In terms of diversity, Ukraine with a large agricultural sector (39 percent of GDP) is likely to be more complementary to the Baltics than Russia (agriculture only 7 percent of GDP). But the Baltics offer other complementarities with Russia. Geography is one, as Russia's access to seaports to Europe is limited and the Baltics offer large potential in this. Diversity therefore can offer some trade and investment creation potential.

However, other factors point to large potential for trade diversion in goods. Existing trade in "new goods" is small and deeper integration could favor trade in the often protected "old industries" leading to trade diversion and slower adjustment and restructuring. The overall level of tariffs and trade restrictions in Russia and Ukraine (average tariffs around 12–13 percent and several NTBs (Table 5)) is also higher than in the Baltics (0 percent in Estonia or, according to one estimate, 10 percent in Latvia and Lithuania) suggesting that an FTA could lead to trade diversion, especially in the latter two.

## **The agreements**

At present, the only free trade agreements between the Baltics and Russia and other former Soviet Union countries are between Estonia and Ukraine, and Latvia and Ukraine. The Estonian agreement 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, but does not deal with many of the nontariff barriers in Ukraine, which may limit 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 lead to net trade creation until transition proceeds further in Ukraine, and it liberalizes its trade regime. However, since the FTAs exports to Ukraine seem to have increased from both Baltic countries. 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 against its exports than the MFN duties. Nevertheless, Estonia has been able to export some products to Russia.

Deeper integration with Russia and other former Soviet Union countries is unlikely to lead to trade creation in goods in the intermediate term given their more protectionist trade regimes compared to the Baltics, and small shares of trade except in traditional goods such as energy. The main trade creation potential in trade with Russia and other former Soviet Union countries at present is offered by transit trade via the Baltics or other services trade, which can take place without trade preferences. Its development is more dependent on development of infrastructure, and openness to investors from all sources. WTO membership should reduce discrimination in trade and in some investment areas as well.

## **IV. TRANSITION POLICIES AND 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 from it depend crucially on progress with transition—with the introducing of market-oriented macroeconomic and structural 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 stabilizing their economies, Estonia seems to be clearly ahead in structural reforms. Its trade policy framework is the most liberal among the Baltics, it is also more advanced in privatization and creating incentives for investment and private sector growth. This may partly explain its better export performance and success in attracting FDI. The following will briefly discuss two elements of the Baltics policies affecting trade and FDI performance—macroeconomic stabilization and creation of incentives for private sector development.

### A. Stabilization Policies

Transition in the Baltics has proceeded rapidly since 1992, and all three have now successfully stabilized their economies.<sup>19</sup> Inflation in 1996 was around 13–15 percent and interest rates have declined to 14–26 percent in 1996. Output growth resumed in 1994–95 (Table 6) and was above 3 percent in Estonia and Lithuania and nearly 3 percent in Latvia in 1996. Return of output growth and decline in interest rates has 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 have increased. However, as 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 concern so far.

In the May 1997 IMF *World Economic Outlook* Estonia ranked third in progress with transition after the Czech Republic and Hungary with a rating<sup>20</sup> of 3.3. Latvia was seventh with 3.1 and Lithuania ninth with a rating of 2.9. The top three countries also have the highest per capita FDI, which underlines the importance of progress with transition in attracting FDI.

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 pressures to move 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. In Estonia the start of accession negotiations is likely to help boost FDI further provided good policy performance continues.

### B. Structural Policies and Private Sector Incentives

A key structural policy in the trade-dependent Baltics has been **trade policy**. In this Estonia differs from its neighbors 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 in 1995 of 28 percent but reduced to 17 percent by 1997) and especially in Latvia (average production weighed tariffs over 50 percent), 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

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<sup>19</sup>For in-depth discussion of stabilization in the Baltics, see Saavalainen (1995) in Banerjee and others; and Citrin and Lahiri (1995).

<sup>20</sup>The rating is a simple average of EBRD transition indicators, which range between 1 and 4. For details, see EBRD (1996).

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 BFTA and to a lesser extent the Europe Agreements may 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 percent). The impact of protection on 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 to establishment of foreign companies in some service industries in which Latvia may have a comparative advantage (ports). This may reduce efficiency 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 liberalizing laws related to establishment in Lithuania.

Estonia is also ahead of its neighbors in developing another crucial structural policy area for trade and FDI development, **private sector legal framework**, which is also closely related to the services barriers. In a recent EBRD classification of laws fostering foreign investment in 1996, Estonia scored four (the maximum) in both extensiveness and effectiveness of legal rules. The study Latvia came second with four and three respectively, while Lithuania only received a two on both counts (EBRD, 1996). The weaker FDI framework in Lithuania may help explain the lower levels of FDI there. It is notable that three of the four transition countries that had the highest score in this classification (Croatia, Czech Republic, Estonia, and Hungary) also had the highest FDI per capita in 1996. Thus progress in transition and in developing private sector incentives are closely related to countries' FDI performance. This underlines the importance of developing appropriate legal frameworks in all the Baltics, but especially in Lithuania, and improving the effectiveness of enforcing the laws as well.

**Privatization**, another element of importance for private sector development, is also the most advanced in Estonia. In 1995 an estimated 65 percent of GDP was private, while in Latvia it was about 58 percent and in Lithuania 55 percent (EBRD, 1996). In Latvia especially, large scale privatization has been slow. The opening of the privatization process for

foreign investors in Estonia is likely to have helped attract foreign investment. In Latvia foreign ownership in privatized companies was only allowed at a later stage in the process (in 1996).

**Restructuring** of the privatized 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 for a long time restructuring was left to owners of enterprises, which were dominated by former management and workers. A new bankruptcy law entered into force in 1996 and can speed restructuring. In Lithuania most privatization has been left to former managers, who have been at times unwilling to restructure the companies. A bankruptcy law has been functioning recently. Labor laws in the Baltics are relatively liberal and are not a major obstacle to restructuring.

Rapid stabilization, 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 with market orientation in Estonia are likely to have contributed to its better trade and FDI performance. Completion of the privatization 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.

## 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. In trade, FDI and transition performance Estonia stands out among the Baltics, although all three have performed well. Estonia has the most liberal trade regime, is 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 is likely to dominate trade diversion. However, their contribution to FDI has so far been minor. The sectoral breakdown of FDI indicates that it has gone mostly into nontradable services or to industries exporting mainly to Russia and other former Soviet Union countries markets. 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 processing 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 are likely to have promoted liberalization of trade policies in Latvia and Lithuania. The BFTA has not yet resulted in large increases in trade (or investment). Trade between the Baltics and Russia and other former Soviet Union countries faces many nontariff barriers and after initial decline continues, 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 greatly 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 for private sector development to attract FDI, and higher savings for investment. RTAs can continue to play a role in promoting liberalization and locking in policy reforms. Preparation for EU membership will dominate trade relations and will gradually harmonize 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. Deeper integration with Russia and other former Soviet Union countries is likely to lead to trade diversion, although these markets in the medium term offer large trade potential in both goods and services. The Baltics should consider joining other agreements such as OECD that can foster further liberalization, FDI and increase credibility of policy reforms.



Table 1. Exports and FDI in the Baltics During Transition (1996)

	Growth of exports of goods (services) between 1992-96 (percent in US\$)	Exports/ capita	FDI cumul. per capita	FDI cumul. 1992-96, million US\$	BRO exports in total goods exports excluding the Baltics	Services exports in total exports
		U.S. dollars			percent	
Estonia	350 (446)	2114	538	794	25	35
Latvia	89 (270)	1036	256	644	36	42
Lithuania	62 (303)*	1099	102	380	45	20

Source: Direction of Trade Statistics (DOTS), IFS, \*for Lithuania 1993-1996 for lack of comparable data for 1992.

Table 2. Increase in Baltic Exports of Goods by Direction Between 1993 and 1996

(percent in dollars)

	Total	EU	EFTA	Baltics	Russia	Ukraine
Estonia	158	172	211	193	13	262
Latvia	37	88	114	158	51	39
Lithuania	185	41	643	227	1494	101*

Source: Direction of Trade and Statistics (DOTS). (In Lithuania there is a large discrepancy between DOTS and IFS data for 1993 explaining the difference in total growth between 1996 and 1993 compared to Table 1).

\*=Lithuanian exports to Ukraine refer to 1994-1996.

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

(percent of total)

Products	Estonia EU	BRO	Latvia EU	BRO	Lithuania EU	BRO
Manuf.	57 (73)	40 (38)	48 (80)	64 (40)	62 (82)	48 (27)
of which:						
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 mat.	27 (8)	12 (14)	48 (2)	3 (4)	16 (3)	2 (6)

Source: COMTRADE, Estonian Statistical Yearbook (1995).

Table 4. RTAs in the Baltics

Agreement	Main Provisions	Rules of Origin	Safeguards
<b>ESTONIA</b>			
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.

Table 4. RTAs in the Baltics (continued).

Agreement	Main Provisions	Rules of Origin	Safeguards
<b>LATVIA</b>			
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, applied 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 selected 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		

Table 4. RTAs in the Baltics (concluded)

Agreement	Main Provisions	Rules of Origin	Safeguards
<b>LITHUANIA</b>			
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); antidumping; 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.		

Table 5. Trade Creation Indicators in Baltic Regional Partners

	Size	Diversity		Share of partner-trade (exports percent) 1995	Tariffs (percent average unweighted)	Other Trade Restrictions
	GDP (US\$ billions 1994)	GDP/CAP (US\$ 1994)	Agriculture in GDP percent			
<b>ESTONIA</b>	4.3	2820	10	-	0	-
EU	7590	20530	2	54	A = 25 I = 6	Various NTBs in sensitive products.
EFTA	385	33218	1	2	A = 74-82 I = 3-6	Various NTBs in sensitive products.
other Baltics	11	1730	15-21	12	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.
<b>LITHUANIA</b>	5.0	1350	21	n.a.	10	Export bans (skins, feathers), Export tax on skins, wool, red clover seed, timber, glands). Import quotas on agriculture.
EU	7590	20530	2	36	A=25	Various NTBs on sensitive products.
EFTA	385	33218	1	1	A = 74-62 I = 3-6	Various NTBs on sensitive products
Baltic	10	1587	15-21	9	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 on sensitive products.

Table 5. Trade Creation Indicators in Baltic Regional Partners (concluded)

	Size GDP (US\$billions 1994)	GDP/CAP (US\$ 1994)	Agriculture in GDP (Percent)	Share of partner- trade (exports percent) 1995	Tariffs (percentage average unweighted)	Other Trade Restrictions
<b>LATVIA</b>	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.
Baltic	9	1730	10 - 21	9	E = 0 Li = 3	Lithuanian export restrictions.
Ukraine	81	1570	39	10	12	Payments and regul. barriers.
CEFTA	98	3590	6	4	8-14	Various NTBs in sensitive products.

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



Table 6. Transition Indicators in the Baltics

	1993	1994	1995	1996
	(percent)			
<b>Inflation, end period</b>				
Estonia	36	42	29	15
Latvia	35	26	23	13
Lithuania	188	45	35	13
<b>GDP growth</b>				
Estonia	-2.1	-0.1	2.9	3.1
Latvia	-16	2	0	2.8
Lithuania	-24	1	3.1	3.6
<b>Lending Rates</b>				
Estonia	27	23	16	14
Latvia	86	56	35	26
Lithuania	91	62	27	22
	(percent of GDP)			
<b>Current Account</b>				
Estonia	-1.4	-7.5	-5.3	-10.1
Latvia	7.0	-2.4	-3.5	-6.8
Lithuania	-4.6	-3.1	-2.3	-4.4
<b>Budget (Financial) Deficit</b>				
Estonia	1.4	2.9	-0.9	-1.5
Latvia	1.0	-1.7	-2.7	-1.2
Lithuania	2.4	-1.5	-1.8	-2.0
<b>Investment</b>				
Estonia	25	29	26	30
Latvia	13	19	19	22
Lithuania	18	19	18	20

Source: IMF, International Financial Statistics.

Table 1. Synopsis of the Trade Regimes of the Baltics - 1996

	Quantitative restrictions		Tariffs/Taxes	
	Imports	Exports	Imports	Exports
<b>Estonia</b>				
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 percent applies to items of cultural value.
Other observations			Antidumping legislation has been submitted for parliamentary approval.	
<b>Latvia</b>				
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 percent (the MFN rate is 15 percent), and on inputs 1 percent average production weighted tariff on agriculture is 53 percent (average MFN is 46 percent), and some specific rates apply. Average tariff for non-agricultural goods is 3.7 percent.	Export taxes apply to waste/scrap materials, round logs and art works/antiquities.
Other observations			Reference prices for some imports.	The export taxes on waste/scrap metals and round logs scheduled to be eliminated by end-1998.

Table 1. Synopsis of the Trade Regimes of the Baltics - 1996 (concluded)

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

Source: Leidy-Ibrahim (1996).

Table 2. Summary of Baltic-EU Europe Agreements

<b>Estonia</b>		
<b>Market Access</b>	<b>EU</b>	<b>Estonia</b>
<b>Agriculture</b>	<ul style="list-style-type: none"> <li>• Reduced duties on 15 products (honey, plants, berries, cucumbers, apple juice); some berries subject to minimum prices (Annex III).</li> <li>• Tariff quotas for meat (live animals, bovine meat, sheep meat); levy within quota 25 or 40 percent of regular levies (Annex IV).</li> <li>• Tariff quotas for 10 products; levy 40 percent of regular, increasing quantities until 1997 (pork, chicken, milk powder, cheese, potatoes, apples, sausages) (Annex V).</li> <li>• 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).</li> <li>• Regular tariffs on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• Zero duties</li> </ul>
<b>Fisheries</b>	<ul style="list-style-type: none"> <li>• Tariff quotas on 6 products (duties 0–10 percent) (Annex VI).</li> <li>• Regular tariffs on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• Zero duties</li> </ul>
<b>Industrial goods</b>	<ul style="list-style-type: none"> <li>• Zero duties (textiles subject to surveillance) (Protocol 1)</li> </ul>	<ul style="list-style-type: none"> <li>• Zero duties.</li> </ul>
<b>Services</b>	<ul style="list-style-type: none"> <li>• Negotiations on liberalization of cross-border services to start 8 years after ratification. International maritime transport services open access.</li> </ul>	<ul style="list-style-type: none"> <li>• Same as EU.</li> </ul>
<b>Investment</b>	<ul style="list-style-type: none"> <li>• National treatment in establishment of companies (except in some real estate), in 1999 for Estonian nationals, except in air transport, cabotage and inland waters.</li> </ul>	<ul style="list-style-type: none"> <li>• National treatment in all establishment except in the same 3 transport sectors as EU. Free capital and current account transfers.</li> </ul>
<b>Labor</b>	<ul style="list-style-type: none"> <li>• Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end-1999 labor movement reviewed.</li> </ul>	<ul style="list-style-type: none"> <li>• Same as EU.</li> </ul>
<b>Approximation of laws</b>		<ul style="list-style-type: none"> <li>• In road, rail, inland waterways by end-1998. TRIPS by end-1999, commercial law gradually.</li> </ul>

Table 2. Summary of Baltic-EU Europe Agreements (cont'd)

**Latvia (4 -year transition period)**

Market Access	EU	Latvia
Agriculture	<ul style="list-style-type: none"> <li>• Reduced duties on 13 products (honey, plants, roses, mushrooms, cucumbers, berries, apple juice); some berries subject to minimum prices (Annex VII)</li> <li>• Tariff quotas for meat products (live bovine animals, meat, sheep meat); levy within quota 25 or 40 percent of regular (Annex VIII).</li> <li>• Tariff reductions for 14 products; levy 40 percent of regular, increasing quantities until 1997 (meat, milk powder, butter, cheese, tomatoes, vegetables, sausages) (Annex IX).</li> <li>• Tariff reductions on 10 processed agr. products; 10 of which subject to quotas increasing until 2000 (sweets, beer, vodka) (Protocol 1 – Annex II).</li> <li>• Regular duties on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• Some tariff reductions for 146 products, 26 of which subject to quotas (meat, cut flowers, vegetables, wheat, margarine, sausages, wine) (Annex X)</li> <li>• Tariff reductions by 2000 on 127 processed agr. products (Protocol 1 – Annex III)</li> <li>• Tariff quotas on 6 processed agricultural products increasing over 6 years (yogurt, bread, soups, gin) (Protocol 1 – Annex IV).</li> <li>• Zero duties on other products.</li> </ul>
Fisheries	<ul style="list-style-type: none"> <li>• Tariff quotas for 5 products (Annex XII).</li> <li>• Regular tariffs on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• 6 products with tariff quotas (Annex XIII)</li> <li>• zero duties on other products.</li> </ul>
Industrial goods	<ul style="list-style-type: none"> <li>• Duty free quotas (Annex V) in <u>textiles</u>; surveillance of textiles (Protocol 1).</li> <li>• Zero duties on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• 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).</li> <li>• Export duties on 16 products to be eliminated by end-1998 (gypsum, hides, wood, metal scrap) (Annex IV).</li> <li>• Zero duties on other products.</li> </ul>
Services	<ul style="list-style-type: none"> <li>• Negotiations on liberalization of cross-border services to start 8 years from ratification; maritime services free access</li> </ul>	<ul style="list-style-type: none"> <li>• As EU.</li> </ul>
Investment	<ul style="list-style-type: none"> <li>• National treatment in establishment except in air transport, cabotage and inland waters; real estate, and Latvian nationals in EU.</li> </ul>	<ul style="list-style-type: none"> <li>• National treatment in establishment except in weapons manufacture, gambling, real estate, port infrastructure ownership (until end-1988), and the 3 transport sectors. Free capital and current account transfers.</li> </ul>
Labor	<ul style="list-style-type: none"> <li>• Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labor movement reviewed.</li> </ul>	<ul style="list-style-type: none"> <li>• In road, rail, inland waterways by end-1998. TRIPS by end-1999, commercial law gradually.</li> </ul>
Approximation of laws		

Table 2. Summary of Baltic-EU Europe Agreements (cont'd)

**Lithuania (6-year transition period)**

Market Access	EU	Lithuania
Agriculture	<ul style="list-style-type: none"> <li>• Reduced duties for 11 products (horses, duck livers, honey, vegetables, mushrooms, berries, apple juice) Annex IX; minimum prices on berries.</li> <li>• Tariff quotas for meat products (live bovine, animals, bovine and sheep meat); levy 25 and 40 percent of regular (Annex X).</li> <li>• 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).</li> <li>• Tariff reductions for 12 processed agr. products (sweets, vodka); 4 of which subject to increasing quotas until 2000 (Protocol 2 – Annex I, II).</li> <li>• Regular duties on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• Reduced duties until 2000 on 95 products (Annex XII) 15 of which subject to quotas increasing until 2000 (Annex XIII).</li> <li>• Reduced duties (by 2000) for 21 processed agricultural products (Protocol 2 – Annex III).</li> <li>• Zero duties on other products (Annex XII).</li> </ul>
Fisheries	<ul style="list-style-type: none"> <li>• Tariff quotas for 10 products (Annex XIV).</li> <li>• Regular duties on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• Tariff reductions over 6 years for 6 products (Annex XV).</li> <li>• No restrictions on other products.</li> </ul>
Industrial goods	<ul style="list-style-type: none"> <li>• Duty free quotas in textiles (Annex VI). Surveillance of most textiles (Protocol 1).</li> <li>• Zero duties on other products.</li> </ul>	<ul style="list-style-type: none"> <li>• Footwear duty elimination in 1997 (Annex II).</li> <li>• Duties on 122 products to be eliminated by 2001 (metal products, plastics, wood products, footwear, appliances, electronics, furniture) (Annex III).</li> <li>• Duties on used cars to zero by 2001 (Annex IV).</li> <li>• Elimination of export duties by 2001 (hides, wood, metal scrap) (Annex V).</li> <li>• Zero duties on other products.</li> </ul>
Services	<ul style="list-style-type: none"> <li>• Negotiations on liberalization of cross border services to start 8 years after ratification. International maritime transport services open access.</li> </ul>	<ul style="list-style-type: none"> <li>• As EU.</li> </ul>
Investment	<ul style="list-style-type: none"> <li>• National treatment in establishment of companies (except in some real estate), in 1999 for Lithuanian nationals, except in air transport, cabotage and inland waters.</li> </ul>	<ul style="list-style-type: none"> <li>• National treatment in establishment 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.</li> </ul>

Table 2. Summary of Baltic-EU Europe Agreements (concluded)

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<b>Lithuania (6-year transition period)</b>		
Labor	<ul style="list-style-type: none"><li>• Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end-1999 labor movement reviewed.</li></ul>	<ul style="list-style-type: none"><li>• As EU.</li></ul>
Approximation of laws		<ul style="list-style-type: none"><li>• In road, rail, inland waterways by end-2000. TRIPS by end 1999, commercial law gradually.</li></ul>

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Source: Baltic-EU agreements.

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