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FOREIGN DIRECT INVESTMENT AND TRADE FLOWS BETWEEN THE NORDIC COUNTRIES AND THE BALTIC STATES

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Abstract: The fact that not all countries in the Baltic Rim utilise their trading and FDI potential provides an incentive for strengthening the existing trade agreements and promoting new ones that increase the scope for trade and FDI. Since all of the Baltic Rim countries are open and dependent on foreign trade, it is important to create the most favourable conditions to trade. It is equally important to secure mutual market access, free from obstacles to trade and FDI, between Russia and the Nordic countries, since it is likely that their mutual trade will increase enormously in the future and partly even be redirected from the Baltic markets towards Russia. The Baltics need to co-operate and define common FDI/trade strategies in their relations with the European Union. As members of the EU, the Nordics (except Norway) are bound by the Common Commercial Policy in their trade relations with the Baltics. The fact that the Baltics specialise in their exports and imports with the Nordics in the same categories of goods and many of the Western FDI projects target the EU markets reflects well the need for common strategies. Expanding FDI raises three particular policy issues for the Baltics. Firstly, as FDI is often concentrated in large dominant companies in oligopolistic industries, the strengthening of antitrust policies is central in order to increase competition and ensure market access. Secondly, cooperation between the various Nordic and international organizations and the Baltic economies needs to be enforced operationally to further facilitate the absorption of international finance. Finally, the trade deficits should be regarded as temporary in so far as they are a consequence of capacity-increasing productive investments and should not be a cause to political concern and debate, which in turn has a negative effect on the investment climate.

Key words: FDI, trade, regional economic integration, the Nordic countries, the Baltic States, the Baltic Rim

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Tiivistelmä: Useat Itämeren alueen maat eivät toistaiseksi hyödynnä ulkomaan kaupan ja suorien sijoitusten potentiaaliaan, mikä lisää tarvetta vahvistaa olemassaolevia kauppasopimuksia sekä luoda myös uusia kauppaa ja sijoitustoimintaa lisääviä sopimuksia alueella. Koska kaikki alueen taloudet ovat avoimia ja riippuvaisia ulkomaankaupasta, kaupalle suotuisten olosuhteiden luominen on tärkeää. Yhtä lailla on esteetön markkinoille pääsy taattava tavaroille ja suorille sijoituksille pohjoismaisille ja venäläisille yrityksille, sillä kauppa maiden välillä kasvanee merkittävästi ja suuntautunee osittain pois Baltian markkinoilta Venäjän markkinoille. Baltian maiden tulisi laatia yhteisiä EU-strategioita. Baltian suhteissa Pohjoismaita (pl. Norjaa) sitoo EU-jäseninä yhteinen kauppapolitiikka. Yhteisten strategioiden tarvetta tukee se, että Baltian maat erikoistuvat Pohjoismaiden kaupassaan samoihin tuoteryhmiin ja monet investointiprojektit tähtäävät EU-markkinoille. Kasvavat suorat sijoitukset johtavat kolmeen erityiskysymykseen Baltiassa. Ensinnäkin, koska suorat sijoitukset usein kohdistuvat suuryrityksiin oligopolistisilla aloilla, on kilpailun lisäämiseksi ja markkinoille pääsyn edistämiseksi kehitettävä kartellilainsäädäntöä. Toiseksi, yhteistyötä Pohjoismaiden, kansainvälisten järjestöjen ja Baltian maiden välillä on syvennettävä entisestään käytännön tasolla kansainvälisen rahoituksen hyödyntämisen parantamiseksi. Lopuksi nykyistä kauppavajetta tulisi pitää väliaikaisena ilmiönä niin kauan kun se liittyy kapasiteettia lisääviin tuotannollisiin investointeihin, jolloin se ei saisi olla poliittisen väittelyn aihe, mikä huonontaa investointi-ilmapiiriä.

Avainsanat: Suora sijoitus, kauppa, taloudellinen integraatio, Pohjoismaat, Baltian maat, Itämeren alue

SUMMARY

The study indicates that current FDI and trade flows are relatively low between certain countries: Norway's and Denmark's FDI and trade activities with the Baltic States are modest, whereas the figures for Sweden and Finland as partners for the Baltics indicate a remarkably more important relationship. Here, geography matters in the sense that FDI and trade activities in Latvia and Lithuania have attracted particularly Swedish FDI and trade and Danish trade (Danish FDI is minimal in the Baltic region) partners out of all Nordic countries, whereas Estonia particularly attracts Finnish partners (whose presence in turn in Latvia and Lithuania is relatively modest). Generally, the relative importance of the Nordic countries both in FDI and trade flows decreases as one moves southwards in the Baltics.

The fact that not all countries in the Baltic Rim utilise their trading and FDI potential provides an incentive for strengthening the existing trade agreements and promoting new ones that increase the scope for trade and FDI. Since all of the Baltic Rim countries are open and dependent on foreign trade, it is important to create the most favourable conditions to trade. It is equally important to secure mutual market access, free from obstacles to trade and FDI, between Russia and the Nordic countries, since it is likely that their mutual trade will increase enormously in the future and partly even be redirected from the Baltic markets towards Russia. The Baltics need to co-operate and define common FDI/trade strategies in their relations with the European Union. As members of the EU, the Nordics (except Norway) are bound by the Common Commercial Policy in their trade relations with the Baltics. The fact that the Baltics specialise in their exports and imports with the Nordics in the same categories of goods and many of the Western FDI projects target the EU markets reflects well the need for common strategies.

Expanding FDI raises three particular policy issues for the Baltics. Firstly, as FDI is often concentrated in large dominant companies in oligopolistic industries, the strengthening of antitrust policies is central in order to increase competition and ensure market access. Secondly, cooperation between the various Nordic and international organizations and the Baltic economies needs to be enforced operationally to further facilitate the absorption of international finance. Finally, the trade deficits should be regarded as temporary in so far as they are a consequence of capacity-increasing productive investments and should not be a cause to political concern and debate, which in turn has a negative effect on the investment climate.

YHTEENVETO (Finnish summary)

Tutkimuksessa tarkastellaan Baltian maiden taloudellista kehitystä ja näiden asemaa Itämeren alueella. Tutkimuksessa keskitytään tähänastisiin ja nykyisiin Pohjoismaiden ja Baltian maiden välisiin suoriin sijoituksiin ja kauppavirtoihin, näiden erityispiirteisiin ja tulevaan kehitykseen alueellisesta näkökulmasta. Samalla perehdytään lyhyesti suorien sijoitusten ja kaupan institutionaalisiin näkökohtiin.

Sijoitus- ja kauppavirrat ovat suhteellisen alhaisia tiettyjen maaryhmien välillä: tilastojen valossa Norjan ja Tanskan sekä Baltian maiden väliset virrat ovat vaatimatonta luokkaa (Tanskan sijoitustoiminta on olematonta, maa käy sen sijaan kauppaa Baltian kanssa), Ruotsi ja Suomi ovat parivaljakkona puolestaan sekä kauppakumppaneina että sijoittajina huomattavasti näkyvämpiä kuin muut Pohjoismaat Baltiassa, erityisesti Virossa. Maantieteellisesti suorat sijoitus- ja kauppavirrat jakaantuvat siten, että Viroon suuntautuu enimmäkseen suomalaista toimintaa, kun taas ruotsalainen pääoma ja kaupankäynti on suuntautunut Viron lisäksi Latviaan ja jonkin verran Liettuaan. Tanskalaiset toimivat Latviassa ja Liettuassa, mutta melko vaatimattomassa määrin, kuten myös suomalaiset. Pohjoismaiden suhteellinen merkitys tai osuus kaupasta ja sijoituksista vähenee siirryttäessä Virosta eteläisimpiin Baltian maihin, Latviaan ja Liettuaan.

Baltian ja Pohjoismaiden väliselle kasvavalle kaupalle on yhä tilaa. Useat maat eivät toistaiseksi hyödynnä kaupan koko potentiaaliaan, mikä lisää tarvetta vahvistaa olemassaolevia kauppasopimuksia sekä luoda myös uusia kauppaa lisääviä sopimuksia Itämeren alueella. Koska kaikki alueen taloudet ovat avoimia ja riippuvaisia ulkomaankaupasta, kaupalle suotuisten olosuhteiden luominen on tärkeää. Yhtä lailla on esteetön markkinoille pääsy taattava tavaroille ja suorille sijoituksille sekä pohjoismaisille että venäläisille yrityksille, sillä kauppa maiden välillä kasvanee merkittävästi ja suuntautunee osittain pois Baltian markkinoilta Venäjän markkinoille. Baltian maiden tulisi laatia yhteisiä EU-strategioita. Baltian suhteissa Pohjoismaita (pl. Norjaa) sitoo EU-jäseninä yhteinen kauppapolitiikka. Yhteisten strategioiden tarvetta tukee se, että Baltian maat erikoistuvat Pohjoismaiden kaupassaan samoihin tuoteryhmiin.

Kaupan suorat ja epäsuorat esteet vaikuttavat myös suorien sijoitusten suuntautumiseen, sillä monet investointiprojektit tähtäävät EU-markkinoille. Itä-Euroopan maiden avautuminen näyttää vaikuttaneen positiivisesti Pohjoismaiden talouksiin tähän mennessä. Potentiaalisesti kasvavat suorat sijoitukset tuovat uusia kysymyksiä eteen Baltiassa. Ensinnäkin, koska suorat sijoitukset usein kohdistuvat suuryrityksiin oligopolistisilla aloilla, kuten esim. elintarviketeollisuus ja telekommunikaatio, on kilpailun lisäämiseksi ja markkinoille pääsyn edistämiseksi kehitettävä kartellilainsäädäntöä. Toiseksi, yhteistyötä Pohjoismaiden, kansainvälisten järjestöjen ja Baltian maiden välillä on syvennettävä entisestään käytännön tasolla kansainvälisen rahoituksen hyödyntämisen parantamiseksi. Lopuksi nykyistä kauppavajetta ei tulisi pelästyä, koska se on syntynyt pääomahyödykkeiden tuonnista. Siten ilmiö on väliaikainen niin kauan kun se liittyy kapasiteettia lisääviin tuotannollisiin investointeihin, jolloin ilmiö ei saisi olla poliittisen väittelyn aihe, mikä huonontaa investointi-ilmapiiriä.

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1. Introduction

1.1 Background to the Report

The present report was prepared as a supplement to the OECD study on economic regional integration through FDI and trade in the Baltic Rim. As this type of regionalization seemed to be significantly more intense within the triangle of Finland, Estonia and the region of St. Petersburg, an in-depth analysis covering this region was undertaken. The purpose of this report is only to give an overview of present FDI and trade flows between the rest of the Nordic countries (Denmark, Norway and Sweden) and the Baltic States. Thus, the report gives an overall idea of the developments between the Nordic countries and the Baltic States.

The report starts with a brief description of the current economic situation in the Baltic States, including a discussion of the main similarities between the three Baltic countries, in order to understand their position in the Baltic Rim. Chapters 2 and 3 offer a more detailed analysis of past and current FDI and trade flows and some comments on their characteristics and future prospects from the regional integration perspective. The chapters further cover a description of the institutional arrangements for FDI and trade, as they usually strongly affect these flows.

This brief overview indicates that current FDI and trade flows are relatively low between certain countries: Norway's and Denmark's FDI and trade activities with the Baltic States are modest, whereas the figures for Sweden and Finland as partners for the Baltics indicate a remarkably more important relationship. Here, geography matters in the sense that FDI and trade activities in Latvia and Lithuania have attracted particularly Swedish FDI and trade and Danish trade (Danish FDI is minimal in the Baltic region) partners out of all Nordic countries, whereas Estonia particularly attracts Finnish partners (whose presence in turn in Latvia and Lithuania is relatively modest). Generally, the relative importance of the Nordic countries both in FDI and trade flows decreases as one moves southwards in the Baltics.

The report has been produced by research fellows Julianna Borsos and Mika Erkkilä at the Research Institute of the Finnish Economy (ETLA), under the co-ordination of Research Director Kari Alho. Julianna Borsos has written the text for chapter 2 and Mika Erkkilä for chapter 3, while chapters 1 and 4 were prepared jointly by them.

1.2 Recent Developments in the Baltic States[1]

Estonia, Latvia and Lithuania restored their independence in 1991 after half a century of Soviet occupation. Since then the three Baltic nations have been facing the major task to create politically independent and stable states as well as to transform their economies into market based economies. The past four years have proven to be crucial and successful years for the Baltics, even though much remains to be done. The current politico-economic Baltic situation is two-fold: In Western Europe the three countries are considered as prospective members of the European Union and in the FSU region they have clearly outstripped all the other republics in abandoning the former system.

Even though the Baltic States differ greatly in the cultural, linguistic, religious and historical aspects, the similarities in their economic (and political) development provides the basis for a regional aspect. As already stated the three countries have performed significantly better than any other FSU country, they are in a similar position vis-à-vis the European Union and their economic regimes resemble each other on the most crucial issues (regarding, for instance, their monetary, political and foreign investment regimes). Furthermore, Estonia and Latvia are

Table 1 GDP in 1991-1995 in the Baltic States*

Country	1991	1992	1993	1994 [1]	1995 [2]
Estonia, mill. kroons					
At current prices	1832	14255	22845	33354	
At constant 1991 prices	1832	1571	1450	1508	
Change from 1991 (%)	-	-14.2	-20.9	-17.7	
Change from previous year (%)	-13.6	-14.2	-7.8	4	4-5
Latvia, mill. lats					
At current prices	143	1005	1467	1885	
At constant 1990 prices	57.3	37.9	30.4	31.2	
Change from 1990 (%)	-8.3	-39.2	-51.3	-50	
Change from previous year (%)	-8.3	-33.8	-14.9	2.5	3-4
Lithuania, mill. litas					
At current prices	423	3277	8351	12610	
At constant 1992 prices	-	3277	2502	2352	
Change from 1992 (%)	-	-	-23.6	-28.2	
Change from previous year (%)	-	-34	-23.6	-6	2-3

* Includes the shadow economy.
[1] Preliminary figures.
[2] Forecasted.
Source: Statistical Offices of the Baltic Countries, 1994.

[1] This section draws partly on Hyvärinen and Hernesniemi (1995a and 1995b). For a more detailed description of the Estonian economy, see Erkkilä and Borsos (1995).

Table 2 Structure of GDP (percentage shares)

Industry	Estonia			Latvia			Lithuania		
	1990	1993	1994	1990	1993	1994	1990	1993	1994
Manufacturing	62	27	20[1]	60	27	27[2]	54	34	35
Agriculture	17	10	11	20	15	10	25	21	23
Construction	9	7	6	7	4	6	10	7	8
Services	12	56	63	13	54	56	11	38	29
Total	100	100	100	100	100	100	100	100	100

[1] Includes electricity, gas and water supply, whose share is 3 per cent.
[2] Includes electricity, gas and water supply, whose share is 6 per cent.
Source: National Statistics 1994 and 1995.

now experiencing an economic recovery, after an initial severe fall in output, whereas Lithuania has succeeded in slowing down the fall in total production (table 1). This has been accompanied by a change in the structure of GDP (table 2). Thus the previously unusually large share of industrial activities is setting to a normal level by Western standards.

The Baltic countries have succeeded well in pushing down inflation to lower, more moderate levels (see country boxes in this chapter). The Baltic currencies, which are fully convertible, have also remained stable.

Estonia has fared best in terms of real GDP growth. GDP increased by 4 per cent in 1994 and is expected to grow by another 4 per cent in 1995. The cumulative fall in output since 1991 is 18 per cent, which is low compared to Latvia and Lithuania. The former resource-constrained economy has turned demand driven and market oriented. Prices were liberalised, so as to reflect the true production costs and the currency was made convertible, together with more restrictive public spending policies and budget surpluses. These changes led to a decline in domestic demand, at the same time as foreign trade, which was formerly oriented towards the all-Soviet Union markets, was redirected towards the West. Unemployment stood at 2.5 per cent at the end of 1994. Foreign trade has subsequently picked up well, the volume of exports

Box 1 Basic Statistics of Estonia

Population as of December 1994:	1.57 mill.
Currency:	kroon (pegged to DEM, fully convertible), 1 DEM=8 EEK
GDP/capita, PPP-corrected (1993):	5000 USD
Inflation (1994):	42 per cent
Unemployment (1994):	2.5 per cent
Real GDP growth 1993 (1994):	- 7.8 per cent (4 per cent)

increased by 60 per cent and imports grew by 82 per cent in 1994. Estonia has also been the most successful of the three Baltics in changing her structure of GDP, away from the dominant positions of manufacturing and agriculture towards an increasing share of services. The energy and food industries have managed to increase their shares of the otherwise declining manufacturing as a share of GDP. The light and forest industries have performed worst, since their shares have declined the most of industrial output. Activities and services related to transit trade, textiles and clothing, wood, energy production and the building materials industry are regarded as Estonia's future industrial strengths and as having potential to expand.

Table 3 Structure of Estonian Industrial Output (percentage shares)

Industry	1991	1992	1993	1994
Energy production	10.0	11.0	11.0	12.9
Mining	2.9	4.3	4.3	5.7
Food industry	27.0	30.9	32.7	35.7
Light industries	18.9	17.0	9.5	10.4
Forestry	9.7	9.3	5.7	7.4
Chemical industry	11.8	8.7	6.9	10.1
Building materials industry	4.6	3.9	2.7	4.3
Engineering and metal industry	11.5	9.7	6.6	4.3
Other	3.6	5.2	6.6	11.0
Total	100.0	100.0	100.0	100.0

Source: The Estonian Economy 1995.

Output in **Latvia** has decreased sharply since 1991. The collapse of the central planning system led to a decline in supply and demand in the vertically integrated production. This was coupled by the disintegration of the Soviet Union, which had previously provided the main outlet for Latvian industrial production. Real GDP declined by 34 per cent in 1992 and further by 15 per cent in 1993, but came to a halt and grew by 2.5 per cent in 1994. Changes in the composition of GDP have also taken place. The largest fall was registered in construction,

Box 2 Basic Statistics of Latvia

Population as of December 1994:	2.657 mill.
Currency:	lat (floating, fully convertible), 1 USD = 0.5 LVL
GDP/capita, PPP-corrected (1993):	5000 USD
Inflation (1994):	26 per cent
Unemployment (1994):	6.5 per cent
Real GDP growth 1993 (1994):	- 15 per cent (2.5 per cent)

which declined by over 40 per cent in 1991 and continued decreasing by 58 per cent in 1992. Services have increased steadily as a share of GDP. Exports fell by 40 per cent and imports by 67 per cent during 1990-1993. The rise in the official unemployment rate has not matched the fall in output. Unemployment reached 6.7 per cent in March 1995.

Prices were liberalised in two stages in during 1991 and 1992. Most of the consumer and producer prices were liberalised in 1991, whereas the energy and energy products prices were mostly freed in 1992. Inflation has subsequently stabilised around 30 per cent a year.

The share of manufacturing in GDP has declined rapidly from 60 per cent in 1990 to 21 per cent in 1994. Metallurgy has fared best in relative terms (a 37 per cent decline from 1990 to 1993). Construction plunged by 86 per cent, the output of the food, light and engineering industries fell by over 60 per cent and the production of the timber and chemical industries decreased by over 50 per cent in the same period. The share of services has increased to 56 per cent of GDP, at the same time as the structure of the services sector itself has changed. Transport, storage and communications account for 40 per cent of the sector, reflecting thus Latvia's status as a transit country.

Table 4 Industrial Production by Industries in Latvia in 1993

Industry	LVL Million	%
Food processing	311.3	29.6
Mechanical engineering and metal processing	238.8	22.7
Energetics	218.8	20.8
Light industry	91.5	8.7
Wood processing, furniture and paper	72.6	6.9
Chemicals	71.5	6.8
Building materials	20	1.9
Other industries	27.3	2.6
Total	1051.8	100

Source: Hyvärinen and Hernesniemi 1995a

The fall in total production has been steepest in **Lithuania**. Real GDP fell by 6 per cent in 1994 and the cumulative decline since 1992 has been 64 per cent. In 1994, aggregate output stabilised at a level less than half of that in 1991. Changes in the composition of GDP have not been as radical in Lithuania as in Estonia and Latvia. The share of manufacturing and agriculture is greater and that of services of GDP is smaller compared to the other two Baltics. Construction, textiles and other branches of the light industry, as well as foreign trade, are expected to grow as a percentage of GDP in the future. Compared to the fall in output, unemployment appears to be at a low level. Official statistics record 39 000 unemployed, but in reality the number of unemployed is estimated at around 100 000, ie. 4.8 per cent of the labour force. The discrepancy between the steep fall in output and the moderate rate of unemployment is to be found in the decrease in productivity. Given that firms have preferred reduced working time to lay-offs, large-scale unemployment has been avoided.

Consumer and services prices rose 3.5 times in 1991 following price deregulation and continued soaring tenfold in 1992. The price increases have subsequently slowed down to around 40 per cent (in 1994) and the Lithuanian currency, the Lit, was pegged in 1993 to the US dollar at an exchange rate of 1 Lit = 0.25 US dollars. Despite stabilisation measures, the Lithuanian inflation rate still exceeds that of Estonia and Latvia.

One of the main strengths of Lithuanian industrial production is expected to be food processing, owing to its strong raw material base and the large markets in the CIS countries. Viewed in connection with other manufacturing activities, such as equipment, fertiliser and biotechnology, Lithuania could very well develop an advanced food stuffs cluster like that of Denmark and the Netherlands in the long-run. Also the inexpensive labour force provides a good basis upon which a competitive clothing and mechanical wood processing industry can be built. Lithuania provides also an important cross-roads in that raw materials that are exported from the CIS countries pass through Lithuania. New capacity, related to transit trade, has already been built in oil refining, the chemical industry and energy production.

Box 3 Basic Statistics of Lithuania

Population as of December 1994:	3.737 mill.
Currency:	lit (fully convertible, pegged to USD), 1 USD = 4 LTL
GDP/capita, PPP-corrected (1993):	5000 USD
Inflation (1994):	45 per cent
Unemployment (1994):	1.7 per cent
Real GDP growth 1993 (1994):	- 24 per cent (-2 per cent)

Baltic trade is becoming more and more EU-oriented, and this will probably be the case in the future too. Trade with Russia currently suffers from discriminatory trade practices on behalf of the Russian Federation. An important factor behind the decelerating growth rate of trade between Estonia and Russia is the latter's unilateral activities aimed at Estonian exports. Such measures include e.g. high tariffs on imports, different charges imposed on transit trade and failure to grant MFN treatment to Estonian exports. The trade potential should be significantly greater in the long-run, given that economic stability between the Baltics and Russia improve significantly (see chapter 3). The change in the country composition of foreign trade has been smallest in Latvia, where the share of the CIS (Russia) in total exports is 43 (28) per cent, thus representing the most important trade partner together with Germany (11 per cent). Some 10 per cent of trade takes place among the Baltic States. On the other hand, the Baltic free trade agreements do not yet function properly.

Table 5 Baltic Foreign Trade by Region in 1994 (percentage shares)

Region	Estonia*		Latvia		Lithuania	
	Exports	Imports	Exports	Imports	Exports	Imports
EU & EFTA	52	65	28	40	31	34
CIS-countries	28	20	43	30	47	50
Other countries	20	15	30	30	22	16
Total	100	100	100	100	100	100

* 1994/I-XI;
Source: Estonian Statistics Monthly 1/1995, Latvian Foreign Trade 1993 and 1994. State Statistic Bureau, Riga 1995 and Economic and Social Development in Lithuania.

Given that the Baltics are small and open countries and consequently dependent on foreign trade, it is important to create conditions as favourable as possible to trade. The Baltics have made moves to secure their access to the most important non-EU industrial markets by concluding agreements that grant them MFN status and to world markets in general by status as observer in GATT and, finally, through negotiations aiming at membership in the WTO. They have also committed themselves to free-trade (with the exception of some products) with their most important European trade partners, first by signing free-trade agreements with the EU (which entered into force in the beginning of 1995) and then subsequently by negotiating and signing Europe agreements. Although trade with CIS countries is relatively important, relations suffer from a lack of agreements. The Baltic Free Trade Area entered into force in April 1994, creating thus a free trade zone of some 8 million consumers. It suffers, however, from poor implementation.

The bilateral free-trade agreements between the EU and the three Baltic countries resemble each other, although they are not identical. They are asymmetric in the sense that the EU, on the one hand, has committed herself to eliminate all import and export duties and quantitative restrictions in industrial products and Latvia and Lithuania, on the other hand, have been granted transition periods in sensitive products of 4 and 6 years, respectively, during which they have to gradually abolish their import and export restrictions. Estonia granted reciprocity upon entry into force. The sensitive products, i.e. textile and agricultural goods, are governed by separate rules. The EU has granted Latvia and Lithuania consolidation of the GSP regime, while Estonia benefits from zero tariffs in textile products, but the EU practises quotas on the imports of certain textile products. The bulk of the Baltic states' exports of agricultural products to the EU are subject to quota tariffs, which are 40 per cent of the normal level that the EU applies to her agricultural imports. Whenever these quotas are exceeded, the EU applies normal customs duties. The free-trade agreements cover also the approximation of legislation in areas such as anti-dumping and competition rules and technical standards.

As a sign of joint co-operation and a response to outside pressure, the Baltics formed the Baltic Free Trade Area from the beginning of 1994. It was primarily the EU which stressed the need for co-operation in the field covering trade relations, since the Baltics see themselves more as competitors than partners in world markets due to their similar economic structures. Trade among themselves accounted for some 10 per cent of their total foreign trade in 1994. The free-trade agreement stipulates duty-free imports of industrial goods. A separate agreement which would extend free-trade to agricultural products is hoped to be signed. The treaty between the three Baltic countries is important both from the point of domestic industry and potential investors, who can sell their products on these extended "home markets". Latvia and Lithuania have been granted transitional periods, during which they will have to successively reduce their customs duties, whereas Estonia granted tariff-free access to the Latvian and Lithuanian imports from the day the agreement entered into force. Practice has shown though that the implementation of the agreement leaves much to be desired, since Estonia is the only country to stick to the rules. Given that Estonia in general applies a very liberal trade regime, i.e. her external tariff is very low or non-existent as compared to Latvia and Lithuania, Estonia has in principle secured a certain minimum standard of treatment in her trade relations with the other two Baltics.

The Baltic states have also negotiated association agreements ("Europe Agreements") with the EU. These are essentially an extension of the free-trade deals, since they introduce e.g. a political dialogue at the ministerial level between the contracting parties and technical aid from the EU to the Baltics and contain stipulations relating to labour and capital flows. Latvia and Lithuania have been granted transitional periods before the provisions of the agreements take full effect.

The MFN agreement between Latvia and Russia came into force on 1 June, 1994. Latvia and Lithuania are relatively more dependent on the CIS as a foreign trade partner than Estonia is. The decline in Estonia's trade with the CIS has been caused by clearing difficulties between

Estonian and CIS companies, economic instability in Russia and the imposition of high customs duties on the part of Russia on Estonian exports.

Given the Baltic countries' geographical position, transit trade forms a big part of their foreign trade. It is thus estimated that re-exports account on average for a quarter of total exports in the Baltics.

The problems that these economies face have mainly to do with their inability to respond fully to market signals and with the difficulties encountered in the private sector. For instance, the Baltics lack a functioning financial sector and supervisory mechanisms needed in the rapidly developing private sector. Another example of the distortions that exist in the transforming economies is the inability to fully absorb the international financial assistance. Privatisation in turn seems to advance reasonably well, but is constantly subject to intensive political debates, as some of the decision-makers would advocate some degree of protectionism for local industry instead of selling national property to foreign investors. Nevertheless, political commitment to reform has been firm. From the industrial policy point of view (see Hyvärinen and Borsos 1994; and Hyvärinen and Hernesniemi 1995 for Baltic industrial policy options) the main long-run problem is to identify and select those industries which possess a competitive advantage. The short-run advantages that are now to be found in labour-intensive sectors will not be an asset indefinitely, e.g., long-run competitiveness cannot be achieved via low wage levels or large-scale trading in Russian resources. Therefore, new FDI and trade strategies should also be adopted in order to be able to face the different future economic situation.

2. Overview on Nordic FDIs in the Baltics[2]

2.1 Institutional Arrangements for FDI in Latvia and Lithuania

Since re-independence, all of the three Baltic States have worked with determination - though in a different pace, Estonia being the pioneer in her reforms - to establish the necessary legal, institutional and regulatory framework required in a market-oriented economy. This framework has mostly evolved and been constructed around FDI-related legislation, which indicates the perceived significance of FDI as a mode of acquiring additional capital, managerial and technological capacity, etc. Latvian and Lithuanian national objectives stated

[2] For the case of Estonia and St. Petersburg, see the OECD study on FDI and trade-based integration in the triangle of Finland, Estonia and St. Petersburg (Borsos and Erkkilä, 1995).

in the various governmental publications and memoranda well reflect this attitude towards foreign direct investment. The race for inward FDI in the Baltics is already now very intense and along the Western economic recovery shows no signs of decrease in Estonia and Latvia, whereas Lithuania experienced a significant decrease in her inward FDIs in 1994.

Likewise Estonia, Latvia and Lithuania have adopted rather liberal FDI policies, allowing the setting up of 100 per cent foreign-owned companies. However, some restrictions are set to foreign investors and licences are required in specific sectors (see table 6). Nevertheless, the current Lithuanian and Latvian legislative bodies do meet the requirements related to FDI set in their Europe Agreements (see appendix 1). Restrictions on foreign investor involvement or requirements to acquire licences are mainly to be found in sectors related to banking, pharmaceuticals, the defence industry, natural resources, and the like (see table 6 for details), which often are subject to licences in various West European countries as well. Lithuania seems to offer the most restrictive business environment for foreign investors. All of the three Baltic countries used to offer generous tax incentives to foreign investors, but they have been gradually eliminated, except in Lithuania.

In Lithuania, the Law on Foreign Investment along with the Law on Enterprises, the Law on Joint Stock Companies and the Law on Register of Enterprises are the main pillars of the legislative framework concerning foreign investors. Similarly, in Latvia, the Law on Foreign Investments and the Law on Entrepreneurial Activity outline the legislative rules for foreign investors. Except for the restricted business spheres, there are no other obstacles for establishing a 100 per cent foreign-owned company in the two Baltic countries and foreign investors have the right to acquire shares of indigenous firms. Furthermore, the repatriation of profits and capital transfers are not restricted.

As table 6 reveals, the various types of business entities are in practice very similar to those existing in the Nordic countries. For instance, Estonia has fully taken advantage of the Finnish system by using it as an example. The underlying difference is to be found in the existence of operation modes that are a legacy of the previous socialist regime; e.g., joint ventures, certain types of co-operative companies, and municipal/state companies (in fields which typically belong to the private sector in Nordic countries). Lithuania makes an exception in that there are only two specific forms of business entities in which foreign capital may be involved. The by far most popular form of business entity among foreign investors in the Baltics are the limited liability company and the joint stock company.

Table 6 Legal Environment for FDI in the Baltic States

Issue Area	Latvia	Lithuania	Estonia
Foreign investment laws	Law on Foreign Investment, Nov. 1991; amended in March 1993, June 1994 and March 1995.	Law on Foreign Investments, Dec. 1990; amended in February 1992. In addition, foreign investment is regulated by the Law on Spheres of Business Activity (either prohibited or limited)	Law on Foreign Investments, Sept. 1991, some amendments by Act on Implementation of the Rights in Things (Dec. 1993). Commercial Law (possibly January 1996).
Restrictions on activities	Foreign investors are allowed to have shares with voting rights less than 50% in: the defence industry; manufacturing or sales of narcotics, weapons and explosives; emission of stocks, banknotes, coins and stamps; sectors related to massmedia, national education, and natural resources. Permission can be obtained (licences) to get larger control in these sectors.	The Law on Enterprises prohibits from establishing or operating gambling houses or organising games of chance for domestic and foreign firms. Prohibited in sectors related to national defence and SOEs* that previously occupied monopolistic position in the Lithuanian market (specific licences can be acquired). Lithuanian majority required in specific sectors (e.g., transport, energy, oil and gas pipelines, communications, etc.)	No restrictions on sector. Specific licences for foreign investors required in banking, mining, energy, certain utilities, transport, retail sales of medicines and communication.
Profit & capital repatriation	No restriction on profit and capital repatriation.	No restriction on after-tax profit and capital repatriation.	No restrictions. Reporting requirements on foreign exchange abolished in May 1994.
Property ownership	Since November 1994, allowed for investors from countries which have an agreement with Latvia on the promotion and protection of investments. Uncertainty due to restitution but claims had to be filed by 1 June 1994.	Non-citizens may not own buildings and land. May lease land at fixed rent for up to 99 years, with priority right to prolong lease.	Property ownership allowed with approval for offices and business purposes. Land not yet subject to trade, but can be owned, if part of production premises. Uncertainty due to restitution.
Tax treatment & incentives	Corporate tax rate is 25%, Before 1995: If foreign ownership > 30% and > USD 50 000 exempt two years after first profit, reduced 50% reduction from profit tax the next two years. If in priority sector exempt three years, 50% reduction the next two years.Omitted in 1995	Corporate tax rate is 29%. If investment made before Dec. 1993, tax reduced by 70% for 5 years, by 50% the next 3 years and if invested in 1994-1995, by 50% for 6 years. Further reductions for priority sectors or if profits are re-invested. Exemptions pro-rated for joint ventures.	Corporate tax rate is 26%. Special tax holidays for FDI eliminated in new tax law, Jan. 1994. Does not concern FDIs made before 1994.
Participation in privatisation	No restrictions. Privatization Agency responsible for privatization procedures. FDI encouraged in priority industries (construction, light industry, etc.)	Permitted in pre-selected companies which are separately listed by the Central Privatization Commission. Employees have the right to acquire up to 50% of shares in the company being privatised.	No restrictions. Privatization Agency responsible for privatization procedures.Evaluation of "entire bid" takes employment and investment into consideration
Other	-------	Plans to establish free economic zones	------

*SOE refers to state-owned enterprise

Source: compiled by Julianna Borsos, 1995.

Table 7 Forms of Business Entities in the Baltic Countries
(where foreign capital allowed)

Latvia	Lithuania	Estonia
• Limited liability company • Joint-stock company • General limited liability partnership • General unlimited liability partnership • Representative office • And several other modes of operation	• Joint venture • Foreign capital firm • (Representative offices are not considered as foreign capital firms, and have not the status of a legal person. National treatment.)	• Limited liability company • Joint-stock company • Partnership • State and municipal company • (Co-operative companies)

In the early 1990's, the joint venture mode of operation was often preferred, due to the benefits brought by having local partners. Many of the Nordic firms that started operating in the Baltics through the joint venture mode in the early 1990's have later moved to the limited liability mode of operation and, in many cases, to 100 per cent ownership, while greenfield investments have become more and more common. Two reasons are to be found: First, partnership was difficult to manage due to differences in business practices and cultures, different goals, and high risks. Second, those firms that already established presence then are now able to run their businesses via full ownership, as experience has accumulated.

As to the increasing share of greenfield investments, the underlying cause is to be found in the lack of promising existing firms to be acquired. This tendency is particularly common in Estonia, and foreign firms in Latvia and Lithuania will probably follow the same path, as the two nations reach a more and more stable political and economic position. This tendency of increasing FDI commitment tends to be larger as the overall national politico-economic development shows more positive signs, as the legal framework improves and as firm-specific market experience accumulates and relationships are established. Western firms investing in the Baltic States (and, namely, in also other Eastern European countries) have preferred a gradual entry process starting with less risky and potentially less rewarding modes.

The Baltic countries guarantee the protection of foreign investment in companies as stipulated in their foreign investment laws. As stated previously, the only restrictions on foreign investment are to be found in certain sectors in which case licences are obtainable. In addition to the protection of FDI provided by domestic legislation, all of the three Baltic States have signed agreements securing the "promotion and reciprocal protection of investments" with most OECD countries, among them the Nordic countries. As a whole, foreign investment is encouraged and protected reasonably well in the Baltics.

As the legislative framework for FDI is rapidly evolving, there are several loopholes and a lack of information concerning new laws. However, promising improvements are going to take place, as these countries are eager to attract additional investors. For instance, the current revision of the laws is already aiming at taking EU directives and other Western guidelines into account. The recently published so-called 'white paper' on Central and Eastern Europe should further enhance the harmonisation of the Baltic legislative body with that of EU legislation.

The actual operationalization of laws is problematic, especially in accounting and auditing. Even though several amendments have been made to the laws and decrees on accountancy in an effort to move towards EU and other international standards, it will probably take a longer period of evolution before Western standards can be achieved. Furthermore, commercial codes are not yet covering all areas, such as arbitrage, and competition issues such as, for instance, dumping or public procurement are also to dealt with. Nevertheless, the results of the most crucial steps of economic and political transformation in the Baltics are highly encouraging, which also manifests in exceptionally large foreign capital inflows in relative terms.

2.2 Nordic FDIs in the Baltics[3]

One should not rely too much on Baltic statistical data, as they include several uncertainties due to the fact that different sources of information (authorities from different ministries, public and private research institutes, consulting firms, etc.) produce surprisingly different figures. Furthermore, methods and classifications vary greatly between the Baltic States. Some statistics even include announced future FDI projects, in which case the actual operationalization of the project has not taken place yet and there has not been any actual transfer of foreign capital yet. Notwithstanding these deficiencies, the data provided by the Baltic States is more informative than that provided by the Nordic countries (see the following tables).

[3] This does not include Finland; for a thorough analysis of Finland, see the OECD study on FDI and trade-based integration in the triangle of Finland, Estonia and St. Petersburg (Borsos and Erkkilä, 1995).

Obtaining any information on Nordic investments in the Baltics or, more generally, in Eastern Europe as a whole has shown to be a tricky task. Apparently, the reason partly lies in the relatively small amounts of Nordic investments in these countries, particularly in Latvia and Lithuania. As one moves southwards in the Baltics, the less there are Nordic subsidiaries. The

Table 8 Major Foreign Investor Countries in the Baltic States

Host country	Home Country	Number of companies, share (%)	Investments, share (%)
Estonia (1.1.1995)	*Sweden*	11	28
	Finland	52	22
	Russia	13	12
	USA	4	7
	Germany	4	4
Latvia (31.7.1994)	*Denmark*	n/a	31
	Russia	26	n/a
	USA	8	18
	Germany	12	9
	Sweden	7	4
Lithuania (11.4.1995)	Great Britain	3	23
	Germany	18	22
	USA	6	12
	Russia	23	7
	Poland	14	4

n/a = not available
Source: authors and national statistics

by far most accurate statistics on a Nordic country's investments in Eastern Europe are produced in Finland (see appendix 2). But even in this case, they have not been able to capture all of the investments, therefore the figures do not correspond for instance to those in Estonia (where Finnish firms are major investors). Other Nordic countries, such as Sweden and Denmark, provide very limited information as the following tables (9 and 10) indicate.

The Norwegian central bank in turn does not publish these data at all, due to the extremely small amount of FDI transactions and stocks. This measure has been undertaken in order to "preserve the anonymity of the reporting firms". However, the following main host countries for Norwegian outward FDI in Eastern Europe are: Hungary, Poland and the former Czechoslovakia. Surprisingly, the former Soviet Union and the CIS as host countries are mentioned as insignificant, even though it is generally thought that Norwegian oil and gas companies would have made significant investments, among other things, in the Barents region.

Table 9 **Danish Direct Investments Abroad** (net, DKK million)

Host Region	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**
Eastern Europe	7	-	1	17	9	19	10	59	76
All countries	2465	2699	5224	4227	5289	16025	10012	13113	9029

Source: Danmarks Statistik

Table 10 **Swedish Direct Investments in Eastern Europe** (net, SEK million)

Country	1991	1992	1993	1994¤
Estonia	*	3	113	89
Latvia	*	1	5	26
Lithuania	*	*	2	6
Russia	2	2	8	-174
Poland	38	19	105	84
Former CSFR	11	3	225	104
Hungary	52	71	156	54
Total	103	99	614	189
All countries#	37597	4516	11833	17434

¤ Up to September 1994.
Total excl. reinvested earnings.
* Too few observations.
Source: Sveriges Riksbank

2.3 FDI Characteristics in the Baltics

The ratio of operational to registered FDI projects is very low in the whole Baltic region, more so in Lithuania and Latvia than in Estonia, which is partly due to the cautious attitude of investors and partly by the political and economic instability perceived by foreign investors. Some of the registrations are also connected to illegal activities (for instance, tax avoidance in the home country, and the like), therefore these companies are merely shell companies. The share of unoperating registered firms is estimated to be some 30-50% in the three Baltic States.

As the following table and appendix 3 on the overall FDI inflows in Eastern Europe indicate, Estonia leads in the race for FDI. According to the FDI values announced in national balance of payments statistics, over 250 million USD flowed into Estonia in the form of FDI during the three first quarters of 1994, whereas the corresponding figures for Latvia and Lithuania were below 200 million USD and below 50 million USD, respectively. Lithuania experienced a remarkable decrease in her FDI inflows as compared with the previous year. This may be due to changes in statistical practices. Latvia in turn experienced the fastest growth in FDI in the Baltic region last year. Hence, the FDI stock per capita is also significantly lower in Latvia (around 60 USD) and Lithuania (around 30 USD) than in Estonia (around 314 USD). Analysing also other economic indicators, Estonia shows to be the real powerhouse of the Baltics. Manufacturing (particularly the food industries, the chemical industry and machinery manufacturing) and trade have attracted a sizeable share (50 per cent or more) of total FDI inflows and services account for another important share of FDI in the Baltics.

The growth of foreign investment in Latvia has been dramatic: from two joint ventures in 1989 to some 3800 companies with foreign capital by January 1994 and over 80 investor countries are represented in this figure. In Lithuania, there were about 3000 companies with foreign capital at the end of 1993. In all of the Baltic countries, Russian investors seem to have become major investors (see table 8, where other major investor countries are to be found). The reasons behind large amounts of Russian FDIs in the Baltic States in 1993 and 1994 are to be found in the unstable political and economic situation in Russia: Russian investors are not confident with the current domestic development in their own country. Some $30 billion of Russian capital is estimated to have been transferred abroad during the 1990-1993 period (Kahiluoto 1994), out of which only a fraction is expected to flow back into the country via legal channels. Furthermore, the clearing of large arrears (for instance on energy deliveries) to Russia may involve Russian direct investments in the form of debt-equity swaps.

As a whole, the Baltic countries have attracted direct investment inflows that are very large compared to their size and given that net inflows of foreign direct investment into the transition economies actually declined by 15 per cent in 1994. However, investment activities between the Baltic States themselves remains very modest. The economic significance of

Table 11 **Net Foreign Direct Investment Flows into the Baltics and Cumulations of Gross Inflows, 1992-1994** (million dollars)

Country	**Annual flows, (net)***			**Cumulative total**			**FDI per capita, USD****
	1992	1993	1994	1992	1993	1994	1994
Estonia	58	160	251"	58	218	468	314
Latvia	43	39	187	43	82	269	60
Lithuania	10	31	33"	10	41	74	30

* Net of inward foreign investment and investment made abroad
** As of January 1995 (*source: IMF*)
" January-September
Source: ECE 1995.

foreign companies is still negligible in the whole region, as state companies and the largest local private companies account for the majority of industrial production. Measured by employment figures, foreign companies are also insignificant employers as a whole, due to their efficiency. Foreign companies need, on the average, only 30 to 60 per cent of the amount of employees in similar Baltic companies.

Most Nordic investors primarily think in terms of overall Baltic markets, even though these three countries differ greatly by their linguistic, cultural, historical and to some degree religious backgrounds. It is their smallness that has determined the market strategies of foreign investors. However, the Baltic markets are usually not the only targeted markets, particularly in manufacturing operations where the products or components are either exported to the EU and Nordic countries and/or to the Russian Federation. Therefore, intra-firm trade has played an important role in Nordic-Baltic trade. As Russian politico-economic tensions are considered problematic and, thus, the investment climate is rather negative for FDI, the springboard position of the Baltic States is an important determinant for undertaking FDI. Subcontracting activities in the Baltics have become more and more important for Nordic firms, especially for Swedish and Finnish multinational companies, which seek to take advantage of cross-country differences in production costs and to rationalise their European (or global) operations in order to upgrade their competitiveness.

Russian investors consider the Baltics as interesting and attracting destinations for FDI for two reasons: Firstly, they are able to run their businesses in Russian (Russian minority 30% of population in Estonia, 34% in Latvia and 9% in Lithuania) and secondly, they are now experiencing a more positive economic development (than Russia) which entails significant profits with low risks (political risks). Considering the current development, Russian investors will probably find it more convenient to invest in the Russian Federation from abroad, including the Baltic States, under the status of foreign investor, due to the more beneficial taxation system for foreign companies in the Russian Federation and due to organisational, financial and other arrangements.

The attitudes towards foreign investors tends to be somewhat more reserved in Lithuania and Latvia than in Estonia, which manifests in problems encountered within privatisation schemes. However, fears of losing national property to "misusers" have much to do with the increasing amounts of Russian capital flows, which often come via third-country mediators to the Baltics. The more and more significant presence of Russian capital in the form of direct investment is generally considered as a menace to national sovereignty.

Analysing available data and company interviews, it seems that the relative share of Swedish and Finnish FDIs in the Baltics, especially in Estonia, has already reached an important level and that it would not further increase significantly. There would rather be a drop-out of investors that initially were seeking to reap the cream off, e.g., looking for rapid profits. Foreign investments are now more driven by long-term objectives and commitment. In Estonia, another reason for the lower activity is caused by the new higher state duty on the registration of new companies.

Several companies in Sweden and Finland have clearly indicated their interest in "relocating" their production units into Eastern Europe in the future, but the Baltic cost advantage can be exploited only for some years to come as economic development in the three countries shows strong signs of catching up more rapidly than expected. Therefore, the considered location sites will probably be found in the Russian area (in the Eastern part of the Baltic Rim), where the cost advantage will be present for at least the following two decades. Norwegian and Danish firms are more Visegrád-oriented and have already accumulated significant experiences in that region and from where many of these firms have penetrated the Russian/CIS markets. Thus, the Baltic countries may attract additional Norwegian and Danish FDIs in the near future, but the region is not likely to become an important host for their FDIs.

3. Trade between the Nordic Countries and the Baltics

This chapter includes a description of the trade between the two Baltic republics Latvia and Lithuania on the one hand and the four Nordic countries Finland, Denmark, Norway and Sweden on the other.

We will review the pattern and the level of trade and then go on to assess the trading potential between the Baltics and the Nordics. Eventually, we will analyse the trading potential in a catching-up scenario, where the income differential between the Nordic and Baltic countries is allowed to gradually vanish.

3.1 The Pattern and Level of Trade in the Baltic States

Estonia's total exports amounted to 16 947 mill EEK (59 per cent of GDP) and imports to 21 535 mill. EEK (71 per cent of GDP) in 1994. Estonia is thus highly dependent on her foreign trade and the demand for her exports on world markets. Estonia's foreign trade is directed towards the EU and EFTA countries. Their export share is some 50 per cent, while 65 per cent of Estonian imports origin there. Russia is still the single most important export market (23 per cent), followed by Finland (18 per cent). The ranking is reversed in Estonian overall imports. Sweden is another relatively important Nordic trade partner. Denmark and Norway do not count among the more important ones. The other two Baltic states' combined share in exports is 13 per cent and 5 per cent in imports.

Table 12 Estonian Main Foreign Trade Partners in 1994

Country	Exports		Imports	
	%	Mill. EEK	%	Mill. EEK
CIS	28	4745	20	4307
Finland	18	3050	37	7968
Sweden	11	1864	10	2154
Latvia	8	1356	2	431
Germany	7	1186	9	1938
Lithuania	5	847	3	646
Denmark	3	508	3	646
The Netherlands	3	508	4	861
The UK	3	508	2	459

Source: Venesaar and Hachey 1995.

Estonian overall exports are concentrated to labour and capital intensive industries (foodstuffs, textiles and wood and paper products), while she imports machinery and equipment, mineral products (intensive in human capital) and foodstuffs. The biggest deficits are in the trade with machinery and equipment and mineral products. Wood and paper products provide the biggest surplus.

Table 13 Estonian Exports and Imports in 1994*

Industry	Exports		Imports	
	Mill. EEK	%	Mill. EEK	%
Foodstuffs	3760.9	22.2	3451.6	16.0
Mineral products	1383.6	8.2	3034.7	14.1
Chemical products	1452.5	8.6	2473.4	11.5
Wood and paper products	1869.1	11.0	869.9	4.0
Textiles and articles thereof	2325.8	13.7	2217.4	10.3
Base metals and articles thereof	1351.3	8.0	1278.0	5.9
Machinery and equipment	1574.1	9.3	4242.9	19.7
Transport vehicles	1288.1	7.6	1850.1	8.6
Other goods	1941.9	11.5	2117.3	9.8
Total	16947.3	100.0	21535.3	100.0

* Includes reimports and reexports.
Source: Kala and Rajasalu 1995

Estonia exports much the same type of goods to the Nordic countries, i.e. timber, paper and wood products, textiles and to some extent also metals and metal products and mainly to

Finland machinery and equipment. Russia imports mainly transport vehicles and foodstuffs from Estonia. Trade with Latvia and Lithuania is concentrated around timber, paper and wood products, foodstuffs and mineral products, which Estonia also exports to Denmark in

Table 14 Estonian Exports to the Main Markets by Commodity Group in 1994 (percentage shares)*

Industry	Russia	Finland	Sweden	Denmark	Latvia	Lithuania
Foodstuffs	42.1	5.1	1.0	20.3	9.2	8.5
Mineral products	7.8	1.7	n/a	34.0	20.3	2.9
Timber, paper and wood products	n/a	13.1	31.8	25.2	19.2	11.0
Textiles	n/a	25.7	26.2	7.7	1.6	1.1
Metals and their products	n/a	13.6	13.5	n/a	4.0	4.4
Chemical products	5.0	n/a	n/a	1.0	4.1	2.3
Machinery and equipment	7.0	19.9	10.1	0.6	6.6	6.4
Transport vehicles	20.4	2.4	1.5	n/a	4.3	3.2
Other goods	17.7	18.5	15.9	11.1	4.9	4.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

* Includes reimports and reexports.
Source: Bank of Estonia Bulletin No. 2/1995 and Kala and Rajasalu 1995.

Table 15 Estonian Imports from the Main Markets by Commodity Group in 1994 (percentage shares)*

Industry	Russia	Finland	Sweden	Denmark	Latvia	Lithuania
Foodstuffs	4.9	11.5	7.1	37.5	1.7	1.5
Mineral products	54.8	6.2	n/a	4.0	1.0	8.8
Timber, paper and wood products	n/a	1.7	3.5	3.5	2.3	2.6
Textiles	n/a	10.8	20.8	7.7	2.8	2.5
Metals and their products	n/a	7.9	4.6	n/a	1.9	2.7
Chemical products	9.3	6.9	n/a	9.4	2.2	1.4
Machinery and equipment	3.8	27.1	22.1	17.5	0.7	0.9
Transport vehicles	7.5	3.6	10.9	n/a	0.9	0.4
Other goods	19.7	24.5	31.0	20.4	1.1	1.1
Total	100.0	100.0	100.0	100.0	100.0	100.0

* Includes reimports and reexports.
Source: Bank of Estonia Bulletin No. 2/1995 and Kala and Rajasalu 1995.

considerable amounts. Estonian imports from the other two Baltics states consist mainly of timber, paper and wood products, textiles, mineral products and to some extent also metal and chemical products. Thus, Estonia both exports and imports timber, paper and wood products relatively much from Latvia and Lithuania. Concerning the Nordic countries, their exports are specialised on machinery and equipment, foodstuffs (all three), textiles (Finland and Sweden) and chemical products (Denmark). More than half of Estonia's imports from Russia is made up of mineral products.

Latvia's total exports reached 553 mill. LVL (29 per cent of GDP) and total imports amounted to 695 mill. LVL (37 per cent of GDP) in 1994. Her foreign trade is oriented towards the Former Soviet Union - the CIS accounted for 43 per cent of exports and 30 per cent of imports in 1994. The two Baltic countries and Eastern Europe exported to Latvia goods equivalent to 14 per cent of Latvia's total imports (the Baltics 10 per cent and Eastern Europe 4 per cent). Their combined share of Latvia's overall exports was 12 per cent (9 and 3 per cent, respectively). Of the Western European countries Germany was the most important as her share of Latvia's exports amounted to 11 per cent and 14 per cent of imports. Holland's and Sweden's shares in Latvia's exports were 8 per cent and 6 respectively, while they accounted for 3 and 6 per cent of imports, respectively. Finland is a relatively minor trading partner. Her export share was 2 cent and her import share was 9 per cent. Denmark and Norway do not trade virtually at all with Latvia. The export and import shares of the EU were some 30 per cent (40 per cent including Finland and Sweden) and 25 per cent (40 per cent including Finland and Sweden) respectively in 1994.

Latvia's advantage in her total trade lies in goods that use much of physical capital and unskilled labour (wood, wood articles, base metals and products of base metals, vehicles and

Table 16 Latvian Main Foreign Trade Partners in 1994

Country	Exports		Imports	
	%	Mill. LVL	%	Mill. LVL
CIS	43	238	30	166
Germany	11	61	14	77
The UK	10	55	2	11
Sweden	7	39	6	33
Lithuania	6	33	6	33
Estonia	3	17	4	22
Finland	2	11	9	50
Denmark	1	6	2	11
Norway	0	n/a	0	n/a

Source: Venesaar and Hachey 1995.

transport equipment). Latvia's imports consist to a large extent of products that use relatively large amounts of human capital and small amounts of physical capital (mineral products, machinery and equipment) and goods intensive in human capital (office equipment, computers and chemical products). The biggest deficits are to be found in mineral products and machinery and equipment, whereas Latvia's trade surplus is greatest in wood and wood articles.

Transit trade plays an important role in Latvia's foreign trade, reflecting her geographical position between East and West Europe. Goods that are subject to such transit trade include mainly mineral products and base metals.

Latvia's commodity pattern of trade with respect to the EU, the EFTA countries, Estonia, Lithuania and the CIS states is such that she exports wood and wood articles together with textiles and textile articles to the EU and EFTA, i.e goods intensive in unskilled labour and physical capital, whereas the imports from these countries are mainly machinery and equipment and vehicles and transport equipment, but also chemicals and textiles to some extent.

Table 17 Latvian Exports and Imports in 1994*

Industry	Exports		Imports	
	Mill. LVL	%	Mill. LVL	%
Live animals and animal products	16.3	2.9	15.8	2.3
Vegetable products	5.5	1.0	20.4	2.9
Foodstuffs	48.6	8.8	35.6	5.1
Mineral products[1]	12.2	2.2	204.4	29.4
Chemical goods	40.7	7.4	90.7[2]	10.2
Raw hides, leather and goods thereof	10.0	1.8	-	-
Wood and wood articles	112.6	20.3	20.6[3]	3.0
Textiles and textile products	73.3	13.2	40.9	5.9
Footwear, headgear	9.7	1.8	-	-
Base metals and articles thereof	56.0	10.1	34.6	5.0
Machinery and equipment[4]	51.2	9.3	111.8	16.1
Vehicles and transport equipment	55.2	10.0	46.5	6.7
Other goods	62.1	11.2	73.3	10.5
Total	553.4	100.0	694.6	100.0

* Includes reimports and reexports
[1] Includes fuels and oil
[2] Includes plastics and plastic products
[3] Pulp and paper
[4] Includes office equipment and computers
Source: Latvian Foreign Trade 1993 and 1994. State Statistic Bureau

Table 18 Latvian Exports to the Main Trading Partners by Commodity Group in 1994 (percentage shares)

Industry	EU(12)	EFTA(6)	Estonia	Lithuania	CIS
Live animals, animal goods and vegetable products	2.5	2.3	12.1	1.7	5.6
Foodstuffs	1.2	0.7	12.8	6.0	17.1
Mineral products	3.4	1.1	5.7	5.0	1.6
Chemical products	2.9	0.5	15.6	14.0	11.0
Plastic articles	1.8	0.1	1.4	1.3	0.5
Raw hides, leather and articles thereof	2.5	1.4	2.1	8.3	0.8
Wood and wood articles[1]	43.1	53.3	7.1	8.0	1.9
Textiles and textile products	15.0	9.4	12.1	20.9	13.3
Footwear, headgear	1.6	-	2.1	2.0	2.7
Stone and ceramics	1.8	0.3	2.1	1.3	1.4
Base metals and articles thereof	7.7	26.0	7.1	6.6	3.0
Machinery and equipment[2]	4.1	1.6	9.9	11.0	16.0
Vehicles and transport equipment	0.9	1.0	7.1	10.3	19.8
Other goods	11.8	2.4	2.8	3.7	5.4
Total	100.0	100.0	100.0	100.0	100.0

[1] Pulp and paper
[2] Includes office equipment and computers
Source: Monthly Bulletin of Latvian Statistics 1/1995

Trade with Estonia and Lithuania differs from that of the EU and EFTA, in that it is concentrated on agricultural products, food, mineral and chemical products, but also on textiles. Latvian exports are composed of textiles, food and agricultural goods, whereas she imports mineral and chemical products. Latvia imports mainly the same goods from the CIS countries as well, but exports food, textiles and machinery and equipment. Agricultural products and food production typically combine some amounts of human capital with relatively minor requirements of physical capital, while chemical goods are human capital intensive.

Lithuania's overall exports amounted to 8146 mill. litas and imports to 9236 mill. litas in 1994, of which re-exports constituted some 35 per cent, whereas re-imports were virtually non-existent (some 1 per cent). Lithuania's foreign trade, like that of Latvia, is oriented towards the former Soviet Union, since 53 per cent of exports (28 per cent to Russia, 12 per cent to the Baltics, 6 per cent to the Ukraine and 7 per cent to Belarus) and imports (39 per cent from Russia, 5 per cent from the Baltics, 5 per cent from the Ukraine and 4 per cent from Belarus) are conducted with the FSU. Germany's share is 12 per cent of exports and 14 per cent of Lithuania's imports. The Nordics - Finland, Sweden, Norway and Denmark - do not

Table 19 Latvian Imports from the Main Trading Partners by Commodity Group in 1994 (percentage shares)

Industry	EU(12)	EFTA(6)	Estonia	Lithuania	CIS
Live animals, animal goods and vegetable products	3.0	2.4	3.0	10.5	0.8
Foodstuffs	8.5	3.3	6.4	1.0	1.2
Mineral products	2.2	9.6	43.6	56.4	50.7
Chemical products	10.7	7.1	12.3	11.2	12.4
Plastic articles	3.5	4.9	5.1	1.5	2.3
Raw hides, leather and articles thereof	0.7	0.3	0.4	0.5	0.3
Wood and wood articles[1]	3.1	8.7	4.2	4.3	2.4
Textiles and textile products	10.4	10.8	4.2	2.8	3.1
Footwear, headgear	1.8	1.4	0.4	0.5	0.1
Stone and ceramics	1.6	2.3	2.5	1.5	1.3
Base metals and articles thereof	4.3	4.5	5.5	2.6	8.9
Machinery and equipment[2]	25.2	26.7	6.8	4.1	8.7
Vehicles and transport equipment	9.4	10.1	1.3	0.5	6.1
Other goods	15.6	7.8	4.2	2.6	1.7
Total	100.0	100.0	100.0	100.0	100.0

[1] Pulp and paper
[2] Includes office equipment and computers
Source: Monthly Bulletin of Latvian Statistics 1/1995

count among Lithuania's major trading partners. They are more important to Latvia than to Lithuania in relative terms. Lithuania is both a big exporter and importer of mineral products, the trade balance being in deficit though by some 1700 mill. litas. Lithuania is an exporter of goods intensive in unskilled labour, i.e. textiles and textile products, goods that use relatively large amounts of human capital and small amounts of physical capital (machinery and equipment) and goods with low capital intensity combined with modest amounts of human capital (food products, fats). In contrast to Latvia, Lithuania is a big exporter and importer of both mineral products and machinery and equipment. The mineral product imports origin in the CIS countries (2916 mill. litas), which also constitute the biggest export markets (637 mill. litas) together with Latvia (358 mill. litas). The big bulk of the gross trade in mineral products is thus conducted with the CIS. The same does not, however, apply with respect to machinery and equipment, in which category the CIS provide the biggest export market (719 mill. litas) and the EU is the single biggest exporter to Lithuania (766 mill. litas), the share of the CIS states being some 20 per cent (311 mill. litas). Identical to the Latvian case, Lithuania is also a big net importer of mineral products and machinery and equipment. Lithuania's trade surplus is greatest in animals and animal fats and food products.

Table 20 Lithuanian Main Foreign Trade Partners in 1994

Country	Exports		Imports	
	%	Mill. LTL	%	Mill. LTL
CIS	47	3829	50	4618
Germany	12	978	14	1293
Latvia	9	733	3	277
The Netherlands	5	407	3	277
Sweden	3	244	2	185
Estonia	3	244	2	185
Denmark	2	163	3	277
Finland	1	81	3	277
Norway	1	81	1	92

Source: Economic and Social Development in Lithuania, Department of Statistics to the Government of the Republic of Lithuania. Vilnius 1995

Lithuania's position in the division of labour among her main trading partners is such that the EFTA and EU countries specialise in the exports of machinery and equipment, together with textiles and textile products (the EU) and food products (EFTA) to Lithuania. Lithuania imports then chemical products and machinery from the other two Baltics, but also food (from Estonia) and mineral products and textiles (from Latvia). The CIS countries' exports consist to two thirds of mineral products.

Table 21 Lithuanian Exports and Imports in 1994*

Industry	Exports		Imports	
	Mill. LTL	%	Mill. LTL	%
Animals and animal fats	954.1	11.7	205.3	2.2
Vegetable products	237.7	2.9	328.9	3.6
Food products	959.4	11.8	404.0	4.4
Mineral products[1]	1345.0	16.5	3058.6	33.1
Chemicals	860.7	10.6	827.0	9.0
Plastics, skins and leather	236.3	2.9	338.6	3.7
Wood, wood articles, pulp and paper	423.9	5.2	265.5	2.9
Textiles and textile products	995.7	12.2	689.1	7.5
Footwear, headgear	85.4	1.0	46.5	0.5
Base metals and articles thereof	498.9	6.1	605.2	6.6
Machinery and equipment	963.6	11.8	1546.0	16.7
Vehicles and transport equipment	296.4	3.6	561.7	6.1
Other goods	289.2	3.6	359.3	3.9
Total	8146.3	100.0	9235.7	100.0

* Includes reimports and reexports
[1] Includes fuels and oil
Source: Economic and Social Development in Lithuania

Table 22 Lithuanian Exports to the Main Trading Partners by Commodity Group in 1994 (percentage shares)

Industry	EU(12)	EFTA(6)	Estonia	Latvia	CIS
Live animals, animal goods and vegetable products	17.2	3.5	6.4	9.2	10.3
Foodstuffs	1.6	1.2	6.5	3.9	23.0
Mineral products	7.0	10.2	35.4	52.7	16.9
Chemical products	18.8	10.0	11.0	14.9	4.6
Plastic articles	2.1	2.2	2.6	1.2	1.3
Raw hides, leather and articles thereof	2.9	1.1	0.4	0.3	1.0
Wood and wood articles[1]	8.9	17.0	4.5	2.9	2.9
Textiles and textile products	19.3	28.8	10.0	3.1	7.8
Footwear, headgear	1.0	0.5	0.7	0.3	1.5
Stone and ceramics	0.4	0.3	1.9	1.1	1.5
Base metals and articles thereof	10.0	20.0	5.3	2.9	1.3
Machinery and equipment[2]	4.6	1.7	8.7	4.7	19.1
Vehicles and transport equipment	3.0	0.8	4.0	1.2	4.3
Other goods	3.2	2.5	2.4	1.6	4.7
Total	100.0	100.0	100.0	100.0	100.0

[1] Includes pulp and paper
[2] Includes office equipment and computers
Source: Economic and Social Development in Lithuania

Lithuanian exports to the Baltics and the CIS resemble those of Latvia, i.e. mineral and chemical products to Estonia and Latvia and food, mineral products and machinery and equipment to the CIS. This confirms the fact that the Baltic countries production structures resemble each other and that they trade to a great extent in the same category of goods with each other and the CIS. Lithuanian exports to the EU and EFTA is better diversified than that of Latvia, since the former exports also, in addition to textiles, wood and base metals, agricultural and chemical products.

Table 23 Lithuanian Imports from the Main Trading Partners by Commodity Group in 1994 (percentage shares)

Industry	EU(12)	EFTA(6)	Estonia	Latvia	CIS
Live animals, animal goods and vegetable products	8.9	7.1	5.4	2.0	1.9
Foodstuffs	6.3	12.1	11.6	2.5	1.0
Mineral products	0.6	2.7	5.0	37.2	62.5
Chemical products	8.5	6.5	23.0	12.0	6.7
Plastic articles	5.0	3.1	6.0	1.1	2.0
Raw hides, leather and articles thereof	0.6	0.6	0.5	0.7	0.6
Wood and wood articles[1]	3.3	7.1	3.7	5.8	1.6
Textiles and textile products	13.4	8.0	9.1	12.9	4.4
Footwear, headgear	1.0	0.4	1.0	1.1	0.1
Stone and ceramics	1.2	2.4	2.8	1.4	0.1
Base metals and articles thereof	4.2	4.7	8.4	3.4	8.8
Machinery and equipment[2]	31.0	25.2	12.3	12.2	6.7
Vehicles and transport equipment	9.8	9.5	4.4	4.7	3.0
Other goods	6.2	10.6	6.6	3.1	0.6
Total	100.0	100.0	100.0	100.0	100.0

[1] Includes pulp and paper.
[2] Includes office equipment and computers.
Source: Economic and Social Development in Lithuania

3.2 The Trading Potential

In this section we present some calculations of the trading potential between the Nordics Finland, Sweden, Denmark and Norway on one hand and the Baltic countries Latvia and Lithuania and St. Petersburg and the Leningrad region on the other.

The calculations are based on the use of a so-called gravity model with distance, the GDP/capita income levels and the GDP levels of the trading partners as explanatory variables for the trade flows. A dummy variable was also included to take account of adjacency of the trade partners. The resulting estimates of the trading potentials are inversely related to distance and positive functions of the other variables. For a more thorough description of the gravity model and its estimation, see appendix 4.

Table 24 gives the potential between Finland, the Baltics, St. Petersburg and Russia. Finland's actual exports to Latvia and Lithuania have grown very rapidly during the past years, i.e. they increased fourfold to Latvia and 2.5 times to Lithuania from 1993 to 1994.

Table 24 The Actual Trade and the Trading Potential between Finland and Latvia and Lithuania in 1994, mill. USD

Exporter	Importer	The Potential Trade	The Actual Trade
Finland	St. Petersburg & Leningrad	348	105[1]
Finland	Estonia	176	650
Finland	Latvia	142	160
Finland	Lithuania	96	82
Finland	Russia	2269	1152
St. Petersburg & Leningrad	Finland	305	258[1]
Estonia	Finland	169	217
Latvia	Finland	128	24
Lithuania	Finland	79	25
Russia	Finland	1707	1391

[1] The actual trade data refer to 1993.

As we saw in section 3.1, Finland does not count among the most important of either Latvia's or Lithuania's trade partners. Finland exported goods worth 160 mill. USD to Latvia and imported goods worth 24 mill. USD in 1994. Lithuania exported goods to Finland for 25 mill. USD and imported goods worth 82 mill. USD in 1993. Much as in the Estonian case, the three largest trading partners of Latvia constitute over 50 per cent of her exports and imports. Lithuanian exports are relatively well diversified, while three fourths of her imports origin solely in Russia. Finnish companies concentrate clearly their efforts on the Estonian markets of the three Baltic states.

Table 25 gives the equivalent figures for Sweden and the Baltics and St. Petersburg.

Much the same applies to Sweden as to Finland. The trading potential with Estonia goes below the actual level, which is a sign of the explosive growth of trade. Sweden is Estonia's third largest trading partner after Russia and Finland.

Especially as regards St. Petersburg and Leningrad, Sweden has much unutilised potential. The export potential exceeds the actual value seventeenfold and the imports fifteenfold. It appears though that Sweden has been able to use the capacity better with respect to Latvian markets as the ratio between the potential and the actual trade reveals.

Table 26 gives the corresponding values for the trade between Denmark and the Baltic republics and St. Petersburg and the Leningrad region.

Table 25 The Actual Trade and the Trading Potential between Sweden and the Baltics and St. Petersburg and the Leningrad Region in 1994, mill. USD

Exporter	Importer	The Potential Trade	The Actual Trade
Sweden	St. Petersburg & Leningrad	348	21
Sweden	Estonia	85	159
St. Petersburg & Leningrad	Sweden	311	21
Estonia	Sweden	83	152
Sweden	Russia	3642	459
Russia	Sweden	2791	742
Sweden	Latvia	130	80
Sweden	Lithuania	139	56
Latvia	Sweden	120	70
Lithuania	Sweden	117	63

Compared to Finland and Sweden, Denmark is even less important as a trading partner for the Baltics. St. Petersburg constitutes a large potential trading partner to Denmark. Latvia offers the greatest potential export market of the three Baltics and vice versa. Denmark has been able to exploit the opportunities better in her trade with Estonia and Lithuania.

Table 26 The Actual Trade and the Trading Potential between Denmark and the Baltics and St. Petersburg and the Leningrad Region in 1994, mill. USD *

Exporter	Importer	The Potential Trade	The Actual Trade
Denmark	St. Petersburg & Leningrad	173	7
Denmark	Estonia	54	47
St. Petersburg & Leningrad	Denmark	148	5
Estonia	Denmark	50	48
Denmark	Russia	3142	277
Russia	Denmark	2300	356
Denmark	Latvia	68	29
Denmark	Lithuania	54	61
Latvia	Denmark	60	10
Lithuania	Denmark	44	35

* The data on Russia refer to 1993.

Table 27 The Actual Trade and the Trading Potential between Norway and the Baltics and St. Petersburg and the Leningrad Region in 1994, mill. USD *

Exporter	Importer	The Potential Trade	The Actual Trade
Norway	St. Petersburg & Leningrad	127	4
Norway	Estonia	41	5
St. Petersburg & Leningrad	Norway	108	2
Estonia	Norway	38	17
Norway	Russia	1975	96
Russia	Norway	1434	345
Norway	Latvia	50	1[1]
Norway	Lithuania	38	23
Latvia	Norway	43	1[1]
Lithuania	Norway	31	20

* The data on Russia refer to 1993.
[1] Refers to 1993.

Norway stands out as the country with the smallest overall level of trade in all categories. Consequently, the potential in relation to the actual level of trade is also great. Denmark and Norway trade considerably less with the countries in question compared to Finland and Sweden.

Of the four Nordics is Finland the most important partner to Estonia both in terms of actual and potential trade. Sweden comes second. Denmark and Norway follow suit in that order. Sweden is of relatively big importance to Latvia measured both as potential and *de facto* exports. Latvia's export potential to Sweden is 120 mill. USD, while it is 60 mill. USD to Denmark, 128 mill. USD to Finland and 43 mill. USD to Norway. Latvia's actual exports to Sweden amounted to 70 mill. USD, 24 mill. USD to Finland, 10 mill. USD to Denmark and 3 mill. USD to Norway.

Lithuania's position does not much differ from that of Latvia in that Sweden is also the most important trading partner to her. Lithuania exported goods to Sweden worth 63 mill. USD in 1994. The corresponding numbers for Denmark and Finland are 35 mill. and 25 mill. USD respectively and for Norway 3 mill. USD. In terms of imports, Lithuania's imports from Finland reached 82 mill. USD, 56 mill. USD from Sweden, 61 mill. USD from Denmark and 3 mill. USD from Norway. The trading potential is though biggest with Sweden, followed by Finland, Denmark and Norway.

If one wants to rank the countries in terms of actual trade, Finland trades most with Estonia and Sweden is the biggest export market for the other two Baltic states, but for them, in turn, Finland is the biggest supplier of imports. In terms of potential trade is Finland the most important partner for Estonia, Finland and Sweden are practically as important for Latvia whereas Sweden is the biggest trading partner for Lithuania.

Finally we turn to the trading potential among the Baltic countries themselves. This is reproduced in table 28. In the light of the gravity model, the Baltics trade, in fact, intensively with each other.

Table 28 The Actual Trade and the Trading Potential between the Baltics in 1994, mill. USD

Exporter	Importer	The Potential Trade	The Actual Trade
Estonia	Latvia	39	116
Estonia	Lithuania	26	76
Latvia	Estonia	36	26
Latvia	Lithuania	35	55
Lithuania	Estonia	22	51
Lithuania	Latvia	32	170

3.3 Catching-up

This section contains a brief analysis of the trading potentials when the income levels in the respective countries are allowed to grow. The analysis in section 3.2 assumed given income levels. We shall postulate a scenario in which the GDP/capita incomes grow on average at 2.5 per cent annually in the four Nordic countries and the GDP/capita grows on average at 5 per cent in the Baltic countries. The time periods chosen are 5, 10 and 20 years hence. All figures are in 1994 prices.

Table 29 tells us the *de facto* value of trade and the potentials after 5, 10 and 20 years in Finland's trade with Estonia, Latvia, Lithuania, St. Petersburg and Russia.

Compared to Finnish trade with Estonia, one notes the much bigger potential in relation to actual trade with Latvia and Lithuania. The St. Petersburg area offers though the biggest potential for Finnish companies and exporters and the figures indicate that St. Petersburg with surroundings will become more important as Finnish trading partner than Estonia, although the roles are reversed for the moment being. Finnish imports will also shift more towards the

Table 29 The Trading Potential in 5, 10 and 20 years' time, mill. USD in 1994 prices

Exporter	Importer	The Actual Trade in 1994	The Potential in 5 years' time	The Potential in 10 years' time	The Potential in 20 years' time
Finland	St. Petersburg & Leningrad	105[1]	504	731	1535
Finland	Estonia	650	247	358	752
Finland	Latvia	160	88	128	269
Finland	Lithuania	82	61	88	185
Finland	Russia	1152	3289	4768	10017
St. Petersburg & Leningrad	Finland	258[1]	449	660	1428
Estonia	Finland	217	240	354	765
Latvia	Finland	24	81	119	257
Lithuania	Finland	25	51	75	162
Russia	Finland	1391	2511	3693	7987

[1] The actual trade data refer to 1993.

St. Petersburg area in the future at the expense of Estonian exporters. Latvia and Lithuania will remain minor trading partners.

Table 30 gives us the actual and potential for Swedish companies in their trade with the Baltic Rim. As in the case with Finland, Swedish trade with Estonia also exceeds its potential now and the potential 5 years due. Sweden is also an important trading partner to Estonia (third in terms of exports after Finland and Russia). There is ample scope for trade especially with Russia both in absolute and relative terms. Sweden trades also intensively with Estonia, while the potentials in the long run would indicate a shift towards St. Petersburg and Russia as a whole.

Table 30 The Trading Potential in 5, 10 and 20 years' time, mill. USD in 1994 prices

Exporter	Importer	The Actual Trade in 1994	The Potential in 5 years' time	The Potential in 10 years' time	The Potential in 20 years' time
Sweden	St. Petersburg & Leningrad	21	303	439	923
Sweden	Estonia	159	126	176	370
St. Petersburg & Leningrad	Sweden	21	275	405	875
Estonia	Sweden	152	121	177	384
Sweden	Russia	459	3976	5503	11561
Russia	Sweden	742	2952	4341	9389
Sweden	Latvia	80	156	227	476
Sweden	Lithuania	56	108	156	328
Latvia	Sweden	70	146	215	464
Lithuania	Sweden	63	92	136	293

As seen from table 31, Denmark has lots of unutilised capacity in her trade with Russia, the St. Petersburg area and Latvia. The potential with Russia is greatest in absolute terms, but measured in relative terms, Denmark has more unutilised capacity in her trade with St. Petersburg with surroundings. Denmark depends also most on Estonia and Lithuania now, but a shift towards St. Petersburg and Russia is to be expected in the long run.

Table 31 The Trading Potential in 5, 10 and 20 years' time, mill. USD in 1994 prices

Exporter	Importer	The Actual Trade in 1994	The Potential in 5 years' time	The Potential in 10 years' time	The Potential in 20 years' time
Denmark	St. Petersburg & Leningrad	7	210	304	639
Denmark	Estonia	47	80	116	245
St. Petersburg & Leningrad	Denmark	5	182	268	579
Estonia	Denmark	48	76	112	242
Denmark	Russia	277	2737	3967	8334
Russia	Denmark	356	2034	2990	6467
Denmark	Latvia	29	100	145	305
Denmark	Lithuania	61	79	115	242
Latvia	Denmark	10	89	131	284
Lithuania	Denmark	35	65	95	206

Norway stands out as the country with the smallest overall level of trade in all categories. She trades more with Estonia and Russia in relation to the potential than with the other countries.

Table 32 The Trading Potential in 5, 10 and 20 years' time, mill. USD in 1994 prices

Exporter	Importer	The Actual Trade in 1994	The Potential in 5 years' time	The Potential in 10 years' time	The Potential in 20 years' time
Norway	St. Petersburg & Leningrad	4	164	238	501
Norway	Estonia	5	71	102	215
St. Petersburg & Leningrad	Norway	2	141	208	450
Estonia	Norway	17	66	98	211
Norway	Russia	96	2183	3164	6647
Russia	Norway	345	1608	2364	5113
Norway	Latvia	1[1]	83	120	252
Norway	Lithuania	23	63	91	192
Latvia	Norway	1[1]	73	108	233
Lithuania	Norway	20	51	75	163

[1] Refers to 1993.

Grouping the three Baltic states, Estonia has most potential to trade with Finland. Finland has been quite successful in exploiting this potential, while one could argue that Estonian exporters have not been as successful on the Finnish markets. Sweden seems to be the "natural" trading partner for both Latvia and Lithuania. The role of Denmark and Norway is relatively minor, although their potential with respect to Russia is enormous. The same, though, applies both to Finland and Sweden. Based on these scenarios, one would envisage a future trading pattern where Estonia is relatively directed towards Finland and vice versa (not to forget St. Petersburg and the Leningrad region). Sweden and companies located in Sweden focus in this scenario more on Latvia and Lithuania. While Sweden trades relatively much with Estonia now in comparison to Latvia and Lithuania, the attention of Swedish companies would shift more to the Latvian and Lithuanian markets in not too a distant future. Estonia will also in the future offer Finnish companies a more promising market (in absolute figures, but not in relative terms if comparing the potential to the actual trade) than Latvia and Lithuania. Estonia is also more important to Denmark as a trading partner today, than it will be in the medium- to long-term according to the estimated potentials. Latvia and Lithuania will emerge and eventually pass Estonia in importance. No significant shifts are to be expected with respect to Norway, but today's situation will by and large prevail.

4. Conclusions

As the preceding analysis has shown, there exists still scope for increasing trade between the Baltic and the Nordic countries. The fact that not all countries utilise their trading potential provides an incentive for strengthening the existing web of trade agreements and actively promoting new ones that increase the scope for trade in the area. Since all countries in the Baltic Rim are open and dependent on foreign trade, it is important to create conditions as favourable as possible to trade. The Baltics have committed themselves to free-trade with the EU and Norway, first by concluding free-trade agreements and subsequently by negotiating Association or Europe agreements with the EU. Although trade with CIS countries is relatively important, especially so for Lithuania, these relations suffer from a lack of agreements. The Baltics have also formed a free-trade area among themselves, with limited success, however, so far, since it is only partly applied in practice. It is equally important to secure mutual market access, free from obstacles to the exchange of goods and FDI flows, between Russia and the Nordic countries, since it is likely that their mutual trade will increase enormously in the future and partly even be redirected from the Baltic markets towards Russia according to the catching-up scenario in which the income levels are allowed to converge.

The existing trade patterns are such that the Nordics export mainly machinery and equipment, but also textiles, foodstuffs and chemical products to some extent. The Baltics export timber and wood products, textile products and metals to the Nordics. The intra-Baltic trade pattern is such that they trade with each other in wood and wood products, mineral products and to some extent also in food and agricultural goods and chemical products, i.e. they both export and import these goods among each other. The CIS countries import mainly machinery and equipment, foodstuffs and to some extent also mineral and textile products. The Baltics' imports from the CIS are concentrated around minerals and mineral products. The Baltics are thus specialised in their trade with the Nordics in raw materials, semi-manufactures and goods with a low value-added, while they import high-tech and high-value added products from them. The CIS exports raw materials (minerals) and mineral products to the Baltics and import mainly machinery and equipment.

The Baltics possess a potential, measured by years of schooling, which are among the longest in the developing world, to develop skill-intensive manufacturing industries. This in itself already provides incentives to develop and diversify their production and export structures. One way of doing this is to secure tariff free access to their main export markets, not only as a means of increasing trade directly, but also to induce foreign investment, which in turn should lead to more trade to the extent that the companies do not only produce for the local market, but also for exports to the neighbouring countries. The importance of the free-trade area among the Baltics should also be seen in this context. Given that it starts functioning properly, it should reduce the likelihood for trade diversion that could otherwise result from the free-trade agreements between the Baltics and the EU. It should thus stimulate intra-Baltic trade, that could otherwise suffer at the expense of Baltic-EU trade.

The Baltics need to co-operate and define common strategies in their relations with the European Union. As members of the EU, the Nordics (except Norway) are bound by the Common Commercial Policy in their trade relations with the Baltics. The need for common strategies is further alleviated by the fact that the Baltics specialise in their exports and imports with the Nordics in the same categories of goods.

The issue of market access (trade) is generally agreed to be of great importance for increasing FDI in the Eastern Baltic Rim. The level of trade barriers in sensitive products and non-tariff barriers in the EU makes a difference in the amount of FDI flowing to the Baltics, as many investment projects indirectly target the EU market. Furthermore, intra-Baltic trade agreements should be put into effect in a more efficient way in order to facilitate market access and the mobility of products within the Baltic region. Many of the Nordic investors further export the products manufactured in the Baltics to Poland, Germany and Russia. Therefore, the potential deterring effect of the existence of trade and other barriers within the countries of the Baltic Rim need to be eliminated. These barriers form an as important impediment as the actual operational problems (systemic problems related to, i.e. loopholes in the legislation and the fast implementation of new laws, vague ownership, infrastructural problems, and so on) that firms face while operating in the Baltics.

Thus, Nordic firms that wish to supply several Eastern European countries from manufacturing, servicing or storage facilities situated in one country in the Baltic region are constrained by these barriers. Consequently, the existence of such barriers impede normal commercial practices. The Association or Europe agreements signed between the EU and the Baltic countries also raise some obstacles to FDI. This particularly concerns those Nordic companies that would re-export their products (which are often so-called sensitive ones) to their home countries or some other EU-market, since manufacturing companies have artificially lower market access than EU companies themselves.

From the point of view of the Nordic home countries, the existence of obstacles to greater FDI, the above-mentioned marginalizing effect of trade agreements and the pattern of Nordic firms' strategies, confirm the fact that the lower Baltic production costs are not the dominant issue in undertaking FDI and choosing a Baltic location for production. Even though the competition from low-wage Eastern European countries is far from having exerted its full effects due to the given obstacles to trade and additional FDI, it seems that the Nordic countries and the Baltics have benefited from increasing FDI and trade within the region until now. Nordic firms' operations in the Baltic States have been supplementing rather than crowding out operations elsewhere. The home country effects have currently much more to do with export stimulation, supporting firm employment effects and home office employment effects than with actual displacement effects.

A recent case study (Borsos 1995) on the domestic employment effects of Finnish FDIs in Eastern Europe came to the above conclusions. The case company analysis indicated a high proportion of intermediate inputs supplied by parent companies, which should have a positive impact on domestic jobs. Furthermore, as FDI motives were market-related, domestic and foreign employment can be assumed to be highly complementary, because this type of FDI is backing trade. Overall exports seemed to have increased significantly. There was a strong tendency to keep higher value-added activities in Finland and there was a high degree of complementarity between activities in the parent firms in Finland and the affiliates in the Eastern Baltic Rim. Finally, various domestic SMEs were directly dependent on Finnish firms operating in the region as customers, distributors, suppliers, etc., and their share was apt to increase as market expansion increases rapidly. The new configuration of the division of labour in the Baltic Rim is a source of competitiveness to all of the countries and firms in the region.

The potential of expanding FDI in the Baltics is large, which raises new policy issues for the Baltic host economies. Firstly, FDI is often concentrated in large dominant companies in oligopolistic industries, such as foodstuffs and telecommunications, where investment returns are high. Consequently, the strengthening of antitrust policies is central in order to increase competition and ensure market access, e.g. reduced entry barriers. Secondly, cooperation between the various Nordic and international organizations providing project financing and the Baltic economies needs to be enforced also operationally in order to further facilitate the absorption of international finance. Finally, the trade deficits accompanied by FDI should not currently be a cause of concern, due to the fact that they are caused by the import of unavailable capital equipment by foreign investors. Thus, the deficits should be regarded as temporary in so far as they are a consequence of capacity-increasing productive investments and should not be a cause to political debate, which in turn has a negative effect on the investment climate.

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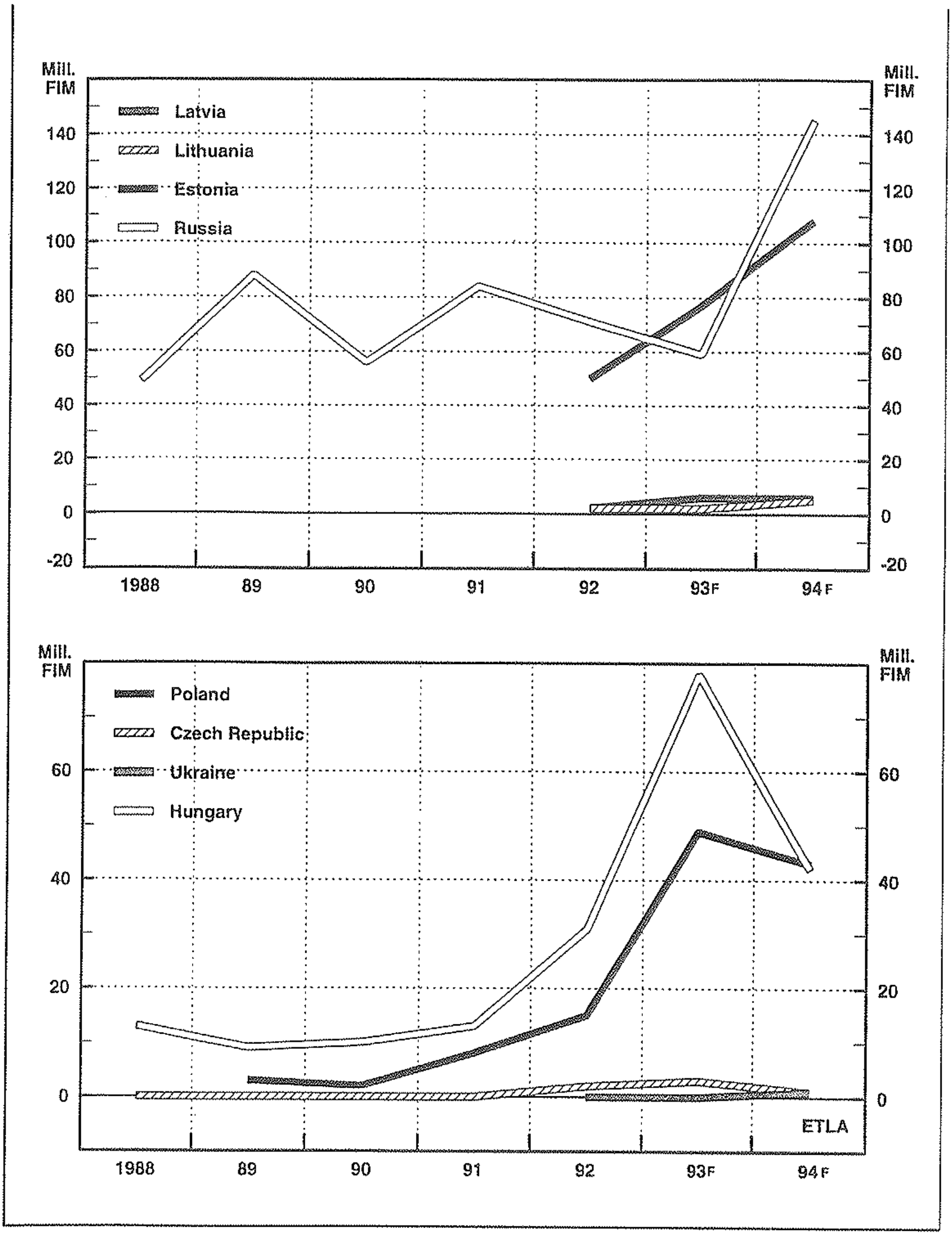
Provisions Related to Investments in Europe Agreements and in Partnership and Co-operation Agreements

Provisions	Europe Agreements	Partnership and co-operation Agreements with Russia	Partnership and co-operation Agreements with Others
1. Establishment of enterprises and professionals	NT reciprocal but to be introduced asymmetrically.	MFN for companies only. For financial services, NT with exceptions.	EU offers MFN. NIS offer best of MFN/NT, with some exceptions (Bel, Mol, Ukr), some of which are transitional.
2. Operations of enterprises and professionals	NT reciprocal but to be introduced asymmetrically.	EU offers NT for subsidiaries with some exceptions. MFN for branches. Russia offers best of MFN/NT.	EU offers NT for companies and MFN for branches, with some exceptions. NIS offer best of MFN/NT.
3. Capital transfers in respect to investments	To be fully liberalized, including also repatriation of profits and transfer of dividends.	To be fully liberalized, including also rapatriation of profits and transfer of dividends. Russia may maintain during a transitional period restrictions on outward investment.	Liberalization of capital movements for FDI including repatriation of assets and profits.
4. Protection of intellectual, industrial and commercial property	CEC to provide same level of protection and subscribe to international agreements.	Russia expected to provide same level of protection and subscribe to international agreements.	Expected to provide same level of protection and subscribe to international agreements.
5. Competition rules, including state aids	Similar to EU rules.	Disciplines inspired from EU rules, but less strict than EA rules	Ukr, Bel, Mold: right to intervene and obtain information; non-discrimination regarding marketing and public procurement rules within 4 years. Kaz, Kyr: right to intervene where trade affected.
6. Law in all areas having impact on agreements	Approximate.	Gradual approximation	Gradual approximation.
7. Industrial standards and certification	Co-operation (PHARE)	Co-operation (TACIS)	Co-operation (TACIS)
8. Investment promotion • Improve legal framework • Conclude investment protection agreements	Co-operation (PHARE)	Co-operation (TACIS)	Co-operation (TACIS)
9. Market access	Free trade in industrial goods, introduced asymmetrically.	MFN for goods and for selected services	MFN for trade in goods (Bel: for selected services)

EA = Europe Agreement; NT = National Treatment; MFN = Most Favoured Nation treatment; CEC = Central European Countries; EA = Poland, Hungary, Czech Republic, Slovakia, Romania, Bulgaria, negotiations with Baltics are ongoing, and are expected with Slovania. Partnership and co-operation agreements signed with Russia, Ukraine and Moldova; Kazakhstan, Kyrgyzstan and Belarus are expected to sign the agreement soon.
Source: European Commission, March 1, 1995, com(95)42.

Finnish Outward FDIs in Eastern Europe in 1988-1994; Annual Net Investment Flows (Millions of FIM, excluding re-invested profits)



Cumulative FDI registrations in Central and Eastern Europe, 1991-1993

Country	1991		1992		1993		
	Number	Millions of dollars	Number	Millions of dollars	Number	Millions of dollars	Per cent
Bulgaria	900	130,0	1 200	170,0	2 300	200,0	1,0
Former Czechoslovakia	4 000	1 076,0	-	-	-	-	-
Czech Republic	-	-	3 120	1 573,5	5 000	2 053,0	10,6
Slovakia	-	-	2 875	231,2	4 350	380,0	2,0
Hungary	9 117	3 137,0	17 182	3 680,0	21 468	6 005,7	30,8
Poland	5 583	479,5	5 740	1 545,6	6 800	2 100,0	10,8
Romania	8 022	268,7	20 684	539,8	29 115	755,0	3,9
Former Soviet Union	4 206	4 462,2	15 300	5 566,5	27 200	6 800,0	34,9
CIS	2 593	4 300,0	8 007	5 250,0	17 200	6 300,0	32,3
Russian Federation	2 022	2 827,4	3 252	2 850,0	7 989	3 153,2	16,2
Ukraine	400	440,0	2 000	480,0	2 800	600,0	3,1
Belarus	283	..	714	265,5	1 250	340,0	1,7
Estonia	1 100	84,2	2 662	142,0	4 150	220,0	1,1
Latvia	295	45,0	2 621	84,5	2 850	150,0	0,8
Lithuania	220	33,0	2 000	90,0	3 000	140,0	0,7
Former Yugoslavia	..	..	..	..	..	..	..
Slovenia	1 000	650,0	2 815	962,2	3 300	1 200,0	6,2
Total	32 828	10 203,4	68 916	14 268,8	99 533	19493,7	100,0

Source: UN World Investment Report, 1994; ECE 1993 and 1994.

The Gravity Model: a Short Description

The gravity model has been employed recently in many studies that have tried to measure the trading potential of the Central and Eastern European countries following their opening up. Formally:

$$X_{ij} = C + b_1 lnD_{ij} + b_2 lnN_i + b_3 lnN_j + b_4 lnY_i + b_5 lnY_j + b_6 lnP_{ij} + b_7 lnA_{ij}$$

The variables are expressed in logarithms. The importing country's GNP/capita-variable (N_j) denotes her demand for imports and the exporting country's GNP/capita (N_i) stands for the supply of goods. The demand for imports rise with higher GNP/capita incomes as does the supply of exports as the country grows richer. The GNP/capita income can alternatively be interpreted as an indicator of relative endowments of capital to labour, whereby a rich country specialises in capital intensive goods and the country with a low GNP/capita income level specialises in labour intensive products.

The GNP-level - which measures size - (Y_i) determines the range of goods that the country exports. A large country measured by its GNP is able to specialise in a broader range of products compared to its smaller neighbour, as larger countries usually have more resources - raw materials, labour and capital - at their disposal. The importing country (Y_j) will in a similar way demand a broader range of goods the bigger it is, since size and heterogenous preferences go hand in hand. Trade flows are adversely affected by a growing distance (D_{ij}), since transportation costs and other costs of doing business usually grow with a growing distance.

The exports from country i to country j are negatively correlated with their mutual distance, positively correlated with their respective GNP/capita income levels and their respective GNP-levels. A dummy was introduced to count for membership in the same trading block (an EU-dummy, P_{ij}). Cultural adjacency (A_{ij}) was likewise captured by a dummy.

The model was estimated from an average of the bilateral trade flows between 17 West European countries in 1988-90. This gave 272 observations.[1]

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[1] The model used here is essentially an up-dated version of the one in Wang and Winters (1991). Their model is estimated from a much more heterogeneous data set compared to the model used in this study.

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