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The Baltic countries´ changing foreign trade patterns and the Nordic connection

Abstract

The 1990s have seen the delinking of the Baltic economies from Soviet industrial structures, rapid liberalization of local economies and foreign trade, and a burst of trade expansion. Estonia's exports, in particular, have grown consistently at a sufficiently high rate to bring about solid export-led growth for its economy. The article gives an overview of the changes that have taken place in the foreign trade of the Baltic countries, paying particular attention to Nordic-Baltic trade relations and possible future developments in trade.

Underlying overall trade development, the Baltics´ trade reorientation to the West has been profound and rapid, especially in Estonia's case. Russia and the other CIS members have been replaced by the EU as the Baltics´ main trading partner. Latvia and Lithuania have reoriented themselves to the non-Nordic EU, while Estonian foreign trade is heavily concentrated on Finland and Sweden. Application of a gravity model of trade suggests (in contrast to results obtained for foreign trade of central and eastern European countries in transition) that the Baltic countries´ foreign trade with a few European countries has exceeded its potential, in particular Finland and Sweden. The extreme is seen in Finnish exports to Estonia which have grown far larger than the estimated potential. The implication is a decline in the share of the two Nordic countries in the Baltics´ foreign trade.

The structure of Finnish and Swedish trade with the Baltic countries differs considerably from the structure of Finland´s and Sweden´s foreign trade in general. Trade is concentrated in resource- and labour-intensive goods, while intra-industry trade is less significant. Nordic-Baltic trade levels, above all Finnish-Estonian trade, have been influenced by a number factors in the opening up of the Baltic economies. These include proximity, lack of competition, free trade arrangements, intermediation of goods and, in Estonia's case, direct investment by Finnish and Swedish companies. A major identifiable element supporting the development of Estonian trade with Finland and Sweden is outward processing in the fields of textiles and machinery.

In the medium and long run, the Baltic countries will have to tackle several wider issues influencing their external sector. These issues include the sustainability of competitiveness in the production of labour-intensive products in the face of efforts by other low-cost producers; the limits imposed by marginal natural resource wealth; the viability of commercial agriculture at such northern latitudes; the exploit ability of forest resources; and development of "east-west" transport/shipping gateways and production geared toward eastern markets. Scarcity of evident competitive advantages and uncertainty related to many fields emphasize two priorities, ie the maintenance of economic stability in terms of policy and institutions, and further investment in relatively well-educated populaces.

Keywords: foreign trade, Baltic countries, Nordic countries.

1 The role of foreign trade in the Baltic economies

Up to the collapse of the **Soviet** Union in 1991, the industries in all Baltic countries were linked to a centralized all-Union industrial structure. The entire set-up, including policy, followed its own peculiar logic which did not necessarily have much to do with usual economic reasoning. Building on the Soviet military and political presence in the Baltic countries the industrial links were created and maintained through planned sectoral activities, i.e. command integration. The ties did result in the exchange of industrial outputs between Baltic countries and the rest of the Soviet Union, but the exchanges were not trade in the normal sense.

In connection with the all-Union way of doing things, there was the complete dominance of all-Union exchanges in the Baltic economies -- indeed, to such an extent that it is hard to draw equal signs with the experience of other economies in transition outside the CIS. In the Baltic republics the links with the Soviet industrial empire occupied a remarkably large share of their economies, far more than in CMEA member countries of the time. The trade of the three Baltic nations with the world outside the Soviet Union constituted only 10-20% of total trade still in the early 1990s, while the figure for the European CMEA countries in 1989-91 ranged generally between 70-85%, with only Bulgaria recording lower shares (50-65%). Much of the Baltics´ non-Soviet trade was with the European CMEA countries, and even the remaining 5-10% with developed market economy countries was handled by Soviet foreign trade organizations based in Moscow or Leningrad.[1] The share of the non-Soviet world was especially low in the Baltic countries´ exports. It was only in the latter half of the 1980s that the Baltic republics were even allowed to set up their own foreign trade organizations, and these played a rather limited role.[2] In sum, with regard to trade and the knowledge of doing business with market economies, the Baltic countries were closed.

It is perhaps a widely held notion that, **after regaining independence** in early autumn 1991, all Baltic countries experienced an impressive explosion in foreign trade; that starting from scratch they opened up their closed economies and pulled themselves up by their bootstraps; and that the Baltic economies plunged into significant decline, but saved themselves quickly through export-led recovery. The data, however, reveals differences: Developments up to the present day and in each Baltic country have not been as sweeping as usually believed. Even at the aggregate level, development have been more patchy.

It is true that, during the period 1993-95, total exports from all three Baltic countries expanded rapidly. The pace in 1993 ranged from about 40% in Latvia to close to 100% in both Estonia and Lithuania[3] (the growth rates used here and below are for the nominal values of trade converted into ECUs. Due to the decline in recent years of the most frequently employed yardstick of international trade flows, the US dollar, use of the dollar here would have tended to exaggerate growth rates of the recent past, particularly since mid-1994).

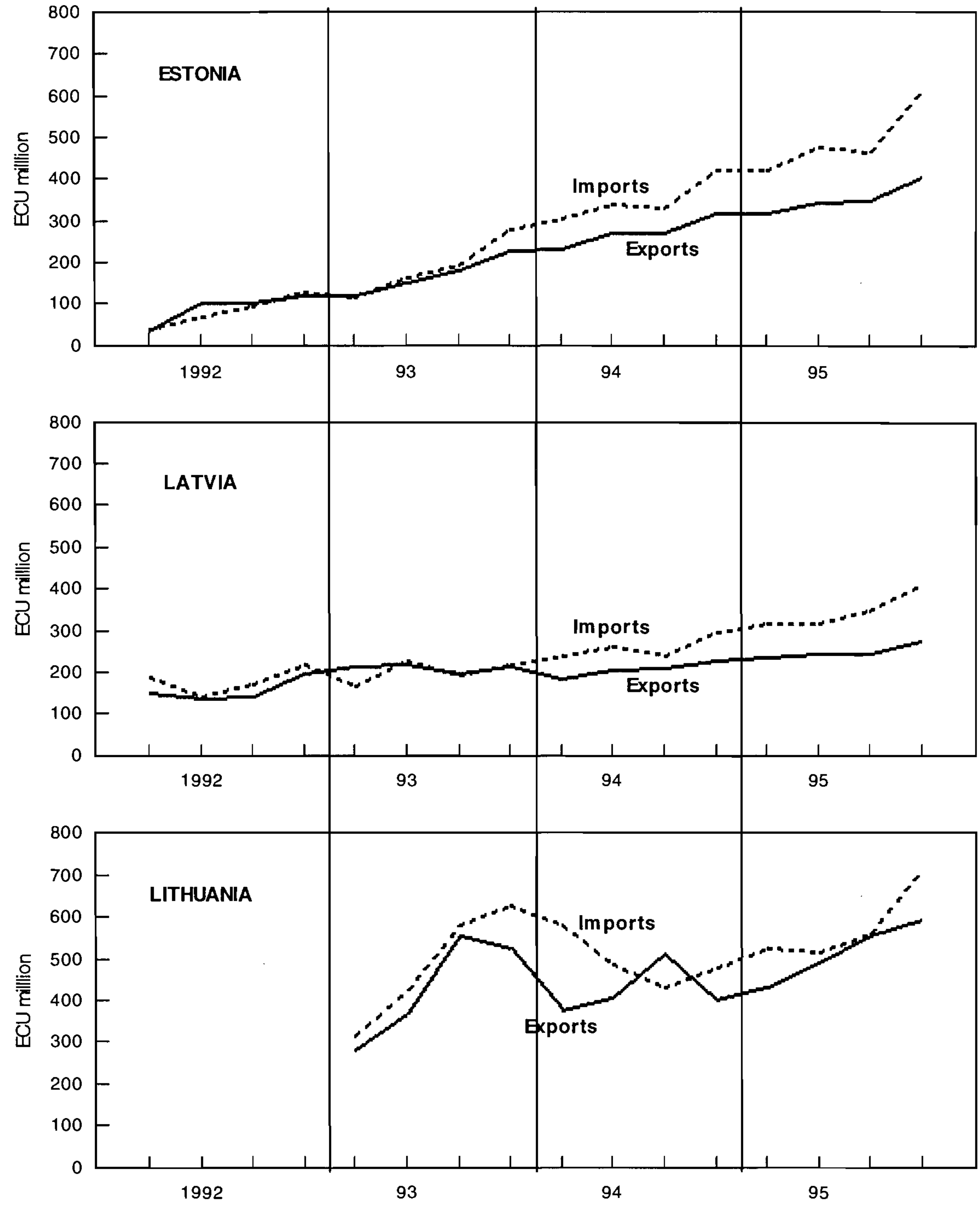
After this phase of easy export expansion, Estonia succeeded in maintaining the rapid growth of its foreign trade, with exports growing by 30% in 1995 and imports increasing by 40% (Fig. 1). This has raised the country´s exports-per-capita level to about USD 1,200 in 1995, equalling the per capita exports of Hungary and, except for the better performance of Slovenia, puts Estonia close to the top among the most intensively exporting central and eastern European countries in transition (CEECs), the Czech Republic and Slovakia (USD 1600-1650 in 1995). The experience of the other two Baltic countries has been less straightforward. The growth of Latvian

[1] Trade statistics of that time are burdened by distortions in Soviet price structures as well as the exchange rate valuation of the Soviet rouble, which could overestimate the share of intra-Soviet exchanges. Alternative valuations would, however, not change the proportions decisively (unless one takes the view that more or less all other products than the most basic commodities, such as fuels and food, in the all-Union exchanges would have had very little value under market conditions).

[2] Laurila (1995).

[3] The starting point was low, since it was set in 1991-92 right after a tremendous collapse in trade had taken place. For 1992-93, data published in various sources on Lithuanian foreign trade in particular show considerable differences.

Figure 1 **Foreign trade of the Baltic countries**



Source: Customs statistics of Estonia, Latvia and Lithuania (conversions by the author).

and Lithuanian exports came to a halt in 1994, then regained momentum and grew by 20% in 1995. The per capita export figure has reached roughly USD 700 in Lithuania and about USD 500 in Latvia, which are in the same range as the Polish level in 1995 (admittedly, these comparisons do not take into account the size differences of the economies compared). Still, in 1995, the Baltic countries, together with Poland and Slovakia, constituted those countries in transition whose exports grew considerably faster than all other CEECs.

In world trade, the small Baltics are minor players -- all three together export and import less than any single country in transition in the group of CEFTA countries and Romania. As suppliers, the Baltics´ exports amounted to USD 5.8 billion in 1995, of which Lithuania accounted for USD 2.7 billion, Estonia for USD 1.8 billion and Latvia for USD 1.3 billion. As markets, they accounted for imports of USD 7.3 billion in 1995, the biggest importers being Lithuania at USD 3 billion and Estonia at USD 2.6 billion, with Latvia at USD 1.8 billion. Due to liberalization of imports, in particular in Estonia, as well as the appreciating real exchange rates linked with the efforts to stabilize their economies, imports to each Baltic country have increased more rapidly than exports throughout 1993-95.

The rapid growth of exports from Estonia has resulted in a clear increase in the share of exports in Estonian GDP -- more than 50% already in 1994. In Latvia the share has declined from about 60% in 1992 to the current 30%, and similarly in Lithuania from 60% in 1993 to about 35%. This reflects a rather typical development in economies in transition whereby nominal GDP swells as a result of inflation, while increases in the value of exports correspond more to growing real volumes of exports. Underlying all this is a setting where increases in export prices -- the prices of tradable products -- are constrained by world markets, whereas domestic prices -- especially non-tradables (eg services) - have much more room to rise when the wage and price level in general adjusts itself towards the level of wealthier neighbours. As for the Baltic countries´ GDP values, inflation, despite its gradual deceleration over the past two to three years, has still been rather high (in 1995 consumer prices rose 23% in Estonia, 29% in Latvia and 36% in Lithuania). As for the value of exports, only Estonia's export volume has grown sufficiently fast to create export-led growth in the economy.[4]

Behind these aggregate developments, however, structural shifts in the Baltic countries´ foreign trade have been far more profound. These shifts have heavily involved the Nordic countries. **In this article** we will, therefore, first highlight the reorientation of the Baltics´ trade to the West and especially to the Nordic countries and will give a brief overview of the outcome of studies utilizing a gravity model of trade for estimating the Nordic-Baltic trade potential. Second, we examine the structural developments of trade between the three Baltic countries and their largest Nordic trading partners, Finland and Sweden. These two overviews are followed by a chapter on specific factors that have contributed to the rapid growth of Nordic-Baltic trade. The article concludes with considerations on the future of the Baltics´ foreign trade.

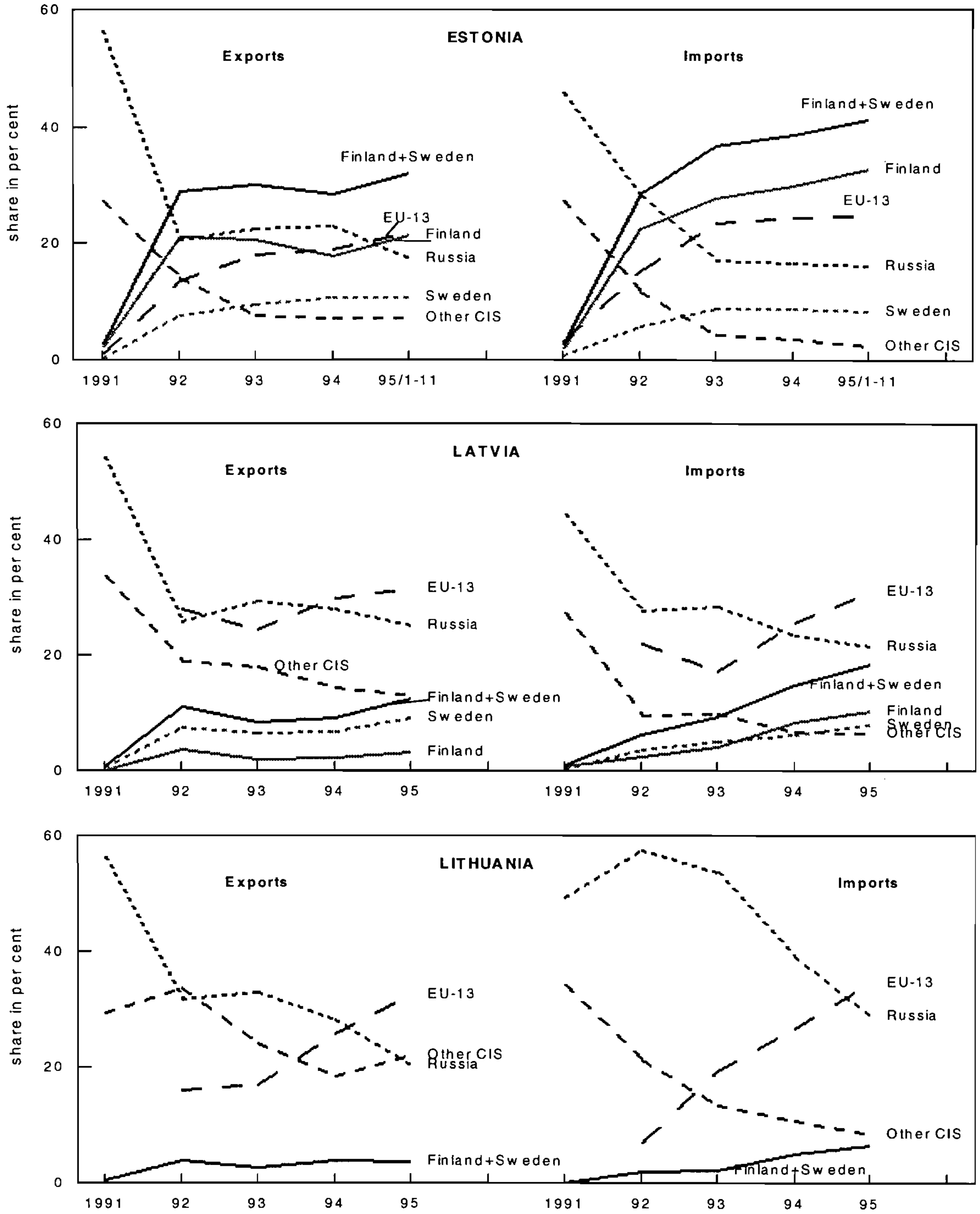
2 The role of the Nordic countries in the trade reorientation

The reorientation of foreign trade has, in general, taken place quickly in all three Baltic countries[5] (Fig. 2). **Exports to the CIS** dropped soon after the industries became delinked from the former Soviet structures in connection with dissolution of

4 Assessments based on nominal values imply an emphasis on the role of exports in income creation. In terms of volume the picture for Latvia and Lithuania during the whole period of 1992-95 would be somewhat different; but for arriving at volume developments, data in the official statistics is only available on Estonian and Latvian export prices in 1994-95. For Estonian aggregate volume estimates, see eg Luiker (1995). On the issue of exports-to-GDP ratio, see Cicinskas, Cornelius & Treigiene (1995) and Shteinbuka & Cirule (1995).

5 As the price and exchange rate distortions in the trade statistics of 1991, though having opposing effects, to some extent overestimated the share of Russia/the CIS, the decline of their share in subsequent years becomes somewhat overestimated as well. Anyhow, even in terms of volume the Baltic countries´ trade with them diminished sharply (see e.g. Anderson, Citrin & Lahiri 1995).

Figure 2 **Reorientation of the Baltic countries' foreing trade**



EU-13: EU excluding Finland and Sweden.

Source: Customs statistics of Estonia, Latvia and Lithuania.

the Union. The Baltic countries abandoned the unstable rouble zone; Estonia and Latvia in 1992 and Lithuania in 1993. As the turbulence in the new trading environment to the east of the Baltics grew, there was also a resulting increase in risk of non-collection on export payments and a growing need to rely on barter. The situation was aggravated when Russia doubled its MFN tariffs vis-à-vis imports from the Baltic countries (which in Estonia's case remained in force through 1995). However, as Estonian exports to Russia and the rest of the CIS had collapsed so drastically at an early stage, exports showed some recovery in 1993-94. Latvian and Lithuanian exports to Russia and the CIS have, in comparison, adjusted more smoothly and entered another phase of decline in 1994 which in the case of Lithuania still continued in 1995. However, developments in 1995 suggest that Lithuanian exports are re-entering the markets of neighbouring Belarus.

The decline of Russia's share in **imports** has been slower for several reasons. The prices of Russian fuel deliveries were increased to world market levels in 1992. Obviously, the Baltics efficiency in fuel consumption could not have been improved overnight. Reorientation of essential fuel imports would have required new technical facilities to replace the existing pipelines from the east. Further, declining income levels in the Baltics favoured imports of such basic commodities as fuels and food. Similar to exports, Estonian imports from the CIS and Russia, after the initial drop, have grown for the past three years. Lithuanian imports from Russia have adjusted more slowly, partly in connection to Lithuania's oil refining capacity. The share of Russia and other CIS states both in terms of exports and imports is lowest in Estonia and highest in Lithuania, though in each Baltic country official statistics may underestimate the share of the CIS during the past few years as customs records for eastern borders have tended to be softer than for the western sea borders.[6]

The Baltics' trade with **the non-CIS** world has expanded briskly due to several concurrent developments and in spite of appreciation of real exchange rates which have been nominally stable for the past two to four years. The change in the economic and trade regimes of the Baltic countries was particularly quick, e.g. exports were extensively liberalized in Estonia in 1991-92, in Latvia in 1992 and in Lithuania in 1993.[7] Baltic firms turned to the West because trade ties with the CIS were shaky and domestic demand continued to fall. Western countries were also improving the conditions of market access for Baltic products. The Baltics' trade with the OECD area grew 2.5-fold during the two years 1993-94 (in ECUs and according to the OECD member states' national statistics). Russia has consequently been replaced by new main trading partners, notably the fifteen EU countries whose share in trade has climbed to 40% in Lithuania, to 50% in Latvia and to 60% in Estonia.

Nevertheless, the trade axis with Nordic EU members and central European EU states are different for each Baltic country. In Latvia and Lithuania, the share of the twelve non-Nordic EU countries in foreign trade has increased rapidly to 30%. In contrast, the Nordic countries have been the main market for Estonian exports from early 1992 onwards, with deliveries to Finland accounting for the lion's share. For Estonian imports, the Nordic share is even larger, amounting to 45%, with Finland accounting for about a third. Nordic dominance clearly diminishes as one moves south through Latvia to Lithuania.

With regard to the size of the trade flows, trade between the Baltic countries and the OECD countries has been relatively concentrated on four Nordic countries. In 1994 they covered 30% of OECD imports from the Baltics, with Sweden accounting for 15% and Finland 8%. Germany, the Netherlands and the United Kingdom have each absorbed 15-20% of exports, partly because their ports handle crude oil shipment delivered via the Baltic countries. In OECD exports to the Baltic countries, the four Nordic countries stood for as much as 45% in 1994, with Finland at 25% and Sweden at 11%. This stems mainly from exceptionally active exports from Finland to Estonia. This connection alone constituted almost 20% of all OECD exports to the three Baltic countries in 1994. In four years Finnish exports to Estonia have

[6] It has been shown that trade statistics in the Baltic countries ignore a considerable amount of export and import activity; see Shteinbuka & Cirule (1995) and Cicinskas, Cornelius & Treigiene (1995).

[7] On the trade regimes of the Baltic countries, see e.g. Purju (1995), Shteinbuka & Cirule (1995), Cicinskas, Cornelius & Treigiene (1995) and Lainela & Sutela (1994).

climbed to an amazing level of intensity, i.e. Finnish exports per Estonian now exceed the respective figure in Finnish exports to its rather wealthy and traditionally closest trading partner, Sweden.

With the overhaul of old regimes and rising aspirations throughout the former centrally-planned economies in Europe as well as efforts in the industrialized West to properly integrate the reforming countries into world trade structures, considerable interest was aroused among politicians, officials and businessmen regarding the potential of economic relations. Economists have added their contributions to the discussion. One approach to exploring **the trade potentials** that have re-emerged with the rise of market-oriented conduct in economies in transition is offered by a gravity model of trade. Gravity models, which were first developed in the 1960s, do not seek to explain why countries trade with each other, but rather simply relate the size of the trading partners and the distance between them as determinants of trade. Of course, more sophisticated and substance-oriented models might outperform gravity models, but in the context of economies in transition which are usually constrained by the lack of reliable data, gravity models are rather useful in assessing trade flows.

During the past few years studies employing gravity models have been made in the Nordic countries and elsewhere to assess the trading potential of the CEECs and/or the Baltic countries.[8] All the studies use variables such as the size of GDP, GDP per capita and the physical distance between the capitals of the trading partners, while some add population size as well. Most of them have also included dummy variables for membership in the same preferential trading block. In some of the studies dummies for a joint border and cultural distance have been added, and exchange rate risks have also been dealt with.

Concerning CEECs in transition, gravity studies have quite unanimously suggested that a great deal of unexploited trade potential has existed in the different block-to-block and country-to-country relationships on the East-West axis.[9] In contrast, studies covering foreign trade of the Baltic countries give different results. Some studies suggest that, in both directions, Finnish-Latvian trade and Swedish-Estonian trade as well as Swedish exports to Estonia have exceeded their potential. A common outcome of all the studies concerned is that Estonian exports to Finland surpassed exceeded its potential, and at the extreme we find the claim that Finnish exports to Estonia since 1993 vastly exceeded the potential. Some studies further suggest that Finnish and Swedish trade with Estonia as well as Finnish exports to Latvia and Lithuania have already reached what should have been their potential levels 5-10 years in the future (the time points naturally depend on the assumption of the growth rate of the trading partners´ GDPs). By this token, the market shares of Finland and Sweden should therefore decline in the future.[10]

These results imply the existence of special underlying factors contributing to the current high Nordic-Baltic trade levels. Some studies indicate this when allowances are made for free trade arrangements and cultural closeness in estimating potential trade, but even so much of the high level of Nordic-Baltic trade remains unexplained.

3 The structures of Nordic-Baltic trade

Finnish and Swedish **exports** to the Baltic countries exhibit major structural similarities. Further, the composition of both countries exports to the Baltics differs considerably from the composition of total exports. In exports to the Baltics, the share of food, textiles and clothing as well as various

[8] Wang & Winters (1994), Baldwin (1993) and (1994), Sorsa (1994), Erkkilä & Widgrén (1994) and (1995), Borsos & Erkkilä (1995a) and (1995b), Kristoffersson & Wesslau (1995) and Wergeland (1995).

[9] This is the outcome even if the models use only the GDP or GDP per capita levels that prevailed at the time of the studies. Dynamic estimates that assume any economic growth, e.g. scenarios where eastern partners start catching up with the GDP levels of the western world, naturally give bigger estimates of unused trade potential.

[10] The estimates of some of the studies suggest that Estonian and Latvian trade with certain other European countries had also surpassed the potential and their share would fall over time in favour of countries that are farther away.

types of consumer goods has been exceptionally high, even if the share of textiles and, in Finnish exports, foodstuffs has somewhat decreased in the past two years (Fig. 3). Paper and paper products, on the other hand, are significantly under-represented. The composition of Finnish and Swedish exports to individual Baltic countries also show differences, e.g. the role of the textile industry in both countries´ exports to Estonia is more pronounced than in their exports to Latvia and Lithuania. Anyhow, these differences are by no means comparable to the fact that in Finnish and Swedish exports the structure is quite specific when it comes to the Baltic market.[11]

The structure of **imports** from the Baltic countries to Finland and Sweden presents a more mixed picture than exports. This is due to oil and oil products, which dominate Swedish imports from Latvia and Lithuania. Indeed, they dominate imports for the rest of the EU as well, apart from Finland. Textiles and clothing occupy a disproportionately strong position in Finnish and Swedish imports, and is strongest in the cases of imports from Estonia and Lithuania. Another Baltic-specific import item is wood and wood products whose rather high share has increased, first and foremost in Latvian exports to Finland, Sweden and the other EU countries likewise. But metal scrap, the biggest item of Estonian exports to Finland, Sweden and the EU countries in 1992, has dramatically dropped off in importance. Chemicals have gained in Lithuanian exports to both Finland and Sweden. A quite exceptional feature in the general rather low-tech pattern of the Baltic countries´ exports to the Nordic and the other EU countries is the growing share of machinery and equipment in Estonian exports to Sweden (mainly electrical machinery) and in particular to Finland (office machines and computers).

In terms of production factors embedded in the broad categories of products supplied by the Baltic countries, imports to Finland differ from those of the rest of the EU. Sweden and the other EU countries have for the most part imported resource-intensive commodities (energy, wood and ores & scrap), though their share in imports to the non-Nordic EU countries has declined. Labour-intensive products, which predominantly means clothing in this context, have during the past two to three years begun to play a more tangible role in Swedish imports. Goods which are intensive in physical capital (metals and chemicals) have been an item for sourcing mainly by the non-Nordic EU and in the case of Sweden figure only in its imports from Lithuania. In general contrast, Finnish imports from the Baltic countries have acquired a more versatile profile which is composed of more equal proportions of goods intensive in labour, human capital (machinery and equipment) and resources. This applies especially to Finnish imports from Estonia.

The structure of Nordic-Baltic trade as well as EU-Baltic trade also suggests that the role of intra-industry trade, which denotes mutual trade flows within the same industries based, eg on specialization and economies of scale, is less important in these trade relationships than in trade between developed, high-income countries. Thus, it is proportionally smaller than in the total trade of the Nordic countries and the EU. However, this is not so much the case of Finnish-Estonian trade during the past couple of years.[12]

4 Specific factors influencing Nordic-Baltic trade

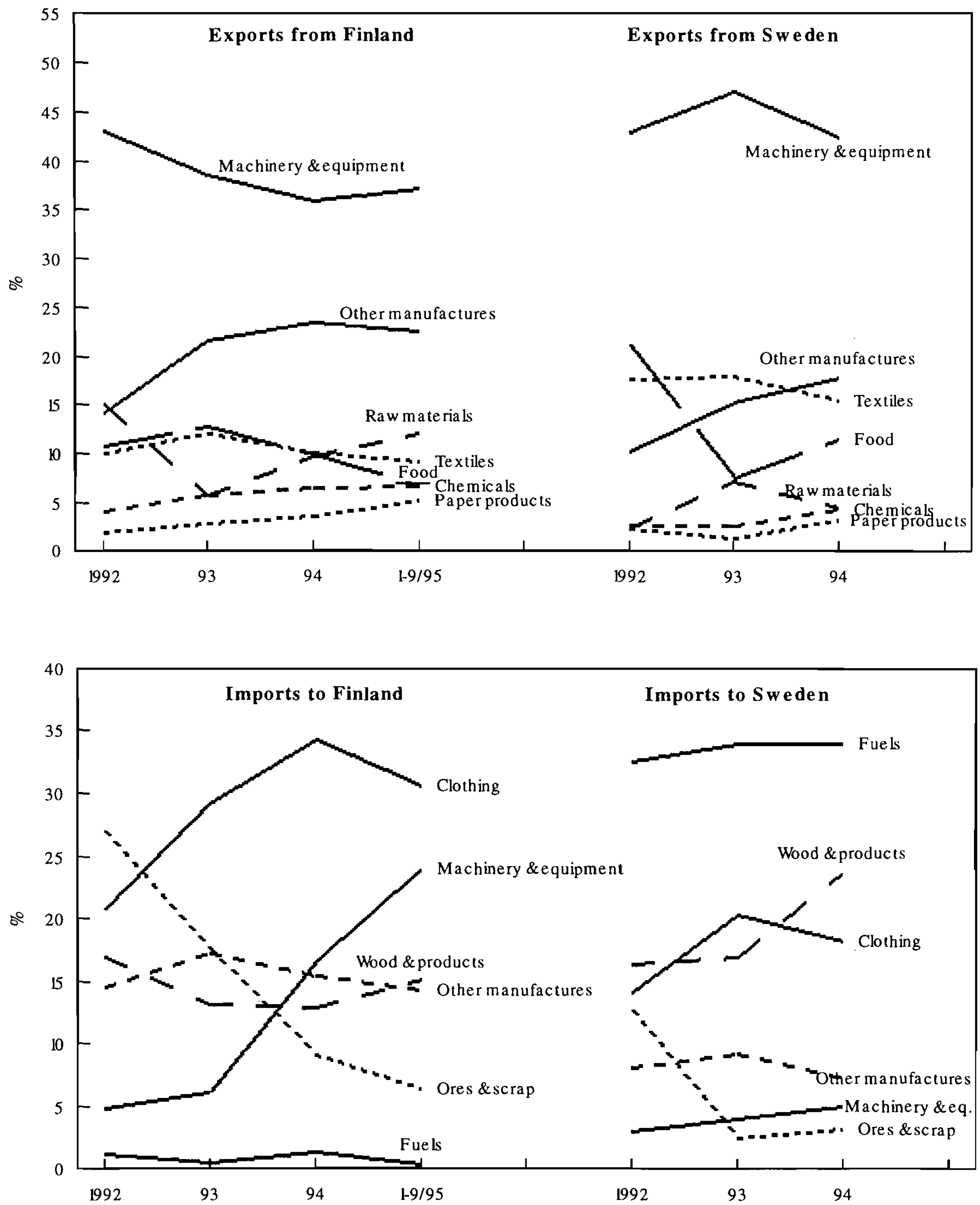
The exceptional level and structure of Nordic-Baltic trade, above all in Finnish-Estonian trade, has been influenced by a range of special factors. Some of the factors are more directly sector-related than others. Nearly all of the specific features have not been created artificially, but rather represent rational behaviour of economic operators in reaction to the business opportunities of the moment. Most features are by nature transitory; indeed some features have already lost much of their relevance and many others are likely to become less important in supporting the growth of trade.

In addition to physical proximity, Finnish-Estonian relations are characterized by other essential notions of **closeness**: i.e. similar cultures, mind sets and closely related languages (indeed the knowledge

[11] A thorough analysis on Finnish-Estonian trade (in 1992) is contained in Erkkilä & Widgrén (1994).

[12] Calculations concerning the share of intra-industry trade can be found in Eurostat (1995) with regard to the EU-Baltic trade and in Kivikari (1995) and Erkkilä & Widgrén (1994) with regard to Finnish-Estonian trade.

Figure 3 **The Structure of Nordic-Baltic trade, share in per cent**



Source: Customs statistics of Finland and Sweden of Finnish among many Estonians living in Tallinn and other parts of northern Estonia is good). Immediately after the Baltic countries regained independence, politicians in the Baltics and Scandinavia took easily to the notion of a Nordic-Baltic neighbourhood. The set-up was suitable for trade development as the change of the economic regime released pent-up demand of Baltic citizens and allowed Baltic buyers to "discover" quick sources of supply close by (actually Finnish and Swedish firms who entered the Baltic market). The push on Nordic firms of all sizes to look for new markets for both output and input was probably intensified by the fact that Sweden, and even more so Finland, were falling into recession right at the time when the Baltic markets began to open up. Meanwhile, firms in most other West European countries were more focused on the evolving markets in the CEECs.

Baltic firms may well follow a pattern experienced by Western firms, whereby they instigate international operations, no matter if they are import or export-directed, with firms in nearby countries. Later, they gradually establish ties with partners farther away as they proceed on their path of internationalization. Thus, how Nordic market shares change depends in part on how fast Baltic firms further internationalize their procurement.

In economies in transition, **competition** functions insufficiently in the early phase. Scarce market information favours exporters who are located close by and are in a position to communicate and establish their presence quickly. At first there is a complete absence of competition legislation (antitrust, monopoly etc.), and later embryonic competition authorities are still inadequate to tackle local monopolies. Foreign competitors, however, challenge local monopolies because and in small markets the situation can change rapidly, converting aspiring entrants suddenly into dominant operators. But even if the Baltics represent small markets, competition can be expected to toughen as the Baltic markets become more integrated and as interest among international firms increases.

Economic and political interest quickly resulted in **free trade** agreements (FTAs) concluded by three Nordic EFTA members, ie Finland, Sweden and Norway, with each Baltic country. All FTAs came into force or were provisionally applied by mid-1992. Though they created quite an extreme example of a network of bilateral FTAs (nine agreements), thus connecting rather spokes to spokes than spokes to hubs, their concessions were boldly liberal in the industrial sector. Trade in industrial products was free of duties, quantitative restrictions and payment restrictions from the outset. Only in a few exceptions was the maintenance of export restrictions allowed.[13] This provided an edge to Nordic exporters on the Latvian and Lithuanian markets, albeit the preferential margins have not necessarily been very high.[14] Nevertheless, the existence of the FTAs hardly explains the Nordic export performance in Estonia, as Estonia, unlike any other county in Europe, has had virtually no import tariffs nor import restrictions from the start of its reforms. The web of bilateral FTAs was substantially multilateralized when cumulation of origin between the FTAs became possible with the application in spring 1994 of an FTA between the Baltic countries. This widening of input options had no time to create any further trade advantage, since Finland and Sweden joined the EU at the start of 1995. On 1 January 1995, the EU's FTAs with the Baltics also came into force, ending virtually all FTA-based preferences enjoyed by the Baltics' other trading partners.

The economic liberalization and imperfect market structures in the Baltic economies and the neighbouring CIS states opened opportunities for **intermediation** by Baltic and Nordic firms and entrepreneurs. Three linkages arose, Baltic intermediation from East to West, from West to East, and Nordic (Finnish) intermediation from the West to the Baltics.

During this decade prices of natural resources and products considered strategically important in Russia and the other CIS counties have to a great extent remained subject to price and export controls. As customs controls on the Baltic-CIS borders have been relatively soft at the same time, the possibility to reap profits from the difference in world market prices and domestic CIS prices has existed. Thus, those having connections with

[13] Free trade agreements between Finland/Sweden and Estonia/Latvia/Lithuania.

[14] The weighted average of import tariffs in Latvia and Lithuania was about 4% in 1994, whereas the dispersion of tariffs is rather high compared to the average; see Shteinbuka & Cirule (1995), Cicinskas, Cornelius & Treigiene (1995), Lainela & Sutela (1994) and Sorsa (1994).

suppliers in the CIS have used the Baltics to channeling goods such as refined metals, metal scrap and oil products to the West.

Nevertheless, these re-exports do not seem to underpin much of the intense Finnish trade ties with the Baltics. True, in its imports from the Baltics Finland has recorded rather high shares of re-exports to Finland (20-30%) and metal scrap imports, and until early 1993 Finland under its FTAs with the Baltics in fact allowed duty-free entry for products originating in the other ex-Soviet countries as well. But the Baltics' oil exports also contributed substantially to the growth of total exports to Sweden and the EU, apparently due to re-exports.[15] As price and export controls in the CIS have been gradually removed since 1994 and CIS suppliers have more and more learned to deal directly with western users, the relative importance of the Baltic re-export bridge from East to West has started to vanish.

As noted, some Baltic traders are delivering goods imported from the West to their customers in the CIS. In the Estonian case, Russia accounted for almost 30% of all re-exports from customs warehouses in 1995, with other CIS states at about 20% and the two other Baltic countries at 15%. A quarter of all warehouse re-exports were vehicles. This eastern connection may account for some of the extra demand for imports from nearby Nordic suppliers.

The third linkage stems mostly from the technical facilities of Nordic/Finnish traders and their established business ties with suppliers in other western countries. Both features have been lacking in the Baltics. Finnish traders have intermediated by providing Estonia with products ranging from western cars to tropical fruits from their storage bases in Finland. Statistics are scarce, but those available suggest that Finnish intermediation has been important. First, Finnish customs data show that in 1993 (the most recent year available) re-exports formed nearly 30% of all Finnish exports to Estonia and close to 20% of exports to Latvia and Lithuania -- much more than in Finnish exports to any other countries. The second indication is in the Estonian central bank statistics, which instead of origin, records imports based on the exporting country. Their records indicate that imports from Finland are greater than what is contained in customs statistics. This refers to a high share of re-exports via Finland to Estonia, but naturally it does not explain the high share of Finland in Estonia's imports recorded by customs (about 30% in 1993-95) -- the central bank statistics raises the share still further, to close to 40% for each of the years 1993-95. For both Nordic and Baltic intermediation the crucial issue is how long it will take for business ties and the technical facilities in the Baltic countries to develop effective direct distribution channels.

Closeness can also encourage other types of business operations, notably those through which production or a part of the production process is transferred or set up in the partner country. Subcontracting would be simplest, but for processing or assembly in a country under economic transition the inputs would often have to be brought from outside, thus creating trade flows both ways. This is exactly what has happened with Estonia's **"outward processing traffic"** (OPT), and there are indications that this applies to Latvia and Lithuania as well, though data comparable to Estonia's is unavailable. It seems clear that OPT is a major factor in Nordic-Baltic trade. In total imports to Estonia the share of imports for processing was 15% in 1995 and exports resulting from processing amounted to 20% of all exports. In imports from Finland and Sweden the share reached one quarter in 1995, and in exports to Finland it climbed to 35% and in exports to Sweden to about 45% (1994). Finland alone accounts for half of Estonia's OPT flows and Sweden another fifth. Finnish and Swedish OPT operations focus very much on making clothing, machinery and equipment. The latter product group has increased in importance as an OPT item and in the Finnish case surpassed the role of clothing in 1995. In addition to the volume, OPT is more sustainable than intermediation. On the other hand, OPT's sustainability is very much tied to differences in labour costs.

Though **foreign direct investments** (FDI) may overlap with OPT to some extent, they consti-

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15 Trade statistics of Latvia and Lithuania do not facilitate assessments and even on the aggregate level the statistics appear rather different as to their deficiencies: According to customs statistics, re-exports in Latvia account for only 3% of all exports, in Lithuania for 35 to 40% and in Estonia (re-exports from customs warehouses) for 10%. Especially the low Latvian figure does not seem credible. Estonian statistics note that a quarter of re-exports from customs warehouses was oil products in 1995 and mention two destinations in the West, viz. the Netherlands and Germany, which accounted for almost 15% of all re-exports.

tute another mode of operation that can support trade. FDI flows to Estonia as recorded in the balance of payments during the past two to three years have been very high, about 10% of GDP.[16] Swedish and Finnish companies have made the majority of investments; most of which have been directed towards industry. The motives for FDIs vary considerably and some of the foreign-owned factories in Estonia, e.g. in the food industry, currently produce goods of local raw materials mainly for local markets. However, the sheer magnitude and the number of Finnish/Swedish FDIs in Estonia, with small markets after all, point to the effect that the FDIs have to some extent propped up the high share of Finland and Sweden in Estonian foreign trade.[17] In Latvia and Lithuania the situation is less clear: Firstly, FDI flows to them have been smaller, although to Latvia (on the balance of payments basis) they have increased during 1994-95 to around 5% of GDP; FDI flows to Lithuania stayed at about 1% of GDP in 1993-94. Secondly, in comparison to Estonia less of the investments have focused on the industrial sector. And thirdly, the Nordic share of FDIs in Latvia and Lithuania is far smaller than in Estonia.

There are **other** factors that have increased exports to the Baltic countries to a varying degree. During the earlier stages of Baltic reforms, aid had a role to play, but relative to imports to the Baltics official transfers in their balance of payments have declined and goods recorded by Estonian customs as aid currently forms a negligible part of all imports. Another issue is that in Finland subsidies for food exports used to be higher than in the EU and helped Finnish food exporters in a few countries in transition that had no mechanisms of the west European type to level the effect of the subsidies, especially in Estonia, which does not even levy import tariffs on food products or agricultural goods. As Finland joined the EU and its trade policy regime at the beginning of 1995, the levels of export subsidies have decreased. This has particularly affected the exports of basic agricultural products, and in general the growth of Finnish food exports to the Baltic countries seems to have more or less come to halt in 1995.

But export subsidies for food have not been abolished with the Finnish EU membership. Food and many other products as well, including those of Finnish origin, still cost less in Estonia than in Finland as the wage level and other costs are lower in the Estonian distribution channels. Therefore extra demand for Finnish exports to Estonia comes from the more than one million annual Finnish visitors to Estonia who buy those exports, bringing them back again and thus - even if one makes modest assumptions on the value of purchases, e.g. USD 20-25 per visitor - adding a couple per cent to the data on Finnish exports to Estonia.

5 Taking a larger view

Alongside the pressures for changes in the specific factors that have intensified trade, Nordic-Baltic trade and the Baltics´ foreign trade overall will face other challenges which are more important in the medium and long run.[18] In the Baltic countries, the indications are that the main impact of the transformation shock has passed, and that both investments and private consumption are growing. Rising income levels will gradually shift the emphasis of demand away from basic consumer items in favour of more differentiated and sophisticated products. Similar to many CEECs in transition, investment growth will enhance imports of machinery and equipment. Infrastructure investments, which are constantly alluded to and definitely needed, will apparently be phased in with a more gradual pace given the tight fiscal policies in the Baltic countries and the fact that international financing will be insufficient to create a quick boom in constructing new infrastructure.

As to the Baltics´ exports, several issues arise. Price and **wage levels** in the Baltics have been low; in part a legacy of the past, and in part due to the initial undervaluation of exchange rates. This

16 The balance of payments probably provides a lower estimate of FDIs, since it does not capture investments where equity is paid in kind.

17 Borsos (1995) notes that foreign-owned companies accounted for 10% of Estonian exports and 7% of imports in 1994 and, based on case studies, refers to the importance of bringing intermediate inputs from Finnish parent companies to the factories in the host country.

18 For similar and different views compared to the ones below, see eg Sutela (1995), Lainela & Sutela (1994), Sorsa (1994), Wergeland (1995), Borsos & Erkkilä (1995b) and Liuhto (1996).

has encouraged labour-intensive and resource-based exports, and taken together, agricultural produce, minerals, wood and textiles still account for more than 40% of exports from each Baltic country. With metals, the share exceeds one half.

The Baltics pursue stabilization policies consistently to bring inflation down, but inflation has proved to be a sticky phenomenon -- for all economies in transition. While the wage gap across the Baltic Sea is still very wide and productivity gains in the Baltics could well offset the harmful effects of wage increases on competitiveness, undisputably Baltic wage levels are rising towards western European levels. And important for cost comparisons, markets are becoming increasingly global. Therefore, the Baltic countries will have to watch wage developments in competitor countries, i.e. the CEECs, low-cost producers farther away, and gradually, what happens as the CIS states improve order in their domestic business environment.

Market globalization will be enhanced by the further lowering of trade barriers both in the Baltics´ target markets and - duty-free Estonia more apart - in the Baltics themselves, as new trade arrangements evolve. The Baltic countries as well as some CIS countries will be full members of the World Trade Organization (WTO) in a few years, implying that they will join the process of lowering trade barriers implemented under the GATT Uruguay Round Agreement e.g. in the field of textiles. The Baltics are also likely to enter into free trade relations with the CEFTA countries. The EU, the main export market for the Baltics, is in turn approaching the period when the work on free trade arrangements with Russia and some other CIS countries close to the Baltics could be started.

Whether the Baltics' **natural resources** constitute a competitive advantage is a matter of debate. Obvious resources are rather spotty (such as the oil shale reserves in Estonia and possible oil deposits in Lithuania) and hardly constitute a national competitive advantage. Further, while arable land per capita is quite abundant and the share of agriculture in work force is high, the agricultural potential is far from evident. Farms are relatively small, and as a basic notion one would have to defend the justification for export-oriented agriculture at such northern latitudes. Also, agricultural exports to western Europe face protective policies, and West European export subsidization and the agricultural potential of economies in transition further south complicate the conquest of Russian markets by Baltic producers. The basis for applying agricultural subsidies to overcome the disadvantages is meager in the Baltics, since fiscal policies continue to be a crucial element of their economic stabilization policies.

Forests cover a considerable part of Baltic land area but their attraction is not clear. Currently Baltic forest resources are exploited for exporting wood and wood products, while for more up-to-date production sizeable investments would be needed for upgrading and building factories. International competition in this field is particularly fierce with strong Nordic competitors well established and Russia's vast production potential; though one should not rule out totally the possibility that foreign firms could make some investments in Baltic forest products industries. Investments in the Baltic forest industry could imply that Nordic-Baltic trade develop into the direction of broadly resembling Finnish-Swedish trade with minor exchanges of forest products. Otherwise, imports of paper and related products from Finland and Sweden will increase in importance.

Baltic transport **gateways** between the West and Russia are currently a business area developed on the basis of existing ports and other transport infrastructure. Freight transport services have retained their position as a tangible source of foreign income for the Baltics. Still, options can complicate matters somewhat. As for a mainstream gateway, direct connections between the economic powerhouses of Europe and central parts of Russia remain a strong option, though it may not compete where sea connections close to the place of origin or destination matter much. As for sea connections and routes with St. Petersburg and northwestern Russia at the other end, much depends on Russian choices. Russia might be well-advised to take the rational way and rely extensively on the facilities and experience of the Baltics. But the possibility exists that the development of Baltic port business could be constrained by risk-alert behaviour by Russian decision makers leading to further construction of Russian ports by the Baltic Sea; once the investment costs were sunk, Russia could see it profitable to use and develop its own ports further. The comfort for the Baltics may be that Russian trade potential is large and can provide room for all optional transport links to grow considerably.

A Baltic "production gateway" is also in the cards. Many foreign-owned firms in the Baltic countries export their products both east and west, and a major motive for their establishment has been to create a springboard for exports to the markets east of the Baltics.[19] Here we see the paradox: on the one hand, the Baltic countries have benefited from the turbulence in the Russian business environment by attracting the attention of investors interested in the eastern Baltic Rim. On the other hand, the springboard effects do not materialize as long as the overall demand in Russia remains dormant. When the revival in north-western Russia does materialize, the foreign investors´ decisions to locate their factories will depend on the prospects for productivity and the safety of the Russian business environment. While this is quite critical, those seeking Baltic springboard locations will also consider whether the effect of Russian barriers on imports from the Baltics will be more manageable and tolerable than Russian taxes or whether the choice would imply a jump of production over the trade barrier into Russia.

Finally, while the Baltics generally lack more obvious competitive advantages and the prospects are thus uncertain, they do possess certain **strengths** which are essential to acknowledge. As policies catering heavily for individual sectors would be accompanied by risks, the pursuance of economic policies which aim at maintaining stable economies will gain priority, coupled with the quite self-evident need to continue to build stable institutions and regimes and to uphold them. A crucial priority and an asset is the Baltics' relatively well-educated population, since upgrading and developing their skills will contribute much needed human capital to Baltic economies and trade.

[19] Borsos & Erkkilä (1995a).

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