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# BARRIERS TO ECONOMIC COOPERATION OF BALTIC RIM COUNTRIES

Report for The Finnish Ministry of Trade and Industry

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The emergence of new market economies has opened up new possibilities to develop the trade and economic cooperation between the Baltic Rim countries. This study evaluates barriers to economic cooperation due to institutional factors and companies as well as what kind of framework the relations between the countries offer for economic integration. The objective is to present an overview of the major barriers and offer proposals for their elimination. The study has been commissioned by the Finnish Ministry of Trade and Industry.

The trade between the Baltic Rim countries is growing very quickly, at a rate of around 20 per cent a year. The calculations on potential trade nevertheless indicate that the mutual trade should be even 80 per cent higher than nowadays. According to the study the most critical barriers to economic cooperation between Baltic Rim countries are shortcomings in legislation and its implementation, criminal activity and poor ethics, hostile treatment of foreign companies, lack or high cost of investment financing, barriers against transport of goods and shortcomings in governmental treaties. The most important recommendations for eliminating trade barriers are presented in concise form in the final chapter presenting the conclusions of the study.

**Hernesniemi**, Hannu, **BARRIERS TO ECONOMIC COOPERATION OF BALTIC RIM COUNTRIES** (Itämeren maiden taloudellisen yhteistyön esteet). Helsinki: ETLA - Elinkeinoelämän Tutkimuslaitos, The Research Institute of The Finnish Economy, 1996, 46 s. (Keskusteluaiheita, Discussion Papers, ISSN 0781-6847; No 555)

Uusien markkinatalouksien syntyminen on avannut merkittäviä mahdollisuuksia kasvattaa Itämeren maiden keskinäistä kauppaa. Tämä tutkimus pyrkii arvioimaan maiden instituutioista ja talouksien rakenteista, yrityksistä sekä maiden sopimuksellisista suhteista johtuvia taloudellisen yhteistyön esteitä. Tavoitteena on esittää kokonaisnäkemys tärkeimmistä esteistä ja tehdä ehdotuksia niiden poistamiseksi. Tutkimuksen on tilannut Suomen kauppa- ja teollisuusministeriö.

Itämeren maiden keskinäinen kauppa kasvaa voimakkaasti, noin 20 prosenttia vuodessa. Kuitenkin kaupan potentiaalista tehtyjen laskelmien mukaan kaupan pitäisi olla jopa 80 prosenttia suurempi kuin mitä se on nykytasolla. Tutkimuksen mukaan Itämeren maiden taloudellisen yhteistyön suurimmat esteet ovat puutteet lainsäädännössä ja lakien toimeenpanossa, rikollinen toiminta ja huono etiikka, investointirahoituksen puute ja sen kalleus, ulkomaalaisten yrityksien nurja kohtelu, tavarakuljetusten esteet ja puutteet maiden välisissä sopimussuhteissa. Tärkeimmät suositukset kaupan esteiden poistamiseksi on esitetty tiiviissä muodossa tutkimuksen johtopäätösluvussa.

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# 1 Introduction

## 1.1 Overview

The emergence of new market economies has opened up new possibilities to develop the trade and economic co-operation between the Baltic Rim countries. This study evaluates barriers to economic co-operation due to institutional factors and companies as well as what kind of framework the relations between the countries offer for economic integration. The objective is to present an overview of the major barriers and offer proposals for their elimination.

The study has been commissioned by the Finnish Ministry of Trade and Industry from Etlatieto Ltd., which is a subsidiary of the Research Institute of the Finnish Economy (ETLA), a private organisation independent of the government. The aim of the Ministry in commissioning the study has been to gain the views of an independent research institute regarding the barriers to co-operation and possibilities for their elimination.

The region consisting of the Baltic Rim countries is clearly on the verge of a new era. In the most optimistic scenario the countries may set an example for the world by developing vigorous trade relations akin to those prevailing in the days of the Hansa League. As intermediaries between the large and raw material-rich Russia and the integrating, industrialised Europe, they can achieve the same growth in wealth as in the Netherlands or Hong Kong. Pooling the comparative advantages and competitive factors of the various countries can give birth to significant new industry in the area. A growing standard of living and developing trade relations can make the region into a significant site for investment by international investors. The governments of the region can play a significant role in fostering development or slowing it down.

Chapter 2 presents an overview of the current and potential economic co-operation within the region. The chapter outlines the mutual trade and evaluates its possibilities for development. In tandem with trade, cross-border business activities are growing and along with them direct investment. The current situation and development possibilities of these factors are also evaluated. Chapter 3 concentrates upon institutional and structural barriers to economic co-operation that officials can have a significant effect upon with their decisions. Chapter 4 considers the impact of the undeveloped nature of business activities and related services. The main responsibility for progress in this respect lies with the companies themselves, but the government also has limited possibilities to foster development. Chapter 5 deals with the mutual agreements between the states in this region. Part of the agreements are intended to promote the process of integration in the region. The possibilities offered by agreements already concluded have not nearly been exploited in full. Chapter 6 presents recommendations for promoting economic cooperation. The recommendations have focused on elimination of barriers that are significant and over which officials can wield influence. The recommendations are made with the boldness of an outside observer.

The Baltic Rim is considered to encompass the countries participating in the Baltic Council: Russia, Estonia, Latvia, Lithuania, Poland, Germany, Denmark, Sweden and Finland.[1]

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[1] The countries evaluated are listed here and in the statistics in the order in which they are located clockwise around the Baltic Sea. Also Norway and Iceland participate in the activities of the Baltic Council, as does the European Commission.

When reading the study, it is worth keeping in mind the psychological fact that the perceptions of entrepreneurs, be they right or wrong, affect their behaviour. These kinds of phenomena are brought forth if they appear to present barriers to trade, investment or other cooperation.

### 1.2 Research objectives and methods

*Objectives*

The objectives of the study are:

- Assess and systematise the Baltic Rim countries'
  - mutual trade barriers
  - barriers to other co-operation between companies
  - barriers to free investment and direct investment of companies
- Evaluate the mutual significance of barriers as regards economic co-operation
- Present both short-term and long-term measures for the elimination of barriers

The Ministry of Trade and Industry, which commissioned the study, will use it to and its recommendations to facilitate elimination of trade barriers in co-operation with the Baltic Rim countries.

*Systematisation of trade barriers*

Barriers will be evaluated in the following framework:

- Barriers stemming from undeveloped institutions, structures and activities of society
- Barriers derived from shortcomings in business activities, i.e. company resources and know-how as well as business structures
- Barriers caused by agreements between governments and their faulty implementation

*Data collection and analysis*

Data for the study was compiled from the following sources:

- Familiarisation with the current situation and potential for trade and direct investment utilising the research reports of ETLA, EBRD and certain other organisations (see references).
- Compiled statistics on Baltic Rim countries' foreign trade, direct investment, financing costs, telecommunications connections, crimes against persons as well as property, and gather the data into tables in order to facilitate comparison across countries.
- Interviewed representatives of organisations promoting foreign trade and investment activity, organisations of entrepreneurs, Finnish and local companies doing business in the various countries (see list of interviewees).
- Familiarisation with written material produced by various organisations, private companies and law firms on barriers and institutional shortcomings regarding investment activity and general business activities in the various Baltic countries.
- Material compiled and analysed was used in December-January in drawing up a preliminary report, which was subsequently condensed into an English language report.

*Recommendations*

The report presents recommendations and proposals for eliminating trade barriers to the following bodies:

- to the ministries of economy and trade- and industry of the Baltic Rim countries, as well as to the other ministries involved
- to the Baltic Sea Council (for elimination of the major common problems and development of the agreement environment and implementation of agreements)
- to individual governments ( the most urgent problems of individual countries)
- to companies (development activities, possibilities for co-operation, new business activities, etc.)

The most important recommendations are presented in concise form in the final chapter presenting the conclusions of the study.

# 2. Current Situation and Potential for Economic Cooperation

## 2.1 Foreign Trade of Baltic Rim Countries

The foreign trade of the Baltic Rim countries has changed significantly owing to the social upheaval in the region. The one-way trade of the Baltic states, Poland and the former East Germany directed toward the former Soviet Union and CMEA countries has been transformed into trade with the Baltic Rim countries. Russia has lost its shares to Germany and the Nordic countries, but has remained a very significant trading partner. Table 1 indicates how important trade among the Baltic Rim countries is to each other.

**Table 1. Trade of Baltic Rim countries in 1994**

| Exports | To World 1000 USD | To World USD Per Capita | To Baltic Rim 1000 USD | Baltic Rim % |
|---|---|---|---|---|
| Russia | 63 242 989 | 427 | 11 171 244 | 17,7 % |
| Estonia | 1 304 923 | 871 | 995 665 | 76,3 % |
| Latvia | 968 394 | 380 | 574 642 | 59,3 % |
| Lithuania | 2 019 300 | 543 | 1 242 225 | 61,5 % |
| Poland | 17 240 104 | 447 | 8 551 650 | 49,6 % |
| Germany | 424 030 355 | 5 209 | 34 666 432 | 8,2 % |
| Denmark | 39 667 460 | 7 621 | 15 113 103 | 38,1 % |
| Sweden | 61 053 325 | 6 962 | 16 702 263 | 27,4 % |
| Finland | 29 513 353 | 5 799 | 11 099 842 | 37,6 % |
| Total | 639 040 204 | 2 168 | 100 117 067 | 15,7 % |

| Imports | From World 1000 USD | To World USD Per Capita | From Baltic Rim 1000 USD | Baltic Rim % |
|---|---|---|---|---|
| Russia | 38 649 553 | 261 | 9 515 137 | 24,6 % |
| Estonia | 1 658 408 | 1 106 | 1 208 354 | 72,9 % |
| Latvia | 1 215 377 | 477 | 795 330 | 65,4 % |
| Lithuania | 2 338 875 | 629 | 1 620 100 | 69,3 % |
| Poland | 21 569 118 | 560 | 9 119 642 | 42,3 % |
| Germany | 378 088 831 | 4 644 | 34 916 369 | 9,2 % |
| Denmark | 33 806 121 | 6 495 | 13 421 711 | 39,7 % |
| Sweden | 51 533 393 | 5 876 | 17 893 524 | 34,7 % |
| Finland | 23 090 074 | 4 537 | 9 120 838 | 39,5 % |
| Total | 551 949 750 | 1 872 | 97 611 006 | 17,7 % |

The countries of the Baltic Rim region and their significance for other Baltic Rim countries can be classified on the basis of foreign trade as follows:

- Russia is a significant supplier of raw materials. Although industrial development is hardly as brisk as in the other Baltic Rim countries, the enhancement of economic division of labour and the size of Russian markets nevertheless spur rapid expansion in its foreign trade.

The economic and industrial potential of the St. Petersburg area are considerably underutilised.

- Estonia, Latvia and Lithuania are very Baltic Rim-oriented. They buy consumer and investment goods from the Nordic countries and Germany. Nevertheless, they still have significant trade relations (incl. transit transport) with Russia. Now the companies of neighbouring countries control these countries as an extension of their own domestic markets, but over the longer run investments will be carried out in the countries aimed at exploiting their competitiveness in the export markets.
- Poland's economic growth has made it an attractive export site. The country's own market consisting of almost 40 million consumers is also sufficient reason for locating manufacturing activities in the country. The bilateral trade relations of Poland and Germany are very important to Poland. Even Poland's share within Germany's exports may in a few years grow larger than those of Denmark and Sweden.
- Germany's industrial base is wide and it conducts trade with various countries on a large scale, so that the significance of the Baltic Rim countries will be relatively modest in its trade. On the other hand, Germany needs raw materials, which it can get from Russia, and energy, which Estonia and Lithuania can produce. As a significant manufacturer its export shares in various countries are nevertheless large and its domestic market constitutes the largest export market in the area.
- The industry of the Nordic countries is oriented toward the international markets and it does not compete with the industry of the economies in transition. To the food, building materials, textile, wearing apparel and wood industries, the transition economies represent extended domestic markets, where part of the manufacturing activities can be carried out at the lowest production costs.

Table 2a presents the percentage of each Baltic Rim country's exports going to other Baltic Rim countries. The significance of Russia and Germany in the region is clearly evident, but over the long run the significance of Poland will also grow.

**Table 2a. Exports of Baltic Sea Countries by Destination in 1994**

| >>--->To | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic Rim |
|---|---|---|---|---|---|---|---|---|---|---|
| Russia | | 0,5 % | 1,0 % | 1,1 % | 1,8 % | *8,5 %* | 0,4 % | 1,3 % | *3,1 %* | 17,7 % |
| Estonia | 23,1 % | | *8,2 %* | *5,4 %* | 0,7 % | *6,8 %* | *3,4 %* | 10,9 % | 17,9 % | 76,3 % |
| Latvia | 28,1 % | 2,6 % | | *5,6 %* | 1,6 % | 10,5 % | 1,6 % | *6,9 %* | 2,4 % | 59,3 % |
| Lithuania | 28,2 % | 2,5 % | *8,4 %* | | *5,0 %* | 11,5 % | 1,7 % | *3,1 %* | 1,0 % | 61,5 % |
| Poland | *5,4 %* | 0,1 % | 0,3 % | 0,7 % | | 35,7 % | *3,2 %* | 2,6 % | 1,7 % | 49,6 % |
| Germany | 1,6 % | 0,0 % | 0,1 % | 0,1 % | 1,5 % | | 1,8 % | 2,2 % | 0,8 % | 8,2 % |
| Denmark | 1,1 % | 0,1 % | 0,1 % | 0,2 % | 1,4 % | 22,4 % | | 10,4 % | 2,4 % | 38,1 % |
| Sweden | 0,7 % | 0,3 % | 0,2 % | 0,1 % | 1,0 % | 13,3 % | *6,9 %* | | *4,8 %* | 27,4 % |
| Finland | *5,2 %* | 2,2 % | 0,5 % | 0,3 % | 1,7 % | 13,4 % | *3,4 %* | 10,9 % | | 37,6 % |
| Total | 1,7 % | 0,2 % | 0,2 % | 0,3 % | 1,5 % | *5,1 %* | 2,2 % | 2,9 % | 1,5 % | 15,7 % |

**Table 2b. Imports of Baltic Rim Countries by Source in 1994**

| <<From | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic Rim |
|---|---|---|---|---|---|---|---|---|---|---|
| Russia | | 0,5 % | 0,5 % | 0,7 % | 2,4 % | 14,6 % | 0,8 % | 0,8 % | *4,2 %* | 24,6 % |
| Estonia | 16,8 % | | 1,5 % | 2,6 % | 0,6 % | 10,0 % | 2,6 % | *8,9 %* | 29,9 % | 72,9 % |
| Latvia | 23,6 % | *3,5 %* | | *5,9 %* | 1,6 % | 13,5 % | 2,3 % | *6,4 %* | *8,5 %* | 65,4 % |
| Lithuania | 39,3 % | 1,6 % | 2,7 % | | *4,0 %* | 13,8 % | 2,6 % | 2,4 % | 2,9 % | 69,3 % |
| Poland | *6,7 %* | 0,0 % | 0,0 % | 0,4 % | | 27,5 % | 2,4 % | 2,8 % | 2,4 % | 42,3 % |
| Germany | 2,2 % | 0,0 % | 0,1 % | 0,1 % | 1,7 % | | 1,8 % | 2,3 % | 1,1 % | 9,2 % |
| Denmark | 1,0 % | 0,1 % | 0,2 % | 0,2 % | 1,8 % | 21,7 % | | 11,6 % | *3,1 %* | 39,7 % |
| Sweden | 1,4 % | 0,3 % | 0,4 % | 0,2 % | 0,9 % | 18,4 % | *6,8 %* | | *6,3 %* | 34,7 % |
| Finland | *8,9 %* | 0,9 % | 0,1 % | 0,1 % | 1,3 % | 14,7 % | *3,0 %* | 10,4 % | | 39,5 % |
| Total | 2,6 % | 0,1 % | 0,2 % | 0,2 % | 1,6 % | *5,9 %* | 2,2 % | 2,9 % | 2,1 % | 17,7 % |

The integration between the Baltic countries is still based largely upon trade in energy, but the investment of Nordic companies in the countries of the region will perhaps diversify the content of bilateral trade in merchandise. The Nordic countries constitute growth areas for the exports of the Baltic countries. Exports began with metal and wood products, but will diversify via subcontracting, the trade with Estonia being a good example. Poland seems to be oriented strongly toward Germany and partly Denmark while Lithuania is oriented toward Germany and Poland. The corresponding figures for the imports of the countries are presented in table 2b.

## 2.2 Trade Potential

From the perspective of the Nordic countries and Germany, the foreign trade of the transition economies has grown swiftly since their own exports and imports from the transition countries have grown swiftly. In actuality part of the growth has been attributable to the dwindling of Russia's and the CIS countries' market shares in the Baltic countries and Poland to their western neighbours. Despite this the growth in the trade figures is very high. In addition, the growth has occurred at a time when the production of the countries and investments have been decreased according to the official statistics.

Even though the trade statistics give an uncertain picture of the trade growth[1], it is evident that the Baltic Rim countries have gained a considerable boost to growth from the freer intra-region trade. The intra-region trade has grown appreciably faster than the trade with the other countries of the world. This can be seen from the last two rows of the table presenting the

[1] The growth figures calculated from a country's own trade flow figures often differ considerably from those reported by other countries for the same trade flows. Despite the discrepancy the figures are correlated with one another.

growth in intra-region trade of the Baltic Rim countries in contrast with the growth in their trade with all countries.

**Table 3. The Trade Growth between Baltic Rim Countries**

| | Year 1994 | | Year 1995* | |
|---|---|---|---|---|
| | Imports | Exports | Imports | Exports |
| Russia | 34,6% | 20,3 | 24,7% | 12,8% |
| Estonia | 85,1% | 60,3% | 44,8% | 42,5% |
| Latvia | 58,7% | 27,2% | 58,3% | 61,5% |
| Lithuania | 51,5% | 11,4% | 22,2% | 14,4% |
| Poland | 15,0% | 24,1% | 19,4% | 33,0% |
| Germany | 20,9% | 22,6% | 15,8% | 25,6% |
| Denmark | 17,0% | 16,9% | 22,0% | 17,6% |
| Sweden | 13,9% | 12,5% | .. | .. |
| Finland | 23,0% | 35,5% | 32,3% | 26,6% |
| Baltic Rim | 24,4% | 19,5% | 21,0% | 20,6% |
| All Countries | 13,6% | 14,9% | 16,4% | 18,8% |

*The 1995 growth figures have been obtained by transforming the year's first 5-10 months to an annual basis. Fluctuations in growth during the year may distort the growth figures.*

The potential for trade has been calculated with a so-called gravitation model. Trade growth in the model is deemed to depend upon the size of GDP, population, GDP per capita and proximity of the countries. Based on the freshest information available table 4 depicts how much of the trade potential is currently unutilised compared to real trade figures. The most significant deviations from potential are denoted in bold figures.

**Table 4. Potential Trade of Baltic Rim Relative to Actual Trade in 1994**

| From >->To | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic Rim |
|---|---|---|---|---|---|---|---|---|---|---|
| Russia | | 0,99 | 0,28 | 0,18 | **3,11** | *1,74* | **3,94** | *1,67* | *1,02* | *1,59* |
| Estonia | *1,48* | | 0,23 | 0,22 | **20,34** | **5,59** | *1,21* | 0,61 | 0,70 | *1,47* |
| Latvia | 0,80 | 0,92 | | 0,38 | **6,16** | **5,61** | **4,03** | *1,37* | **2,45** | *1,98* |
| Lithuania | 0,27 | 0,27 | 0,11 | | *1,62* | *1,71* | *1,16* | 0,90 | *1,78* | 0,70 |
| Poland | **4,14** | **10,34** | *1,88* | *1,38* | | **2,01** | 0,96 | *1,50* | *1,28* | **2,13** |
| Germany | *1,73* | **2,77** | *1,78* | *1,98* | **2,17** | | **2,12** | *1,86* | **2,91** | **2,06** |
| Denmark | **3,25** | *1,36* | *1,62* | 0,72 | *1,20* | **2,15** | | 0,57 | *1,29* | *1,65* |
| Sweden | **4,17** | 0,45 | 0,89 | 0,93 | *1,38* | **2,40** | 0,53 | | 0,64 | *1,59* |
| Finland | *1,80* | 0,26 | 0,42 | 0,53 | 0,99 | **2,76** | *1,18* | 0,59 | | *1,58* |
| Total | **2,00** | 0,87 | 0,70 | 0,87 | **2,13** | **2,21** | *1,55* | *1,32* | *1,58* | *1,80* |

*The potential exports of a country are divided by the realised exports. If the figure exceeds one, part of the trade potential projected by the model is unutilised. Calculations: Mika Erkkilä, ETLA, January 1996.*

The table reveals large unutilised possibilities for many countries. For example, according to the results of the gravitation model Poland could expand its exports to Russia four-fold, to Estonia, ten-fold, and to Germany two-fold; its total exports to the Baltic Rim countries could double. At the same time Germany should be able to double its exports. Only Lithuania would not appear to have export growth possibilities. This may be due to the phenomenon that Lithuania's trade figures actually reflect a great deal of transit transport, which the gravitation model is not able to take into consideration.[2] The elimination of trade barriers could thus have significant welfare effects. In its entirety, the intra-regional trade could grow by about 80 per cent according to the gravitation model.

The model also indicates the effects on the trade balance. Russia's surplus will decrease, the Lithuanian deficit will grow and German trade might start to run a deficit. The Estonian and Latvian trade balances will strengthen appreciably while those of Denmark and Sweden will show a slight improvement. Poland's trade balance with Baltic Rim countries will remain in deficit and Finland's surplus will remain at relatively the same level as at present.

If the realised trade exceeds the potential trade substantially, this is usually attributable to various additional factors, for example, similarity of language and culture. Researchers have offered this as an explanation for the trade between Finland and Estonia, among others, where the realised trade has surpassed the potential projected by the gravitation model.[3] In principle the Baltic Rim area is full of cultural and language ties that could form a significant resource in the intra-regional trade of these countries.[4]

The growth in the trade depends on the level of gross domestic product as well as its growth. Let up assume that the rate of growth in the Baltic Rim countries follows the so-called catching-up model, as a result of which the income differences between the countries are eliminated. On the basis of historical experience it can be assumed that the growth rate in Germany, Denmark, Sweden and Finland averages 2.5 per cent annually. Let us assume that in the transition economies the rate of growth is twice as fast, i.e. 5 per cent annually. With these assumptions the gravitation model generates potential levels for the trade between the various countries as presented in table 5.

If the economies grow in accordance with these assumptions and the results of the gravitation model are even approximately correct, the trade between the Baltic Rim countries will grow from the USD 100 billion of 1994 to USD 330 billion in the year 2000 and almost USD 900 billion by the year 2010. This would require considerable investments in transport and frontier infrastructure as well as deliberate measures to reduce barriers related to state bureaucracy. In actuality the value added content of traded goods will rise and the trade will be conducted in increasingly more valuable high tech products. The unit value of goods traded will thus rise so that the volumes of trade will not rise as much as the trade value.

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[2] Much of the exports to Lithuania actually end up in Russia or other CIS countries while Lithuania transports Russian oil and chemicals as well as selling exceptional amounts of electricity to Latvia.

[3] Estonians know Finnish to a large extent since it is Estonia's most closely related language and Finnish television was closely followed in northern Estonia during the time of Soviet control. Thus, among other things, many Finnish brand names became well known to Estonian consumers.

[4] The language resources promoting trade potential could be: the Russian language population in the Baltics, the closeness of the Finnish and Estonian languages, the Polish minority in Lithuania, the Swedish minority in Finland, the Finnish language minority in Caralia, the general knowledge of the Russian language in the Baltic countries and Poland, the Swedish language in the Nordic countries, the widespread knowledge of English as a common language and the traditional knowledge of the German language.

**Table 5. Actual Trade in 1994 and Trade Potential in 2000 and 2010, million USD in constant 1994 prices**

| Exporter | Importer | Exports v.1994 | Potential Exports v. 2000 | Potential Exports v. 2010 | Exporter | Importer | Exports v.1994 | Potential Exports v. 2000 | Potential Exports v. 2010 |
|---|---|---|---|---|---|---|---|---|---|
| Estonia | Russia | 301 | 817 | 2 231 | Germany | Poland | 6 419 | 25 403 | 69 404 |
| Latvia | Russia | 272 | 400 | 1 092 | Denmark | Poland | 570 | 1 254 | 3 426 |
| Lithuania | Russia | 570 | 277 | 757 | Sweden | Poland | 597 | 1 509 | 4 123 |
| Poland | Russia | 935 | 7 075 | 19 330 | Finland | Poland | 488 | 887 | 2 425 |
| Germany | Russia | 6 644 | 21 059 | 57 535 | Russia | Germany | 5 355 | 17 017 | 46 491 |
| Denmark | Russia | 425 | 2 529 | 6 909 | Estonia | Germany | 89 | 905 | 2 472 |
| Sweden | Russia | 446 | 3 393 | 9 269 | Latvia | Germany | 102 | 1 045 | 2 854 |
| Finland | Russia | 1 537 | 5 046 | 13 785 | Lithuania | Germany | 232 | 722 | 1 972 |
| Russia | Estonia | 336 | 611 | 1 669 | Poland | Germany | 6 150 | 22 595 | 61 731 |
| Latvia | Estonia | 25 | 42 | 116 | Denmark | Germany | 8 881 | 34 909 | 95 375 |
| Lithuania | Estonia | 51 | 25 | 68 | Sweden | Germany | 8 133 | 35 699 | 97 534 |
| Poland | Estonia | 14 | 273 | 745 | Finland | Germany | 3 959 | 19 950 | 54 507 |
| Germany | Estonia | 165 | 838 | 2 289 | Russia | Denmark | 245 | 1 767 | 4 828 |
| Denmark | Estonia | 42 | 105 | 288 | Estonia | Denmark | 44 | 98 | 269 |
| Sweden | Estonia | 197 | 162 | 443 | Latvia | Denmark | 15 | 112 | 305 |
| Finland | Estonia | 647 | 309 | 844 | Lithuania | Denmark | 35 | 74 | 203 |
| Russia | Latvia | 625 | 318 | 869 | Poland | Denmark | 550 | 965 | 2 636 |
| Estonia | Latvia | 107 | 45 | 123 | Germany | Denmark | 7 802 | 30 190 | 82 482 |
| Lithuania | Latvia | 171 | 34 | 94 | Sweden | Denmark | 4 227 | 4 109 | 11 227 |
| Poland | Latvia | 45 | 155 | 424 | Finland | Denmark | 1 012 | 2 178 | 5 950 |
| Germany | Latvia | 316 | 1 029 | 2 811 | Russia | Sweden | 811 | 2 481 | 6 778 |
| Denmark | Latvia | 43 | 127 | 348 | Estonia | Sweden | 142 | 159 | 433 |
| Sweden | Latvia | 112 | 182 | 496 | Latvia | Sweden | 67 | 167 | 456 |
| Finland | Latvia | 152 | 116 | 316 | Lithuania | Sweden | 63 | 103 | 282 |
| Russia | Lithuania | 719 | 240 | 656 | Poland | Sweden | 443 | 1 215 | 3 319 |
| Estonia | Lithuania | 71 | 29 | 79 | Germany | Sweden | 9 500 | 32 307 | 88 267 |
| Latvia | Lithuania | 54 | 37 | 102 | Denmark | Sweden | 4 132 | 4 300 | 11 748 |
| Poland | Lithuania | 113 | 285 | 780 | Finland | Sweden | 3 225 | 3 494 | 9 547 |
| Germany | Lithuania | 484 | 1 754 | 4 792 | Russia | Finland | 1 950 | 3 622 | 9 895 |
| Denmark | Lithuania | 70 | 92 | 252 | Estonia | Finland | 233 | 296 | 809 |
| Sweden | Lithuania | 72 | 122 | 334 | Latvia | Finland | 23 | 104 | 285 |
| Finland | Lithuania | 79 | 76 | 208 | Lithuania | Finland | 19 | 63 | 172 |
| Russia | Poland | 1 129 | 6 428 | 17 561 | Poland | Finland | 301 | 701 | 1 916 |
| Estonia | Poland | 9 | 331 | 905 | Germany | Finland | 3 336 | 17 723 | 48 422 |
| Latvia | Poland | 16 | 177 | 484 | Denmark | Finland | 950 | 2 237 | 6 112 |
| Lithuania | Poland | 101 | 299 | 817 | Sweden | Finland | 2 920 | 3 430 | 9 371 |

*Assumption: Average gross domestic product growth in Russia, Baltic countries and Poland is 5%. Growth in other countries averages 2.5%. Calculations Mika Erkkilä, ETLA, January 1996.*

In any case the growth projections of table 5 can be used at least summarily to appraise the development needs of the infrastructure in the transport routes of the various states and at the frontiers. At the same time it is possible to assess the growing problems caused by the infunctionability of formalities in customs activities etc.

## 2.3 Direct Investments and Assessment of Their Development

In addition to exports, foreign direct investment is a sign of growing economic cooperation between countries. For the transition economies the foreign direct investment is necessary also as a source of investment funds because their own long-term capital markets do not function. Furthermore, direct investment provides companies with new technology and new marketing channels as well as marketing and management skills.

Table 6 presents how well the transition economies of the Baltic Rim have fared in the competition for direct investment. By following a liberal trade policy and implementing market economy reforms quickly, Estonia has been able to gain direct investments of USD 285 per capita, ranking second to Hungary. All in all the Baltic countries have improved their rankings in the investment list.

Over the long run it is presumable that Estonia, Latvia and Lithuania can obtain significant amounts of foreign investment if they follow a deliberate export-oriented strategy. Because of the small domestic market, investments will be carried out in these countries primarily with exports in mind. In order to be sufficiently attractive they will have to be able to offer a better location than competitor countries, stable environment, production factors competitive with respect to price and quality, unrestricted foreign trade as well as inexpensive transport and communications connections.

Russia is an interesting site for international investors owing to its vast raw material resources and its large domestic market. Many large multinational companies have decided to operate in its markets. Since Russia offers exceptional production possibilities, investors are willing to bear a great deal of uncertainty and pay higher costs for investing in the country.[5] On the other hand, the uncertainty has evidently been so great that the investment flows to Russia have been considerably smaller than the legal and illegal capital movements flowing out of Russia. While cumulative investments to Russia in 1992-1994 were USD 2.1 billion, Russian citizens and companies are estimated to have illegally invested USD 18.2 billion in securities and real estate abroad in 1994.

Of the countries included in the comparison, Poland has been able to attract the second least in direct investments per capita. It must nevertheless be assumed that the amount of foreign investment in Poland will grow because the economic development has got off to a good start and the markets are interesting because of their size.[6] On the other hand the bank markets are developing swiftly so that investments can be funded also from domestic sources.

[5] By making early investments a new brand name can be created in a market and strategic advantages can be procured via natural resources and exploration and development rights before competitors.
[6] Poland's industrial production has staged a sharp upturn, rising by 4.8% in 1992, 12.2% in 1993 and 14.5% in 1994. GDP growth was 2.6% in 1992, 3.8% in 1993 and 5% in 1994. In light of these growth figures the economic development has been the most positive in the Central and East European countries.

Direct investment also entails a transfer of human capital. There are no studies, however, upon which it would be possible to estimate, for instance, the annual investment flows. One example of human capital flows is offered by the inputs of Finnish entrepreneurs in Estonia. There are an estimated 5000 Finnish-owned companies in Estonia. It is estimated that some 1000 entrepreneurs work or hold management positions in these companies. The input of each is conservatively estimated at a value of USD 20,000 per year. This generates a figure of USD 20 million, which is approximately the same as Finnish investments in fixed assets in Estonia in 1994.

**Table 6. Foreign Direct Investments to Transition Economies**[7]

| | | 1992 | 1993 | 1994 | Cumulative 1992-94 | Per Capita 1992-94 |
|---|---|---|---|---|---|---|
| 1 | Hungary | 1 471 | 2 339 | 1 146 | 4 956 | 481 |
| **2** | **Estonia** | **58** | **160** | **253** | **471** | **285** |
| 3 | Czech Republic | 983 | 517 | 850 | 2 350 | 228 |
| 4 | Slovenia | 113 | 112 | 88 | 313 | 157 |
| **5** | **Latvia** | **43** | **51** | **155** | **249** | **92** |
| 6 | Slovak Repuplic | 100 | 156 | 187 | 443 | 84 |
| 7 | Turkmenistan | 11 | 104 | 100 | 215 | 55 |
| 8 | Kazakstan | | 473 | 330 | 803 | 47 |
| **9** | **Lithuania** | **27** | **61** | **60** | **148** | **39** |
| 10 | Albania | 32 | 45 | 53 | 130 | 38 |
| 11 | Croatia | 13 | 72 | 98 | 183 | 38 |
| **12** | **Poland** | **284** | **580** | **542** | **1 406** | **37** |
| 13 | Romania | 77 | 94 | 428 | 599 | 26 |
| 14 | Bulgaria | 42 | 55 | 105 | 202 | 22 |
| **15** | **Russia** | **700** | **400** | **1 000** | **2 100** | **14** |
| 16 | Azerbaijan | 0 | 20 | 50 | 70 | 10 |
| 17 | Moldova | | 14 | 23 | 37 | 9 |
| 18 | Ukraine | 170 | 200 | 91 | 461 | 9 |
| 19 | Kyrgyzstan | | 10 | 25 | 35 | 8 |
| 20 | Uzbekistan | 9 | 48 | 87 | 144 | 7 |
| 21 | Tajikistan | 8 | 9 | 12 | 29 | 5 |
| 22 | Belarus | 7 | 18 | 10 | 35 | 3 |
| 23 | FYR Makedonia | | | 5 | 5 | 2 |
| 24 | Armenia | 0 | 0 | 3 | 3 | 1 |
| | **Total** | **4 148** | **5 538** | **5 701** | **15 387** | **39** |

*Source: EPRD, Transition Report 1995, Investments and enterprise development, London 1995*

*Impact of Uncertainty on Direct Investments*

EBRD has investigated the investment barriers in the transition economies. According to their study unstable conditions in a country cause, among other things, a decline in the level of investment. Investors have almost always alternative investment alternatives. If uncertainty is deemed too great, it is better to invest in the certain alternative (so-called "wait and see"

[7] It should be noted that methods of registration of direct foreign investment in the countries of the Baltic region are different. These methods should be harmonised. In addition, it would be reasonable to present comparable data on foreign investments received as foreign loans.

option). One way to reduce uncertainty often used is to invest as little start-up capital as possible and finance future investments with internal financing.

If investments are made under uncertain conditions, they will not be made targeted in an optimal way. It may turn out that too much will be invested in services or low-tech industry, where money can be pulled out quickly and great amounts of capital are not tied up in investments. These distortions may have significant long-term effects. The country may end up on a growth path marked by undeveloped technology and low capital intensity.

Policies increasing uncertainty about the government can also significantly increase the costs of investment. These can be related to, for example, changes in tax rates or customs. The inability to suppress inflation has been shown to affect investments. According to the EBRD study, the lower inflation can brought down, the more the country seems to receive investments (EBRD 1995). High inflation affects, for instance, the profitability of companies via taxation. The effective tax rate under conditions of inflation is raised by, among other things, withholding taxes and regulations that force the subtraction of goods' and production inputs' historical costs from sales revenues instead of their replacement costs.

### *Direct Investment Growth Potential*

There are no theoretical models depicting the growth potential for direct investment. International examples nevertheless indicate that many small countries that do not have natural resources can obtain significant direct investments. For example, Singapore with a population of 2.9 million has received almost USD 7040 per capita in investments during 1992-1994. Costa Rica with 3.3 million residents has attracted USD 243 per capita in direct investment (Fias 1995). These together with the example of Estonia show that a small country seeking to break into export markets has possibilities to attract foreign direct investments.

### *Comparative Advantages of Baltic Rim Countries and Emerging Clusters of the Region*

The states in the Baltic Rim, located within a relatively small geographical area, exhibit significant differences in quality and prices of production factors. There are also significant raw materials available relatively nearby. The sea and transport infrastructure already in place enable relatively inexpensive transport for all industrial sectors. The region is also significant in terms of its consumer base, for which reason large companies have drawn up and implemented their own Baltic strategy.

The region boosts significant industrial concentrations such as the Nordic forest, basic metal, telecom and energy clusters. On the other hand, these countries possess know-how where competitive advantage is threatened such as the shipbuilding, construction materials, furniture, textile and clothing as well as food industries, where international competition is keen. Furthermore, the transition economies inherited significant scientific and technical know-how that has gone almost completely unused and threatens to go to waste. These factors are prerequisites for the emergence of strong Baltic Rim industrial clusters, where companies function in multinational networks and individual companies in several countries.

# 3. Institutional and Structural Barriers

## 3.1 Telecommunications and Other Communications Barriers

Telecommunications is a very important tool of foreign trade. Connections have improved considerably during the last couple of years as the networks of the East have been connected via new cable connections to the Western exchanges and mobile phone networks have come alongside phone line communications. The connections will improve along with digitalisation. The problem is still both the Baltic countries and Russian connections to the countryside and more remote parts of Russia. From the standpoint of entrepreneurs, a greater problem is the high cost of foreign and mobile phone calls. Investments in the telephone network are burdened by the fact that users are accustomed to free local service and rates that are too low considering the costs. A problem for new and foreign companies, for instance, is the insufficiency of direct lines and long waiting times.

In studies published in the summer of 1995, communications barriers were deemed to be one of the most important trade barriers (OECD 1995a, 1995b, 1995c). With the upgrading of connections, satisfaction has improved. Nevertheless the number of phones per capita is still low especially in Poland and Russia. In the St. Petersburg area the number of phones per capita is greater than in the Baltics owing to the former needs of the Soviet Union. The low number of phones per capita in Latvia has been offset by connecting phones to the same line, which causes problems in practice.

Table 7 presents the prevalence of phones, mobile phone and faxes in the Baltic Rim countries. Faxes are quickly replacing the telex in both Russia and the Baltic countries. Often times small companies cannot afford faxes, which posses a barrier to trade.

**Table 7. Telecom Equipment in Baltic Rim Countries**

| | Phones per 100 persons, 1994 | Mobile Phones per 1000 persons, 1994 | Telefaxes per 1000 persons, 1993 | Digitalisation rate, 1994 |
|---|---|---|---|---|
| Russia | 16,3 | 0,2 | 0,2 | 12,2 |
| Estonia | 29,4 | 9,1 | 1,5 | .. |
| Latvia | 27,5 | 3,3 | 0,3 | .. |
| Lithuania | 24,1 | 4,5 1) | 0,8 2) | 4,5 |
| Poland | 13,0 | 1,0 | 0,8 | 17,7 |
| Germany | 48,2 | 27,5 | 16,0 | 45,0 |
| Denmark | 60,0 | 96,8 | 35,7 | 53,3 |
| Sweden | 68,0 | 157,4 | 37,3 | 80,9 |
| Finland | 55,0 | 132,8 | 22,7 | 76,8 |
| **Total** | **27,9** | **16,6** | **6,7** | .. |

*1) Figure from 1995. 2) Figure from 1994.*

*Large need for investment*

Even if connections work, the number of users will grow and new technical demands and the deterioration of the old lines will require large investments in phone systems in the coming years. The Soviet Union neglected telecom investments in its last decade. For example, the digitalisation of the Baltic phone network is just now getting under way. Digitalisation will take at least 10 years.

In practice the local phone teleoperators do not have the means to make the needed investments and other local investment funds are directed toward activities generating revenues more quickly. Thus the countries will have to allow foreign operators that have the resources to carry out the initial investments. They will naturally have to get their invested funds back via earnings from phone users. This will succeed within a reasonable time and without placing an unreasonable cost burden on long distance and foreign calls only if the local service becomes a profitable business.

*Other forms of mass communication*

The quickness of postal deliveries has increased considerably. Sending a letter from one country to another take 3-7 days. For example, in Estonia the postal service has reached such dependability that mail-order firms are operating in the country. On the other hand, people do not dare send valuable materials such as computer diskettes and merchandise samples in the mail.

Cooperation may be needed in the Baltic Rim countries in the television and radio networks. In several countries the following questions will have to be addressed: 1) How can activities be organised efficiently and equitably? 2) What should be the policy toward unregulated business activities and foreign operations?

In the future the internet will be a significant factor. Already now Finland and Estonia are linked to a merchandise exchange network that can transmit information internationally on subcontractors able to manufacture various goods. The internet will form both an efficient information intermediation network as well as an international market place. Cooperation between the Baltic Rim countries will guarantee that now when many of the countries in the region renew their telecom networks, these future needs will be taken into consideration.

## 3.2 Problems in Transport and Border Infrastructure

The transport infrastructure would work fairly well for current flows of merchandise, but transports are slowed significantly by border formalities. The most serious problem is for deliveries that must be at their destination on a previously agreed upon time. Poorly functioning borders can be an insurmountable barrier for transport of perishable foodstuffs.

The goal in border formalities should be that new exporters or transport companies are able to easily take care of transport via any border station in the different Baltic countries. This would reduce transport costs directly and boost greater competition, thereby fostering trade somewhat. At the same time it would force forwarding agents to diversify toward services with real value added instead of their only special skill being able dealing with customs officials at border stations.

**Table 8. Average Waiting Times at Various Border Stations**

| **Russia** | Trucks | h | min. | **Estonia** | Trucks | h | min. | **Latvia** | Trucks | h | min. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Torfjanovka | 55 | 4 | 02 | Tallinn harbour | 10 | 1 | 22 | Ainazi | 3 | 3 | 15 |
| Brushnitsnoe | 52 | 4 | 05 | Ikla | 2 | 1 | 30 | Others | 1 | 22 | 00 |
| Svetogorsk | 3 | 1 | 13 | Tallinn, passenger | | | | *Latv. Average* | *4* | *7* | *56* |
| Nevel | 3 | 1 | 12 | habour | 2 | 1 | 25 | | | | |
| Uukuniemi | 2 | 0 | 12 | Others | 3 | 0 | 48 | Other States | 15 | 4 | 14 |
| Others | 11 | 41 | 07 | *Est. Average* | *17* | *1* | *17* | | | | |
| *Russ. Average* | *126* | *7* | *06* | | | | | **Total average** | 162 | 6 | 15 |

*Source: Finnish Ministry of Transport publication L2/96. The figures were was compiled from Finnish truck drivers in April 1995. According to the study, the waiting times for Eastern transport mean added costs averaging USD 1200 per truck per year. The combined annual costs were about USD 17 million.*

The average waiting times could be reduced significantly if information was compiled and published regularly. The information could steer the companies in this field toward faster border crossing places. In addition, competition between the customs points and closer monitoring of the upper officials could shorten the waiting times. The transport ministries of the governments could have this sort of benchmark studies carried out in conjunction with the firms operating in this field.

*Transit transport*

In addition to the sluggishness of the transit transport, there are also problems with various kinds of abuse. In order to prevent goods in transit imported into a country from staying there, normal tariffs may be charged on the cargo. The tariff is then rebated when leaving the country. Thus the international TIR-Carnet system does not work in practice.

Another way to prevent goods from being sold illegally in the transit country is to organise guarded escorts for transit deliveries. Transport firms and exporters regard the costs of guards and gathering of enough participants in the convoy as an excessive burden.

*Transport infrastructure investment needs*

As trade develops and in order to foster trade, investments in transport infrastructure are needed. In interviews the following investment needs were most often mentioned: 1) changing of harbours into two-way transport and elimination of bottlenecks, 2) upgrading of the deteriorating railways and 3) construction of an electricity transfer network.

## 3.3 Undeveloped Nature of Banking and Insurance Activity

The barriers to business activity caused by the undeveloped nature of banking activities are as follows: 1) lack of long-term investment financing - or that interest rates are very high, 2) lack of securities to back loans, because it is difficult to find assets under the control of companies that can be pledged as collateral, 3) bankruptcy risk of banks and 4) links between organised crime and banks. Intermediation of payments and money transfers are generally regarded as working smoothly, even though payments from the Baltic countries to and from Russia are slow.

*Shortcomings in long-term financing*

The poor availability of investment funding is a main barrier to development of the Baltic economies. The sorely needed investment financing is obtained as investments from western countries, privatisation and internal financing of companies. The loans intended for long-term investments in the Baltics and Russia come primarily from international credit institutes (World Bank, EBRD, NIB etc.). Their financing is market based financing intended for environmental protection or large-scale infrastructure projects. Estonia has been able to intermediate long-term loans on market terms to investors, which is regarded as a promising sign about the new development stage of financial conditions. In Poland the development of the financial markets has been especially swift. According to Salomon Brothers the Polish banking markets are some of the most promising ones in the world.

The main preconditions for development of long-term loan markets are belief in the stability of the currency, bringing inflation under control and a real interest rate within the limits of companies earning potential. The adjacent table depicts the situation in the economies of the Baltic Rim region with respect to these factors.

**Table 9: Value of Currency, Credit and Deposit Rates, Inflation**

| | Exchange Rate Regime | Inflation Rate, 1994 | Inflation Rate, 1995* | Deposit Rate, 1995 | Lending Rate, 1995 |
|---|---|---|---|---|---|
| Russia | Pegged within band of 4300-4900 Roubles per 1 USD | 203,0 % | 214,0 % | ~215% | ~220% |
| Estonia | Pegged to Deutschmark, 1 DEM = 8 Kroon, Currency board | 42,0 % | 28,4 % | 8,80 % 6) | 19,40 % 6) |
| Latvia | Informally begged to SDR. Base money fully backed by net international reserves | 26,0 % | 24,0 % | 14,70 % 9) | 35,00 % 9) |
| Lithuania | Pegged to US dollar, 1 USD = 4 Litas, Currency board | 45,0 % | 36,3 % | 21,90 % 9) | 27,30 % 9) |
| Poland | Pegged against a currency basket, band +- 7 %, crawl 1,2 % per month | 30,0 % | 24,2 % | 24,00 % 6) | 26,00 % 6) |
| Germany | Exchange rate mechanism | 3,0 % | 1,6 % | 3,85 % 6) | 11,00 % 6) |
| Denmark | Exchange rate mechanism | 2,0 % | 2,1 % | 3,80 % 3) | 8,40 % 3) |
| Sweden | Floating | 3,0 % | 0,9 % | 5,71 % 6) | 11,29 % 6) |
| Finland | Floating | 1,1 % | 0,3 % | 3,25 % 6) | 7,85 % 6) |

*3) March , 6) June and 9) September*

*Lack of securities to back loans*

A key problem regarding the availability of both long-term and short-term financing is the lack of assets that can be pledged as collateral. Because of uncertain ownership or lack of appropriate registers the property cannot be mortgaged. The possibilities of foreigners to obtain securities backing loans is limited by the prohibition against owning land, for example, in Lithuania and Russia.

Another serious problem is collection of debts. Since banks and lenders lack almost any possibilities to collect receivables pledged against payments, no-one wishes to extend credit except against very sound collateral.

*Bankruptcy risk of banks*

The bankruptcy of Latvia's largest bank Banka Baltica and the merger of Lithuania's two largest banks under a treat of bankruptcy indicate how large the risks associated with the banks can be. The uncertainty related to the banks hinders business activity considerably. People are hesitant to keep large sums of money in banks and companies divide their deposits among several banks to minimise the risks. At the same time the governments, for example, in Lithuania and Russia limited the number of bank accounts in order to be able to control them efficiently. This forces companies to use artificial arrangements such as setting up daughter companies and using them to diversify funds over several bank accounts. Both countries have subsequently liberalised these practices in 1995.

The elimination of bankruptcy risk in banks requires an advanced bank inspectorate. Sufficient capital adequacy requirements must be set and uncertain receivables written off promptly as credit losses. A fundamental part of the banking system is deposit insurance, which does not, however, have to be 100%. The Banka Baltica bankruptcy provides a good example that it is better for the state to promise depositors partial but sure protection than promise to reimburse funds deposited in poorly performing banks. It teaches depositors to take risks into consideration, but maintain faith in the system.

*Lack of competition*

The companies interviewed expressed the wish that foreign banks would open branches in the Baltic countries so that the costs of bank services and interest rates would decline. The bank experts interviewed felt, however, that the banking markets in Latvia and Lithuania, for instance, are still too unstable to allow the safe practice of banking activities. The opening of a bank geared toward foreign trade in St. Petersburg and Russia was deemed almost impossible because the bank must ensure from foreign trade documents that it payments are related to corresponding imports or exports. If this is not the case, the government can collect from the bank the same amount paid.

*Insurance activity in baby shoes*

Insurance activities are in the initial stages of development in both the Baltics and Russia. The local companies are just learning about insurance operations.

Many types of insurance are simply not available because there is an insufficient clientele to spread out the risks and the insurance companies own capital is completely insufficient to cover the risks. In many cases insurance is intermediated from abroad, so that the multiple risk increments make the insurance expensive. Those interviewed expressed the wish that foreign companies would establish a presence in this region in order to increase the supply of insurance.

**Box 1: Does the Mafia get Information from Banks and Officials?**

When conducting the interviews it was found that the banks and officials are suspected of forwarding information about firms to outsiders such as to companies selling credit information and to the Mafia. The latter was regarded as a particularly serious problem. In order to avoid revealing their sound financial situation to the Mafia, entrepreneurs avoid keeping large sums of money in banks and especially in only one private bank. The second focus of suspicion about leaks was tax officials. Companies suspected that persons belonging to Mafia groups are employed in the tax offices. There was speculation that these persons would forward information about companies that paid suspiciously little taxes, which could be used as a basis for blackmail.

## 3.4 Criminal Activity as a Barrier to Trade

Criminal activity is mentioned both in studies and in the interviews conducted as one of the most serious trade barriers. The most serious factors disturbing business activity were: 1) smuggling, 2) bribery of officials, 3) blackmail and collection of protection money and 4) crimes against property and persons.

It is paradoxical that in the short run criminal activity offers clear ways to prosper. In the longer run, criminal activity slows down business growth. The real competitive advantages of companies do now emerge because they are overshadowed by advantages gained by illicit means.

Furthermore, criminality is often associated with bribery, which erodes the ethics of civil servants. Both of these factors hinder the development of companies' activities: 1) Higher taxes and surcharges are levied on honest companies, so that the state can get revenues to provide necessary services for the common good. 2) Officials expecting bribes treat unfairly the honest companies that do not resort to bribes.

In the interviews conducted the companies emphasised certain ways by which they have been able to avoid becoming victims of crime. It is difficult for organised crime to clamp down on business that are complicated and require special know-how. Companies that take care of their payments to officials honestly and turn to the assistance of officials are difficult to blackmail. Large companies are not subject to blackmail and victims of requests for protection money or it is easier for them to avoid these kinds of companies than small ones.

*Smuggling*

A comprehensive assessment on the volumes of goods smuggled in the Baltic Rim countries has not been made. Even if one were carried out, its results would be at most rough estimates. A revealing look at the problem can be obtained from the adjacent table depicting the discrepancies in the bilateral trade figures of the Baltic Rim countries based on customs figures. Smuggling is an important reason for discrepancies but not the only one. (For more detailed information see Appendix 2).

The main reason for smuggling when the goods are goods that are legally marketable and purchasable is the benefit gained from avoiding tariffs and value added tax. Sometimes it may be a question also of assets, taxable income or illicit wealth being moved from one country to another. The aim here is under uncertain condition to keep property under ones own control, lower taxation or hiding the origin of assets obtained in an irregular manner.

The poor ethics of customs officials and low pay are often mentioned as important factors easing smuggling. Customs posts are often located in regions that are some of the more undeveloped and poorer ones in the country.

**Table 10. Differences in Countries' Imports and Export Statistics**

| Importing | Exporting Countries | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Countries | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic total |
| Russia | | 34,4 % | 27,6 % | 51,8 % | 1,2 % | 15,1 % | 24,1 % | 30,3 % | -5,8 % | 14,5 % |
| Estonia | 17,0 % | | 3,9 % | 17,0 % | 30,4 % | 0,1 % | -3,8 % | 25,2 % | 76,9 % | 18,3 % |
| Latvia | 54,1 % | 60,1 % | | 57,7 % | 15,1 % | 47,9 % | 34,9 % | 30,2 % | 32,2 % | 49,4 % |
| Lithuania | -27,6 % | 46,6 % | -17,6 % | | 17,2 % | 33,5 % | 13,5 % | 22,3 % | 13,3 % | 2,5 % |
| Poland | -28,7 % | 4,2 % | 48,3 % | 22,4 % | | 7,7 % | 9,1 % | -2,1 % | -6,0 % | 2,3 % |
| Germany | -52,3 % | -33,3 % | -155,5 % | -12,5 % | -2,1 % | | 23,3 % | -6,9 % | -9,6 % | -6,1 % |
| Denmark | -40,7 % | 12,0 % | -310,4 % | -114,8 % | -9,5 % | 5,9 % | | 7,5 % | -3,2 % | 3,7 % |
| Sweden | 11,1 % | -17,3 % | -243,4 % | -30,3 % | -4,2 % | 0,0 % | 15,4 % | | -0,5 % | 2,7 % |
| Finland | -5,0 % | 7,4 % | -33,1 % | -25,8 % | 1,5 % | -1,8 % | 26,1 % | 17,5 % | | 6,3 % |
| Total | -27,2 % | 17,1 % | -52,5 % | 26,7 % | -1,8 % | 6,4 % | 20,7 % | 2,9 % | -3,0 % | 2,5 % |

*The percentage differences in trade flows are calculated according to the following equation: Difference % = (value of exports reported by exporting country - value of imports reported by importing country)/exports reported by exporting country*

In order to eliminate smuggling, tariffs must be set at a reasonable level. From the standpoint of economic growth and individual welfare, tariff-free trade would be the desirable situation. This is ultimately the goal of bilateral and multilateral trade agreements. To the governments, however, tariffs constitute a source of revenues.

Appropriate measures to reduce smuggling would be:
1. Lowering of tariffs so that the incentives for smuggling decrease substantially and thereby increase state revenues.
2. Elimination of tax differentials between countries on both goods imported and manufactured domestically.
3. Keeping wages of customs officials on a competitive level, taking care of their training and equipment. Adequate compensation and training in ethics are not, however, sufficient. They require support from mechanisms to uncover abuse efficiently and sufficiently stringent punishment of offenders.
4. Cooperation between states (exchange of information, training and technical assistance) in monitoring of trade must be stepped up so that in addition to more efficient surveillance improvements can be made in customs routines.

**Box 2: Optimal Tariff Levels - Experiences of Mars Inc.**

Multinational Mars Inc. manufactures and exports candy, foodstuffs and pet food. In its export activities it faces various tariff levels in different markets. Tariffs affect also the investment decisions of companies. The company has come to the conclusion that for their products the state-revenue maximising tariff level is about 5-12%. Tariffs of this magnitude guarantee healthy competition in the markets of a country, which is a prerequisite of Mars for locating production in a country.

In a study by the company in 1993, it was found that goods that are easily sold will be smuggled if tariffs are raised over 10-12 per cent. Figure 1 depicts the connection between the market shares of smuggled goods and tariff levels in Central European markets. The government losses all revenues from smuggled goods. Tariff revenues dwindle also because the demand for legally imported products declines when tariffs are raised since prices rise (so-called price elasticity). The combined effect of these two factors is depicted in figure 2.

Figure 1: Black Market % vs Duty

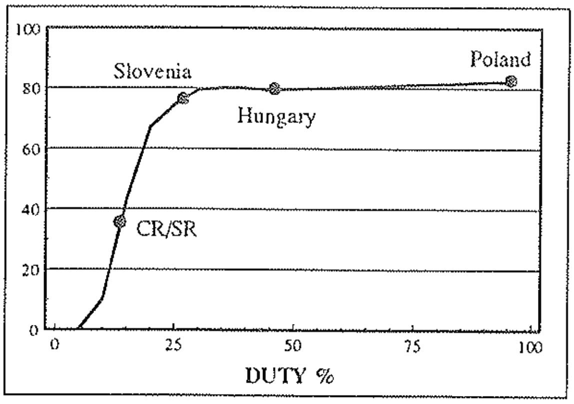
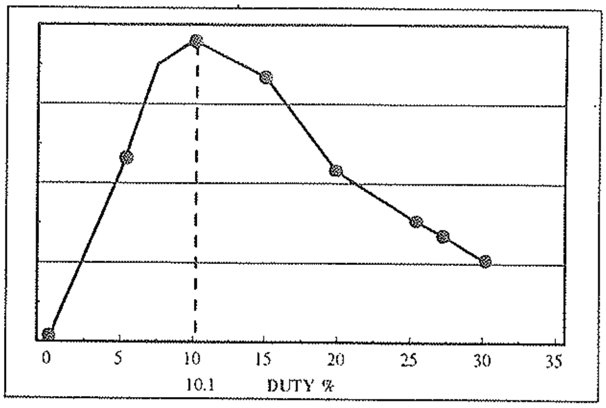



Figure 2: Government Revenue




*Smuggling spoils image:* Smuggling is deemed to pose a problem by Mars Inc. also because it spoils the product image of the company. In its legal exports Mars is able to ensure that the products offered to consumers are of good quality. This is not possible in the case of smuggled goods. Often, for instance, products found by consumers to be spoiled have, according to their bar codes, been originally sold to other markets. From there after the expiration date they have been smuggled to countries with high tariffs. Also the association of the products with the black market often in poor conditions, spoils the product image.

*Healthy markets prerequisite for investment decisions:* Mars Inc. assesses with the aid of exports whether the markets of a country are suitable for production. High tariff levels do not give the right picture of the actual markets and competitiveness of local manufacturing that must be known when making production decisions. On average, it is not worth making investments of USD 100-120 million based on competitiveness protected by high tariffs.

*Important conclusions for decision makers:* 1. There is an optimal level for tariffs. If tariffs are raised over this point tariff revenues will fall. 2. Foreign investments requiring tariff protection will not necessarily build competitive production.

***Source:** Jan Ahlskog, European Public Policy Advisers Ltd, Mars Inc. public relations manager in Baltic countries and Belorussia.*

# 4. Company-Related Barriers in the Transition Economies

During recent years competitiveness or the lack thereof on international markets has been studied by using Michael E. Porter's diamond model of competitiveness and the concept of clusters.[1] A cluster is a collection of companies operating in various industrial sectors or support units (such as universities or research institutes). In clusters companies create competitive advantages for one another via synergy and externalities. Both research organisations and companies accumulate new human capital for the needs of the cluster. According to the diamond model the most significant sources of competitiveness are 1) demanding client relationships foreshadowing trends in world markets, 2) strengths in research and related sectors, 3) comparative advantages in production factors and 4) sufficient competition and incentives for profitable activities in the various sectors of the cluster. Other important factors include the actions of the government.

Systematic studies of the transition economies in the Baltic Rim region have not been carried out. On the other hand, the competitive clusters of these countries are just in the beginning stage and therefore difficult to identify. The diamond model of competitiveness nevertheless offers a good framework for analysing the business environment of companies with respect to barriers appearing in connection with trade and other economic cooperation.

## 4.1 Customer Relations

Customer relations are undergoing profound change. In the socialistic production regime the lack of a price mechanism hindered important information links from clients to producers. Consumer preferences and willingness to pay did not determined what products were produced, in what proportions and nor the characteristics of the products. On the other hand, correct information was not conveyed to the consumer either about the production costs. Now the producer/consumer relations must be built from scratch, which will give a significant boost to the product development of these countries' enterprises and set efficiency requirements for operations.

The liberalisation of prices is still incomplete. For example, energy and fuel prices are still kept artificially too low. The low production inputs give companies competitive power in the short run. Over the long run, they constitute a competitive barrier, because it is not worthwhile investing in technology to boost production efficiency or save energy. At the same time other countries invest in competitiveness-bolstering technology.

As a consequence of the lack of the price mechanism there was no need to build a distribution channel or invest in marketing. Now the lack of competent marketing personnel and marketing support is deemed by companies to be one of the greater barriers to trade. Companies have been quickly set up in order to take care of marketing tasks. These services nevertheless still

[1] For example, competitiveness studies have been made using this framework on the four Nordic countries Denmark, Sweden, Norway and Finland. The main results are published in: Sövell, Zandler, Porter: Advantage Sweden; Moller, Pade: Industriel Succes, Konkurrecefactor i 9 danske brancer; Reve, Lensberg, Gronhaug: Et konkurrancedyktig Norge; and Hernesniemi, Lammi, Ylä-Anttila: Advantage Finland - the Future of Finnish Industries.

have shortcomings. For example, the buyer of services has to procure services themselves from different suppliers. On the other hand, companies do not have sufficient skills and economic resources to use the services that are available. Instead of market research, mere company lists with contact information are ordered. Neither is the credibility of future trade partners checked out ahead of time. In addition, there are difficulties in fulfilling packaging requirements, sufficient labelling on product contents, adherence to hygiene regulations and with respect to consumer protection and product liability regulations (Saks 1995a, 1995b, 1995c).

One of the most significant results of the Nordic competitiveness studies was the simple observation that the clients of companies in clusters were to a significant extent other companies, not ordinary consumers. Customers buy machinery and equipment needed in production, raw materials, intermediate goods, maintenance service and consulting, etc. The strong growth in the consumer markets currently and the uncertain investment conditions perhaps steer the business activity too much toward the consumer markets and prevent development of inter-company business activities.

An important element in developing marketing is training, which facilitates understanding of the relations between producers and end-users. In training regarding marketing skills, attention must be focused on marketing related to the needs of the clients. In sales promotion it is important to gain feedback from clients as a basis for product development. The marketing personnel serving corporate clients must have a thorough knowledge of technology so that when selling products other arguments than prices can be used such as performance, reliability, cost savings and to ensure that user requirements are passed on to product development.

The government can in conjunction with other countries strive to implement uniform hygiene, product content, packaging and safety requirements, etc. in order to promote the competitiveness of their companies. Often, for example, in the Nordic countries there has been a deliberate policy of seeking to predict trends and implement somewhat more stringent regulations than on average in the export markets in order to force their own industry to gain competitive advantages.

An important factor fostering competitiveness is consumers with demanding requirements and that demand foreshadows world market trends. The exacting nature of consumers can be promoted, among other things, by developing consumer protection and allowing import competition. In the Nordic competitiveness studies it was found that many companies deliberately seek to choose certain clients or client groups as key clients with which operations can be developed and improvements made in products. Being able to foreshadow demand has been a significant competitive advantage, for example, to the Swedish and Finnish mobile phone industry. Also the government can act as a demanding customer fostering development in industry and offer reference possibilities for manufacturers of new innovative products.

## 4.2 Support and Related Industries

Competitive clusters typically have strong support and related industries and closeknit networks with companies in different industries. For example, the Danish food industry benefits from biotechnology companies that serve also the pharmaceutical industry. The Finnish and

Swedish forest industries have given birth to a robust paper machine and pulp equipment industry and bred talented consultants that are now essential for the competitiveness of the forest industry. The Nordic countries are witnessing swift growth in telecommunications and telecom subcontractors, with the next emerging field being companies exploiting technology in service production.

No sophisticated production process can function in an isolated fashion. It requires an infrastructure with, on the one hand, companies in support and related industries promoting special competitiveness and, on the other hand, service companies indispensable to all companies such as law firms, telecommunications and delivery services. This lack of infrastructure in many cases prevents western companies from investing in transition economies. For example, in all Baltic countries there are plans to erect pulp plants. It is not worthwhile, however, to build plants if forestry and logging, delivery, water purification etc. are not organised efficiently enough. According to experts new paper and pulp plants will be built in Russia only in places where there is a production infrastructure already in place.

The socialistic economy had an infrastructure. It is not optimal in the current situation for the following reasons: It was concentrated upon products that were not based on market demand. It was too tightly vertically integrated. The production chains were long and individual parts might be supplied by only one large-scale manufacturer, so that there was a lack of competition. The vulnerability of the chain was exacerbated by the tendency to stick to their own technological systems. Many of the plants were located over too wide an area because there was no need to be concerned about transportation costs and prompt delivery times. It is difficult to reorganise the remnants of the production chains into a well-functioning system.

What are the prerequisites for erecting a well-functioning infrastructure in the transition economies? This evidently requires a clear strategy by the government regarding which fields they wish to emphasise in the future. It can be based on the analysis of existing and emerging factors of competitiveness. A clear strategy can bring about investment decisions that support one another, without which it is difficult to develop industrial clusters. While it is difficult for a country to create its own clusters, it may be prudent to follow a complementary strategy of linking industries to the clusters of neighbouring countries.

## 4.3 Production Factors

Production factors can be divided, on the other hand, into inherited and created factors and, on the other, into generic and specialised production factors. Inherited production factors are, for example, forest resources, ores and other minerals as well as arable land. Created production factors include advanced telecommunications infrastructure, manufacturing plants as well as advanced education and research organisation. Generic production factors are, for instance, inexpensive financing for investment or labour with a basic education. Labour with special training or financiers specialising in certain industries can be regarded as specialised production factors.

The Baltic Rim countries are at a historical cross-roads, in the respect that in a narrow geographical region there is a wide range of competitive production factors in all of the above-mentioned types of production factors. This assessment nevertheless applies only to the region as a whole. In individual countries there are significant shortcomings in the production factors. The exploitation of comparative advantages would require wide-scaled economic cooperation.

The shift from planned to market economies has dramatic ramifications for the production factors in Russia, the Baltic countries, Poland and former East Germany:

- Many of the specialised production factors have lost their value as their products are no longer good enough for the markets. Areas facing obsolescence include those whose products are based on technology differing radically from western technology or plants manufacturing military equipment and their employees.
- The general financial systems, the government's ability to take risks in financing as well as collective liability arrangements for accidents and natural disasters for the most part disappeared, while market-base financial institutions and insurance institutions have not developed enough to fill the void.
- The education and research system experienced a crisis, because the demand for their trained graduates and their research results collapsed. Many university teachers and research institutions have switched vocations.
- Many raw materials may lose their significance as production factors if the products made from them are shunned because of concerns over environmental protection.

The transition economies of the Baltic Rim still have competitive advantages in production factors. Russia is regarded as one of the richest country in the world in terms of raw materials. All of the countries in the region have timber in excess of their own needs. The price/quality ratio for labour is high and the labour force has demonstrated to be fit for generic tasks. The infrastructure functions fairly well. Furthermore, industrial traditions are strong.

The problem in the short run is to get the former state companies to commit themselves to using production factor resources efficiently. For example, in light of the experiences of Poland, this has succeeded best in those companies that have a foreign owner. Foreigners have been willing to invest capital and offer ready-made marketing channels, as well as assisting in the company's management and product development. In many cases the company has been reorganised so that the old management has retained its position and employees have been willing to give up their control to the management.[2]

Over the long run the financing for universities and research institutions should be safeguarded and tight connections with companies built. During the days of planned economies companies did not have their own R&D activities in practice, but rather separate research institutes were responsible for this. Trained persons were employed automatically. Now the division of labour has changed to be the same as in other Baltic Rim countries. Industry is founding its own R&D units and providing advanced training for its own labour force in its areas of core knowledge. Society is responsible for providing a basic education and retraining of the labour force as well as basic research. In addition society is needed for investments in generic technology areas regarding education and research and risk financing for new technology.

[2] In Poland the administrative bodies of the employees previously controlled the company's management. As compensation for giving up power, the employees initially had the right to obtain 20 % of the companies' shares at half price and subsequently a 15 % of shares without charge.

## 4.4 Competitive Conditions

The profit motive enabled by private ownership and competition as a means for earning profits play a key role in market economies. Sufficient domestic competition is an important factor of competitiveness in Porter's diamond model. Companies in the same country operate under similar conditions. They are taxed according to the same principles. Their unit labour costs are of the same magnitude. In the export markets they face uniform exchange rates, etc. Under these kinds of conditions a company performing poorly must compare itself to those that succeed. This spurs actions to develop production and new innovations.

In socialist economies there is a glaring lack of competing companies. For this reason domestic competition cannot be fostered merely by transferring the ownership of old plants and companies into private hands. There is a need for reorganisation of companies and opening of domestic markets to foreign competition. Foreign competition, for example, in heavy industry may owing to the thin company structure be the only practical solution but it is probably a sufficient condition for safeguarding competition. Competition is arising quickly in the service sectors in the transition economies, but in manufacturing the renovation of business activities is just getting under way.

The privatisation process has proven to be difficult in manufacturing in a way that fulfils all of the main objectives. The main goals are often rapid privatisation in order to foster growth, sufficient new investment, employment-promoting capital investments, accumulation of state revenues and provision of compensation for production equipment to the former owners, i.e. the employees. The adjacent table presents the current stage of privatisation in the transition economies of the Baltic Rim.

From the perspective of business development and probably also welfare, it will be important for three incentive-boosting features to strengthen:

- A company should have clear owners that are interested in the growth of profitability and sales revenues
- The owners of the company should be able to offer the companies support other than mere financing, such as management, marketing and product development investments
- The actual management as well as the employees should participate in expanding operations and boosting profitability

These goals will be best reached if foreign investors are allowed similar rights as domestic investors. In some cases it will be reasonable to hold companies as a public property, for example if the exceptional large or risky investments are needed or some special functions are given to companies.

Companies continuing from the socialist period own a lot of cultural and sports facilities, day-care centres and recreational centres. Many investors regard these as an excess burden on the costs of business activities. The problem is solved in many cases by transferring these facilities to the control of local government.

**Table 11. Privatisation in Russia, Baltic States and Poland, situation in 1995**

**Russia**

The private sector is likely to account for about half of Russia's GDP. By July 1994, 15,052 medium and large-scale enterprises, employing more than 80 per cent of the industrial work-force, had been privatised in a voucher-based privatisation scheme. The second, cash-based phase was finally accepted and activated September 1995. State shares of 140 key enterprises was planned to be sold before the end of the year 1995. However, the original target to rise over 9,000 billion Rb in privatisation revenue in 1995 was likely to be missed by a large margin. For 3,054 "strategic enterprises", including mainly large energy, defence utility companies, majority state ownership is to be retained for at least two to three years. According to estimates 43 per cent of the shares in privatised companies are owned by workers, 17 per cent by management and 11 per cent are distributed by investment fund, foreigners and domestic individual investors. By mid-1995 more than 100,000 small businesses had been transferred into private hands. The overwhelming part of these were in retail trade, public catering and consumer services sectors. Small firms have been sold primarily through employee buy-outs or public auctions.

**Estonia**

The private sector accounted for 49 per cent of industry and 65 per cent of GDP. Virtually all large enterprises have been privatised except those in the transport, telecommunications and energy sectors. The privatisation strategy has been based on the East Germany Treuhand model. Privatisation of small enterprises (e.g. shops, other services and farms) had been largely complied through employee buy-outs and auctions.

**Latvia**

The private sector share of GDP is estimated to be under 60 per cent of GDP. Large-scale privatisation is still lagging behind other areas of reform. The privatisation programme emphases international tenders and public offerings of shares. The first international tender of 45 large enterprises were offered to the public under a pilot programme in January 1995. The privatisation of small enterprises in the service and trade sectors is almost complete, with significant foreign participation, mainly from Scandinavia and Germany.

**Lithuania**

The GDP share of the private sector is estimated to be about 61- 63 per cent. The first phase of the ownership transfer involved 6,700 enterprises, 84 per cent of which had been privatised by the end of June 1995. Originally only voucher privatisation had been envisaged, but some cash auctions have also taken place. Preference has generally been given to employees and management. Foreign citizens, joint ventures and firms with foreign capital cannot own land, which have prohibited their participation in the privatisation.

**Poland**

Private sector share of GDP rose to 56 per cent of GDP and of 61 per cent of employed. Under two main privatisation tracks, enterprises can be liquidated and their assets sold, leased or transferred to a new private company, or they can be commercialised (for examples through conversion into joint-stock companies). By end-1993 more than 2,000 of the 8,841 large enterprises owned by government were privatised. In 1994, 321 enterprises were privatised and 244 were commercialised. In 1995, after the long delay the voucher-based mass privatisation programme got under way and 413 enterprises were allocated to national investment funds. Most small retail, wholesale and construction enterprises (20,000) were privatised by local governments early in the reform period.

*Source: EBRD, Transition Report 1995, Investment and enterprise development, London 1995*

## 4.5 Business Ethics

From the standpoint of competition, business ethics play a key role. Juuso Salokoski, EBRD's representative in the Baltic States, sums up the situation as follows: "The development of transition economies will be solved in private companies. Increasing numbers of companies will have to make decisions about operating according to ethical standards. From the standpoint of the company that decision is often worthwhile, since honest business activities open the road to higher profits over the long run. Foreign companies hold the key in his respect. They will have to set a good example even under difficult conditions."

**Box 3: Views of Finnish Entrepreneurs on Russia and the Baltics**

In the summer of 1995 a study was conducted on the views of Finnish companies exporting to or operating in Finland's neighbouring regions regarding the business environment in the Baltic countries and Russia. Some 122 responses were obtained, representing a response rate of 34%. The average firm responding to the questionnaire had exported FIM 19.5 million worth of goods to the neighbouring regions, the median being FIM 6.5 million and the maximum FIM 170 million. The companies operating in the neighbouring region differ from the typical Finnish export companies. There are firms of all sizes and very different industrial sectors. Many of the companies seeking to enter the Russia and the Baltic markets have almost no previous experience in exports. Especially among the ranks of the small companies there those that have specialised in exports to neighbouring regions. Part of the firms kept their share of exports to the region low owing to the risks involved.

*Estonia Safe, St. Petersburg has Great Possibilities and Risks*

The entrepreneurs were asked their opinion of the business environment in Estonia, the other Baltic countries, St. Petersburg and the rest of neighbouring Russia. The results appear in the adjacent figures. The business environment of Estonia is for the most part satisfactory and it is believed to improve in the future. The problem is deemed to be the increasingly keen competition and the expected rise in the cost level and dwindling of sales margins. These complaints means that the economy is growing and the markets are working. There is room and expectations for improvement in legislation, financial activities and transport. As regards organised crime Estonia has reached a crossroads. The decisive actions of officials and development of business ethics could bring about rapid improvement.

The impression of entrepreneurs about St. Petersburg were considerably gloomier. Legislation and its interpretation in practice was mentioned as one of the more complicated barriers to business activities. The laws are disorganised and change often. There is a shortage of personnel that knows the law and even the officials do not know the laws well enough. The unpredictability of changes in laws, orders and fees is deemed to be a grave problem. Other significant barriers to business activities in St. Petersburg are customs, the activities of officials and financing arrangements. Financing and legislation are intertwined in the respect that without proper property protection laws and investment protection it is difficult in practice to find any property suitable as collateral. Taxation is regarded as heavy: in extreme cases taxes can be higher than profits. When taxes are raised more local companies leave them unpaid. This means a tightening of taxation for those paying taxes. Crime is also a problem with no improvement in sight.

Latvia and Lithuania are considered to be more difficult environments than Estonia, but easier than Russia. Companies have less trust in the Latvian and Lithuanian legislation than that of Estonia. The financial markets and bank connections work worse than in Estonia. Many factors such as the business environment are nevertheless expected to improve. The impression of the business environment in neighbouring Russia is relatively similar to that regarding St. Petersburg.

The firms are trade agents and they make investment decisions. These kinds of studies give valuable information to the decision makers of various countries. They should be done regularly and in the same fashion with entrepreneurs from several countries.

***Source:*** *Antti Piispanen, Business Potential for Finnish Companies on the Eastern Baltic Rim (in Finnish), ETLA C 72, Helsinki 1996*

Figure1: Business Environment and Development Outlook in St. Petersburg and Estonia

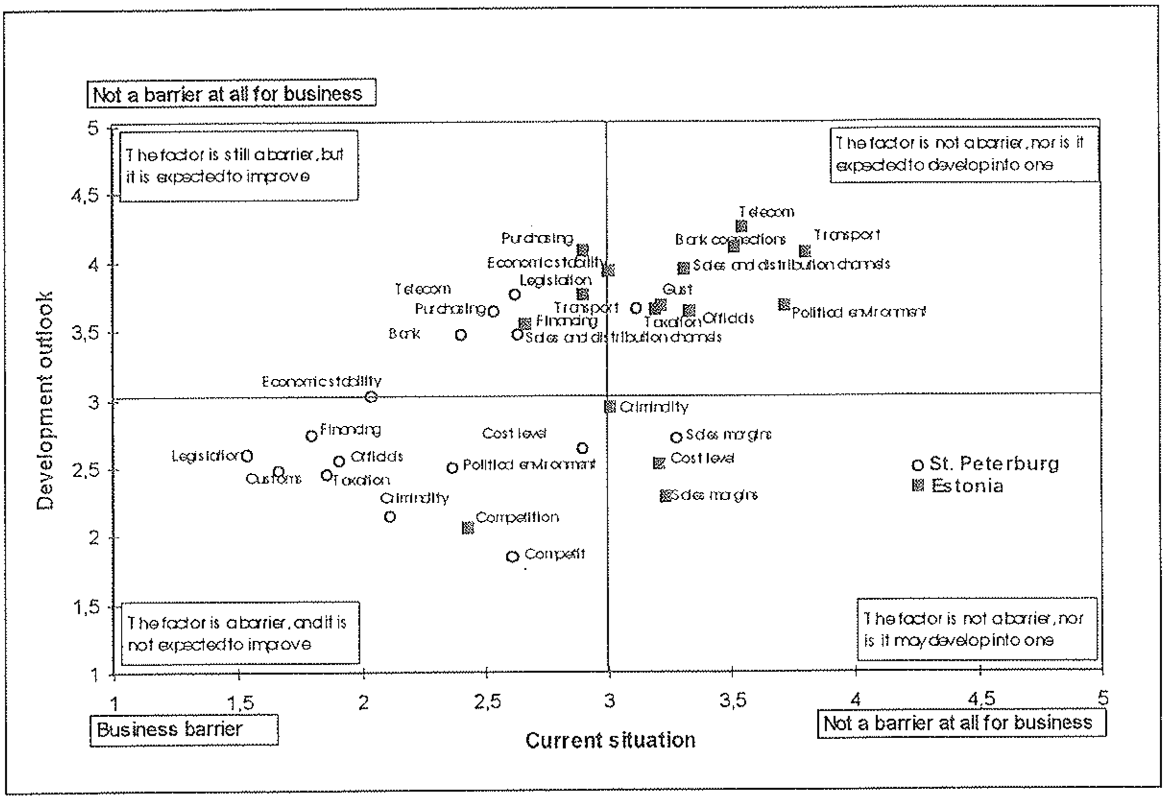
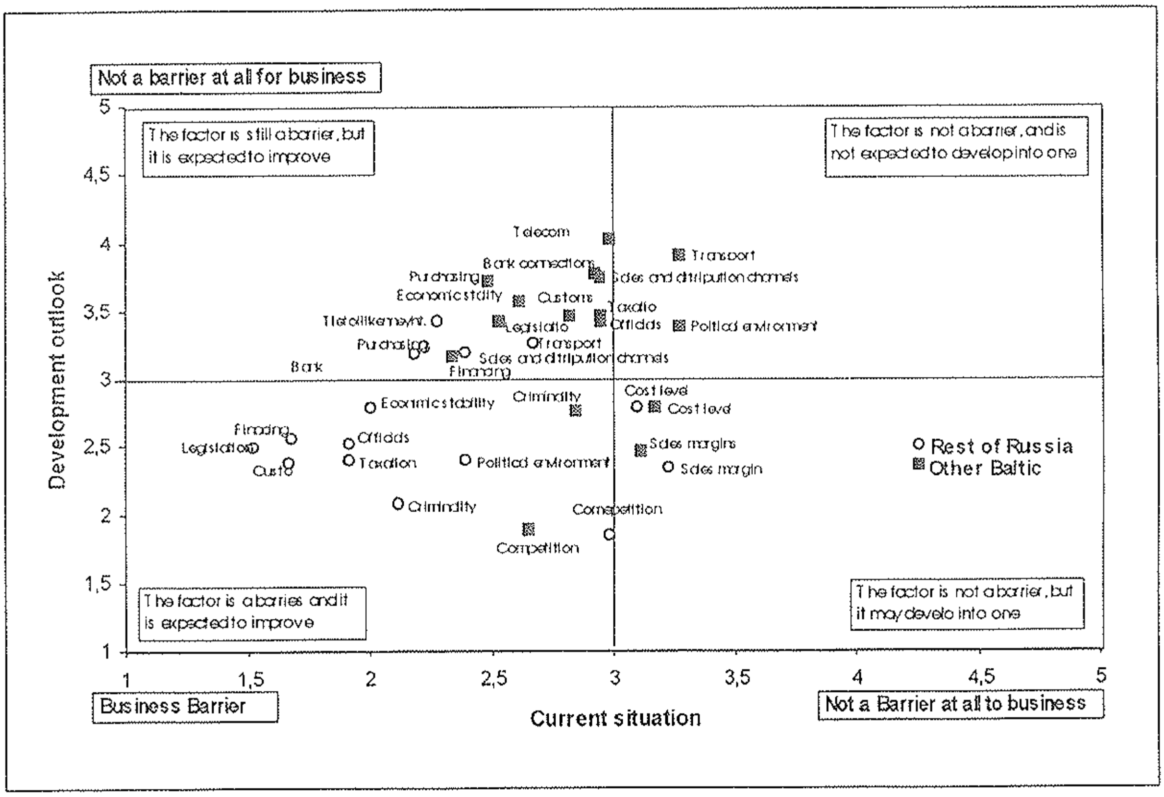



Figure 2: Business Environment and Outlook in Rest of Russia and Baltics



# 5. Treaty Environment

## 5.1 Shortcomings in Mutual Treaties of Baltic Rim Countries

*Treaties between Baltic Countries and Russia*

Shortcomings in treaties have constituted a significant barrier to trade between the Baltic countries and Russia as well as for the Baltic countries' pronounced reorientation of trade relations toward the west.

*Treaties between Baltic Countries*

A free trade agreement between Estonia, Latvia and Lithuania went into effect in April 1994. The agreement is aimed at creating a free trade zone for the 8 million residents of the area. The agreement calls for the abolishment of tariffs on imported manufacturing goods. In certain instances, it is nevertheless possible to levy duties on exported products, and quotas can be imposed on imports and exports of certain "sensitive" products. Agricultural products were not included in the free trade agreement.

In practice the agreement has not yet brought the desired effects. In the intra-regional trade the most important goods are still petroleum products and electric energy imported from Russia. A division of labour between the countries where each would use its own comparative advantages has not yet formed or begun to emerge with respect to other goods.

There are several natural reasons for the smallness of trade between the Baltic countries:
- The comparative advantages of the countries are rather similar. Thus it is not possible for strong trade relations to form immediately. For example, the comparative advantages of the Nordic countries differ so much from those of the Baltics that intra-regional trade is undergoing robust growth.
- Another factor is the countries' small GDP and low income per capita. From this perspective it is natural that the trade between these countries is not necessarily high yet. [1]

On the other hand, the mutual trade is limited by two important factors that could be changed immediately by government action:
- Despite the free trade agreements Latvia and Lithuania levy tariffs. Estonia, in contrast, practices a very liberal trade policy. In addition to the fact that different tariff levels hinder the development of trade directly, they divert some of the trade into smuggling. Goods are exported to Estonia, from where they are smuggled to the markets of the other Baltic countries. If free markets really worked, the Baltic countries would be considerably more attractive investment targets in the eyes of foreign investors.
- Another concrete factor is the omission of agricultural products from the realm of free trade. It is precisely agricultural products and foodstuffs where intra-regional free trade and the consequent competition should work. Agricultural products and the food industry are some of the potential areas where the Baltic countries can in the future compete in broader export markets. Now intra-regional competition should be given a chance to work. The

[1] See calculations on the magnitude of trade potential and actual trade on page 7.

proximity of free markets with eight million residents and the export markets of the CIS countries could spur the formation of strong food industry companies. At their disposal they would have producers competing intensively without subsidies.

The Baltic countries should harmonise their tariffs externally and shift to completely tariff-free regimes in intra-regional trade. In the case of goods such as tobacco, alcohol, etc. taxes of the same magnitude could be levied on goods produced outside the region as are levied on the domestic industry's output. The countries would have to impose the same import protection on imports of agricultural goods, which would mean a rise in Estonia's tariffs and possibly a decline in Latvia's and Lithuania's tariffs.

Harmonisation and intra-regional free trade would reduce the costs of monitoring frontiers between the countries and more resources could be steered toward improving the customs control for the external borders of the free-trade zone.

From the standpoint of developing trade the agreement between the Baltic countries regarding visa-free travel is important. The citizen of these countries can travel in other Baltic countries without a visa, but travellers must have a valid passport. In the same connection the countries have agreed that the citizens of 32 other countries, primarily in Europe, can travel with a valid visa for one Baltic country in all of the Baltic countries. This agreement greatly eases the business travel and transport of goods in the area.

## 5.2 EU and Impact of its Integration Treaty

*Russia*

The European Union has set out a strategy for Russia. It recognises the special status of Russia and sets as its goals the maintenance and development of economic and political relations. The EU seeks to promote Russia's democracy aspirations via support programmes, strengthens economic cooperation and consolidates cooperation in legal and social policy questions in the framework of partnership and cooperative agreements and fosters defence and security policy debate. At the same time the EU is increasing its economic and political cooperation with other CIS countries and promoting the relations between CIS countries.

The trade relations between the EU and Russia have been agreed upon with a temporary agreement that goes into force on February 1, 1996. The temporary agreement covers only trade in merchandise. Closer cooperation is to be promoted via partnership agreements, which the Russian parliament and certain EU member countries have not yet ratified. The EU and Russia are currently negotiating various kinds of trade agreements for certain industrial sectors. This kind of an agreement has already been made for the steel industry. Furthermore, the EU and Russia have agreed (July 17, 1995) upon giving each other most favoured nation status, which will in some respects ease access to each other's markets.

*Poland*

Poland signed a trade and cooperation treaty with the EU already on Sept. 19, 1989. The five-year treaty offered most favoured nation status and gradually phased out quantity restrictions from exports of Polish goods to the EU. Poland signed the European Agreement in 1991 and it went into force on April 1, 1994. The agreement was implemented in practice, however, with a temporary agreement already starting on March 1, 1991. According to the agreement the free-trade zone will be implemented in some ten years' time by abolishing tariffs and surcharges on trade between the EU and Poland. The European Agreement includes stipulations on the mobility of labour, trade in services, capital, competition etc. Economic cooperation within the Phare programme was also agreed upon. Poland has applied for EU membership.

During the five-year period of 1995-1999 Poland will receive support worth ECU 1 billion via the Phare programme. Polish officials have set its most important goals as being harmonisation of Polish laws with EU legislation, development of the infrastructure, upgrading of facilities at border crossings and regional development.

*Baltic countries*

The Baltic countries and the EU have concluded agreements of association, the aim of which is to foster the development of the Baltic countries into market economies. The agreements include provisions regarding the establishment of companies. The European Parliament has approved these association agreements signed with the Baltic countries on June 12, 1995. They will go into force when the parliaments of the Baltic and EU countries have ratified the agreements. Estonia and Latvia have already approved the treaties. Ratification of the treaty has for the time being been impossible, since the constitution does not allow foreigners the right to own land. Since freedom to own land may obstruct Lithuania from joining the EU, the parties of the country have agreed that foreigners will be given the right to own land as will Lithuanians. In Estonia's case the treaty went into effect immediately, while the Latvian transition period extends to 1999 and Lithuania's to the year 2001. The Baltic countries and the EU have previously signed a free-trade agreement that went into force on January 1, 1995. In actuality a gradual shift toward free trade began already then.

## 5.3 Other International Agreements

*Russia*

The reorganisation of the economic relations between Russia and the other CIS countries has progressed slowly. This is partly the result of the continual shrinking of trade between CIS countries (28 % in 1993, 26 % in 1994 and 10-12 % in 1995), which dampens the interest in economic cooperation. Another problem is the unpaid energy bills of many countries to Russia, which totalled some USD 3 billion at the end of last year (RUR 14,100 billion). This does not give a good negotiating position to the indebted CIS countries. An important barrier to development of cooperation is that integration is deemed a threat to the new-found independence of these countries.

Russia has drafted legislation on state regulation of foreign trade. The legislation sets out Russia's priorities in trade and domestic market protection mechanisms. It also makes the necessary legal provisions for Russia's joining the World Trade Organization (WTO). Russia's trade barriers can probably most efficiently be eliminated in conjunction with WTO membership negotiations and talks between Russia and the EU.

*Poland*

Poland is one of the Visegrad countries participating in the Central European Free Trade Agreement (CEFTA), which went into effect on March 1, 1993. At the present time CEFTA includes Poland, the Czech Republic, Slovakia and Hungary. The free trade agreement between these countries is a framework agreement. The concrete agreements for removing barriers have been made between the respective countries.[2] The agreements also differ from one another. The countries were originally supposed to shift to free trade by the year 2001, but in 1994 the countries agreed to move up the timetable, with the barriers on industrial goods being abolished already by January 1, 1998.

CEFTA applies to trade in manufacturing goods and only partially to agricultural goods. Manufacturing goods are divided in the bilateral agreements into various categories, the tariffs upon which will be phased out according to different schedules. The countries initially agreed regarding agricultural products that tariffs would be lowered by 20-50% in a framework for certain quantities. The aim is now completely free trade in many products by Jan. 1, 1998. Agreement was reached on this point after multilateral talks, marking a new stage of development in the CEFTA history.

Slovenia, Romania and Bulgaria are joining the CEFTA countries.[3] The Visegrad countries have also asked the Baltic countries about joining CEFTA. Changing the CEFTA into a genuine free-trade zone would require harmonisation of the various country's tariffs to be uniform with respect to external countries. After this, once goods have entered the free trade zone they would enjoy free mobility within the zone. If agreement on harmonisation is not reached sooner it will take place at the beginning of 1998, when tariffs will be abolished completely.

The role of CEFTA from the standpoint of the Baltic Rim countries belonging to the EU is important in many respects: 1) From the EU's perspective its task is to hasten the development of the countries making them fit for membership, 2) after a transition period starting in the beginning of 1998 it will constitute a genuine free trade zone, 3) it will make the countries familiar with the groundrules of free trade.

*Baltic countries*

The Baltic countries signed a free trade agreement with EFTA[4] on December 7, 1995 based on the cooperative agreement of 1991. The free trade agreement applies to manufacturing goods, processed agricultural products and fishing. It also pertains to regulations on competition, activities of state monopolies, state aid, and copyrights as well as new country-of-origin rules. with respect to Estonia and Latvia the agreement does not include a transition period. Lithuania in contrast has agreed that the tariffs on certain manufacturing products will be phased out by the beginning of the year 2001. Trade in agricultural products has for the time being been agreed upon in bilateral agreements. EFTA has also engaged in talks on these goods, but agreement has been hindered by differences in the economic policies of the Baltic countries.

Estonia, Latvia and Lithuania have applied for membership in the WTO.

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[2] In actuality the countries made six bilateral agreements as the Czech Republic and Slovakia function as one counterparty, since they have a customs unions with one another.

[3] Slovenia has already made an entry decision. It will become a CEFTA member as of January 1, 1997.

[4] EFTA currently consists of Switzerland, Liechtenstein, Norway and Iceland.

**Table 12. Key Trade Agreements Concerning Baltic Rim Countries**

**European Union (EU)**

Germany, Denmark and from the beginning of 1995 also Sweden and Finland belong to the EU. The single European market was introduced on Jan. 1, 1993 and the European Economic Area was formed Jan 1994. Countries are integrated in ways which go far beyond duty-free treatment of industrial goods.

**Central European Free Trade Area (CEFTA)**

CEFTA includes Poland from Baltic Rim Countries. Other "members" are Czech Republic, Slovakia and Slovenia (from Jan. 1, 1995). Actually there are general framework agreements and concrete bilateral agreements between the countries. The aim is to shift to free trade in industrial products and several types of agricultural products starting on Jan. 1, 1998.

**Baltic Free Trade Area**

A free trade agreement between Estonia, Latvia and Lithuania went into effect in April 1994. It includes the free trade of industrial products but not agricultural products.

**Europe Agreements**

The Europe Agreements establish bilateral associations between each of the European countries and the EU. They cover harmonisation of legislation, economic co-operation, financial and political and cultural co-operation.

- The agreement with Poland was signed in 1991 and it went into force in 1994. According to agreement the free trade area will be implemented in ten years.
- The Europe Agreements with three Baltic states were signed in 1995. There are short transition period for Latvia and Lithuania but none for Estonia because of its rapid progress of economic and political reform.

The preparation of Central European and Baltic countries for EU membership is supported within the framework of the Phare Programme.

**Agreements between EU and Russia**

EU and Russia have a temporary trade agreement that went into force February 1996. It covers only trade in merchandise. Closer co-operation is to be promoted via partnership and co-operation agreements, which have not yet been ratified. The EU supports the advancement of Russian democracy within the framework of the Tacis programme.

**World Trade Organisation (WTO)**

Russia and Baltic states are negotiating to obtain membership in the WTO. Poland is a member in the organisation.

# 6. Recommendations on Abolishment of Barriers to Economic Cooperation

## 6.1 Critical Barriers

The trade between the Baltic Rim countries is growing very quickly, at a rate of around 20 per cent a year, which clearly exceeds the growth in trade with other countries. The swift growth is primarily a result of the low starting level. Abolishing trade barriers could provide a boost to growth. According to calculations on potential trade, the mutual trade of the Baltic Rim countries could be 80 per cent higher than nowadays if it were as high as normally prevails between countries located within a corresponding proximity to one another and with population and income levels of comparable magnitude.

The internationalisation process for companies in the region is just at the onset. The barriers with respect to locating operations in another country are still greater than barriers to foreign trade. Cooperation in production, i.e. the emergence of competitive business clusters, has yet to begin in the Baltic Rim. The growth in foreign trade between these countries, direct investments by companies and emergence of competitive business clusters encompassing several countries are signs that the possibilities for economic growth have been used to their utmost.

The most critical barriers to economic cooperation between Baltic Rim countries are listed in the adjacent table. In the following we will focus on the main means by which barriers can be eliminated or at least their negative effects reduced.

**Table 13. Critical Barriers to Cooperation between Baltic Rim Countries.**

| |
|---|
| * SHORTCOMINGS IN LEGISLATION AND ITS IMPLEMENTATION |
| * CRIMINAL ACTIVITY AND POOR ETHICS |
| * HOSTILE TREATMENT OF FOREIGN COMPANIES |
| * WEAKNESS OF TRANSITION ECONOMY COMPANIES |
| * LACK OR HIGH COST OF INVESTMENT FINANCING |
| * BARRIERS AGAINST TRANSPORT OF GOODS |
| * SHORTCOMINGS IN GOVERNMENTAL TREATIES |

## 6.2 Main Actions to Abolish Barriers

*Shortcomings in legislation and its implementation*

Uncertainty caused by shortcomings in legislation and its implementation is a significant risk factor from the standpoint of companies engaged in foreign trade. This phenomenon discourages, for example, the extension of trade credits. The level of trade is consequently lower. Its impact upon direct investment is even more dramatic. Companies would rather wait and enter an easier business environment.

Uncertainty can be eliminated via systematic legislative action. The aim should be to implement wide-ranging and permanent trade and business legislation that is as uniform as possible in different countries. A good law steers the activities of companies. It is simple, its economic impacts are known, and it is not in conflict with the laws of economics.

The efficient and fair implementation of laws is another means of eliminating the uncertainty of entrepreneurs. The responsibility for this lies with the courts and public officials dealing with companies. A knowledge of business and, on the other hand, the international exchange of officials' experiences and information facilitate the achievement of these goals.

From the standpoint of eliminating uncertainty, it would be important to take into consideration that foreign companies do not value special privileges, but rather want to ensure that even under difficult conditions foreign firms will be treated on par with domestic companies.

*Criminal activity and poor ethics*

Another serious barrier to trade and economic cooperation is criminal activity and poor ethics with respect to public officials as well as companies. The following of honest methods promotes business development because then the success hinges to a large extent upon the efficiency and quality of a companies' own activities. Criminal activity appears in the Baltic Rim area in the form of smuggling and illicit business activities.

Smuggling can be eliminated by setting tariffs and surcharges at an appropriate level. An appropriate level of tariffs and surcharges does not encourage smuggling and maximises state revenues. Also large differences in tariffs, taxes and other surcharges between countries should be eliminated, because they always create a motive for smuggling.

Smuggled goods often end up being sold illegally. Taxation that is deemed to be excessively high creates a motive for illicit business operations. Illegal business activities can be prevented by keeping taxation reasonable and by enlarging the tax base. This can be achieved by focusing tax auditing activities toward a larger group of companies, by developing accounting and other control systems and by training personnel. Modern competition regulations, consumer protection and environmental laws provide consumers and competitors operating in an honest fashion the means to force companies to run their business honestly. The laws ensuring social and pension security for employees and entrepreneurs can steer companies to play by the rules.

The bribing of officials can be reduced by giving instructions on uniform business practices, customer rights and safeguarding possibilities to make complaints. High enough wages for officials and, on the other hand, the inevitable loss of a job for offenders will raise the ethical standard. Both asking for a bribe or offering one must be made a punishable offence. Foreign companies that have been used to high ethical standards in their home country bear a special responsibility in promoting the observation of the ground rules of business ethics.

*Hostile treatment of foreign companies*

Foreign companies face greater difficulties in locating operations in a new country. This is either a question of directly discriminatory legislation or the prejudicial attitudes of officials. A subsequent problem may be the unequal treatment with respect to domestic companies. Part of the problem is due to the unfamiliar surroundings. Foreign companies are often liable to special monitoring by officials and subject to bribery requests.

In order to facilitate direct investment the legislation should give also foreign companies the right to own land. The permits needed when starting up a business, including related requirements and prices, should be made public ahead of time. Care must be made that those fulfilling the requirements receive permits immediately. In order to prevent arbitrary actions by officials there must be the possibility to appeal decisions. The granting of work permits to key foreign personnel of the company must be made as flexible as possible.

It is especially important to get the protective agreements applying to foreign companies such as most favoured nation in trade and national treatment status, investment protection, property rights etc. in force in all Baltic Rim countries.

In order to eliminate the initial difficulties in activities, foreign companies have to be treated in the same manner as domestic companies in taxation, control of business conditions, competitive bidding and the privatisation process. In order to safeguard healthy business activity, the government's regulative role, on the one hand, and its own possible business activities, on the other hand, must be separated and public monopolies dismantled. In the case of disputes, the fair treatment of foreign companies requires that the judicial decisions of different countries delineated in international agreements are adopted and followed without being watered down.

Foreign companies are always in an adverse position vis-à-vis domestic companies as they function in a foreign country under unfamiliar business conditions. This requires that when the target country draws up its own laws it should adhere to international practices as closely as possible. On the other hand, the companies' home country and the company itself must take care that they have sufficient support networks such as offices for commercial secretaries, connections with chambers of commerce and forums where the experiences of the company's domestic and foreign personnel can be exchanged.

*Weakness of transition economy companies*

The weaknesses of transition economies' companies is attributable to the different requirements of the former economic system and the still poor resources of new companies. Part of the problem stems from the fact that the states still want to retain a controlling grip over the companies or that they avoid taking responsibility completely for industrial policy because it seems like a step backward.

The transition economies need an industrial strategy, the main component of which is improving the operating environment of industry and business by creating preconditions for success. Competition must function as must the relationship of a customer and producer, which requires competition and consumer protection regulations but on the other hand also, for example, swift action by the government in privatisation and when necessary a client that is demanding and sets high performance goals. The government can also foster the formation of company networks. An especially important task is the renewal of production factors as a supplier of training and research as well as a risk-bearing financier of new companies or products.

The significant uses of the Tacis and Phare financing could be training of company personnel as well as development of new products and modes of production. Foreign companies also have an important role as a transferer of know-how as well as supplier of marketing channels and financing. The universities and research institutes must increase their international activities. An important barrier to the companies of transition economies is the lack of an export or import credit rating. Furthermore, there is an acute need to bring the insurance system of the transition economies up to par.

*Lack or high cost of investment financing*

The lack or high cost of investment financing is one of the worst problems of the transition economies of the Baltic Rim area. The lowering of a high nominal and real interest rate to companies' real level of production possibilities requires general stabilisation of the economy. Of key importance in this respect is bringing inflation under control as well as keeping the currency exchangeable even under difficult conditions and as stable as possible. One practical means of lowing interest rates is for the government to borrow in its own currency, thereby providing benchmark rates for other long-term credits and eventually efficient hedging possibilities via options and forward markets.

In order to improve financing possibilities, the bank system of the transition economies must be stabilised by requiring sufficient capital adequacy, portfolio dispersion, matching of bank funding and lending and by ensuring reasonable deposit protection for depositors. Bank inspection must be organised efficiently. In addition bank secrecy must be safeguarded. Banks should not be burdened with non-banking activities by forcing them to assume responsibility for tax inspection or monitoring of foreign currency movements. It would be important to get foreign banks to increase competition in the transition economies.

A key problem is the lack of assets that can be pledged as security to back loans. This would require rapid clarification of ownership rights and compiling of information into public registers. It is necessary to compile information on mortgages and pledges in the registers. At the same time, efficient legal means of collecting unpaid loans must be made by liquidation of the security pledged as collateral.

Companies can lower the cost of borrowed funds by making better project plans and developing project administration skills. Financing know-how must be emphasised as well as control systems and accounting activities in general.

*Barriers against transport of goods*

In order to facilitate a lowering of trade barriers, the customs practices of the Baltic Rim countries must be standardised. The countries of the region must ensure that various border stations and transporters can obtain comprehensive information regarding customs regulations and border crossings in advance.

The efficiency of border inspections should be further upgraded by adopting technology. Flexibility could be improved by segmented transport, use of reputable companies, standardisation of certificates and by shifting to use of spot checks. International cooperation can be increased by training and standardisation of documents as well as statistics. The efficiency of border stations and quality of activities could be upgraded by creating a benchmarking system, where transporters report the waiting times for passing through different border stations and difficulties in border crossings.

The possibilities for transit traffic will be improved by getting TIR-carnet to function well and by setting up TIR routes. In transit transport of bulk goods companies should be given the right to establish free warehouses and ensure that companies still get back the taxes paid on goods imported into the country when goods are exported from the country. A distinction must be made in the statistics on transit transport and other foreign trade in order to make controls more efficient.

Investments must be made to upgrade the efficiency of the transport infrastructure at the state level as well as in joint projects. The Baltic harbours must be changed to facilitate better two-way transport and the St. Petersburg harbours require investments to open bottlenecks. In the short run the efficiency of harbour activities can be improved by organising work. The Baltic and Russian railways are in sore need of maintenance investment. The electricity and other energy distribution networks must be linked with new distribution networks in order to facilitate increased international trade. Via Baltica should be developed and identified investments financed i.e. by EU sources according to agreed Paneuropean transport routes.

Competition between transport companies must be made more efficient by liberalising permit practices, standardising size and weight limits within certain transition periods and by dismantling state monopolies in railroad, air transport and harbour administration. At the same time transport and forwarding companies must develop their activities, expand from mere freight transport and customs assistance to logistics as a overall service and as a supplier of value added services for companies' distribution channels.

*Shortcomings of governmental treaties*

Several shortcomings in the set of treaties regarding economic cooperation and trade between the Baltic Rim countries can be singled out. The free trade agreements of the Baltic countries do not work in practice in such a fashion that they would form a real free trade zone. The bilateral agreements between the governments of the CEFTA countries are heterogeneous but culminate in the same end result. The set of Russian treaties with the Baltic countries and other CIS countries are still plagued by shortcomings. Furthermore, Russia has not made treaties with all of the Baltic Rim countries regarding the treatment of foreign companies and investments. The free trade agreements require bilateral coordination. The integration between the EU and transition economies can be affected by the protectionistic stance of the EU in agricultural trade.

In order to develop the trade in the Baltic Rim further trade agreements between Russia and the other Baltic Rim states are needed. It would ease exports to the CIS countries if Russia succeeded in its objective of making the CIS into a more homogeneous trade zone. The attractiveness of a free trade zone consisting of the Baltic countries and CEFTA would grow if they were able to harmonise customs regulations and tariff levels as well as hasten the timetable for eliminating tariffs and if the Baltic countries could also take agricultural products into the scope of agreements. After these reforms the Baltic free trade zone and CEFTA can merge in practice, which would facilitate the development of relations between the Baltic Rim area and the EU.

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# Appendix 1
# Export and Import Statistics of the Baltic Rim Countries in 1994

## Baltic Rim Countries' Exports to Baltic Rim Countries 1994, 1000 USD

According to Foreign Exchange Statistic of Exporting Country

| From>To | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic total |
|---|---|---|---|---|---|---|---|---|---|---|
| Russia | | 336 196 | 625 318 | 719 492 | 1 129 382 | 5 355 018 | 245 393 | 810 851 | 1 949 594 | **11 171 244** |
| Estonia | 301 129 | | 107 183 | 70 701 | 8 911 | 88 591 | 44 490 | 141 612 | 233 048 | **995 665** |
| Latvia | 272 474 | 25 127 | | 54 180 | 15 727 | 101 962 | 15 162 | 66 691 | 23 319 | **574 642** |
| Lithuania | 570 100 | 51 425 | 170 500 | | 101 275 | 231 600 | 35 100 | 62 850 | 19 375 | **1 242 225** |
| Poland | 934 588 | 14 430 | 45 243 | 113 313 | | 6 149 775 | 550 074 | 443 308 | 300 919 | **8 551 650** |
| Germany | 6 643 530 | 165 498 | 315 961 | 483 970 | 6 419 124 | | 7 802 309 | 9 499 686 | 3 336 354 | **34 666 432** |
| Denmark | 425 332 | 42 235 | 42 914 | 70 287 | 569 582 | 8 881 102 | | 4 131 709 | 949 942 | **15 113 103** |
| Sweden | 445 627 | 196 978 | 111 556 | 71 624 | 597 244 | 8 132 678 | 4 226 546 | | 2 920 011 | **16 702 263** |
| Finland | 1 537 091 | 647 361 | 152 467 | 78 704 | 488 359 | 3 958 679 | 1 012 225 | 3 224 957 | | **11 099 842** |
| Total | 11 129 871 | 1 479 250 | 1 571 141 | 1 662 271 | 9 329 603 | 32 899 404 | 13 931 299 | 18 381 664 | 9 732 562 | **100 117 067** |

## Baltic Rim Countries' Imports from Baltic Rim Countries 1994, 1000 USD

According to Foreign Exchange Statistic of Importing Country

| To<From | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic total |
|---|---|---|---|---|---|---|---|---|---|---|
| Russia | | 197 676 | 197 297 | 274 708 | 945 842 | 5 639 768 | 322 620 | 310 536 | 1 626 692 | **9 515 137** |
| Estonia | 279 109 | | 24 138 | 42 676 | 10 048 | 165 254 | 43 828 | 147 350 | 495 952 | **1 208 354** |
| Latvia | 287 276 | 42 716 | | 72 166 | 19 449 | 164 499 | 27 955 | 77 855 | 103 416 | **795 330** |
| Lithuania | 918 150 | 37 725 | 63 725 | | 93 875 | 321 925 | 60 825 | 55 625 | 68 250 | **1 620 100** |
| Poland | 1 453 098 | 8 537 | 8 133 | 78 571 | | 5 925 899 | 517 813 | 609 901 | 517 690 | **9 119 642** |
| Germany | 8 158 019 | 118 068 | 260 493 | 260 510 | 6 276 549 | | 6 812 456 | 8 692 067 | 4 338 207 | **34 916 369** |
| Denmark | 345 193 | 39 149 | 62 218 | 75 384 | 602 111 | 7 342 034 | | 3 911 085 | 1 044 537 | **13 421 711** |
| Sweden | 720 706 | 166 051 | 229 045 | 81 924 | 462 055 | 9 498 036 | 3 494 762 | | 3 240 944 | **17 893 524** |
| Finland | 2 047 951 | 215 761 | 31 048 | 24 379 | 296 534 | 3 395 400 | 702 163 | 2 407 603 | | **9 120 838** |
| Total | 14 209 501 | 825 682 | 876 097 | 910 318 | 8 706 463 | 32 452 815 | 11 982 421 | 16 212 021 | 11 435 687 | **97 611 006** |

## Differences in Baltic Rim Countries' Imports and Exports Statistics 1994, 1000 USD

Reported Exports - Reported Imports

| Importing | | | | | Exporting Countries | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Countries | Russia | Estonia | Latvia | Lithuania | Poland | Germany | Denmark | Sweden | Finland | Baltic total |
| Russia | | 103 453 | 75 178 | 295 392 | -11 254 | 1 003 762 | 102 712 | 135 091 | -89 601 | **1 614 734** |
| Estonia | 57 088 | | 988 | 8 749 | 4 382 | 244 | -1 592 | 49 628 | 151 409 | **270 896** |
| Latvia | 338 042 | 64 467 | | 98 334 | 25 794 | 151 462 | 14 960 | 33 701 | 49 051 | **775 811** |
| Lithuania | -198 658 | 32 976 | -9 545 | | 19 438 | 162 045 | 9 462 | 15 999 | 10 454 | **42 171** |
| Poland | -323 716 | 374 | 7 594 | 22 704 | | 493 225 | 51 769 | -12 657 | -29 331 | **209 961** |
| Germany | -2 803 001 | -29 477 | -158 531 | -28 910 | -126 774 | | 2 068 646 | -559 389 | -379 528 | **-2 016 965** |
| Denmark | -99 800 | 5 341 | -47 056 | -40 284 | -52 037 | 460 275 | | 315 461 | -32 312 | **509 588** |
| Sweden | 90 145 | -24 439 | -162 354 | -19 074 | -18 747 | 1 650 | 636 947 | | -15 987 | **488 140** |
| Finland | -98 357 | 17 288 | -7 728 | -5 004 | 4 385 | -59 046 | 247 778 | 512 408 | | **611 724** |
| Total | -3 038 257 | 169 983 | -301 455 | 331 907 | -154 813 | 2 213 617 | 3 130 682 | 490 242 | -335 846 | **2 506 061** |

## Appendix 2

## Possible Reasons for Discrepancies in Import and Export Statistics, an Alternative View

A slight discrepancy in figures is due to currency conversation. The exchange rate valid on the day when an export or import operation was carried out, but not the annual exchange rate is used to estimate export and import volumes by countries.

There are other reasons for these differences:
- different customs clearance and declaration procedures
- different commodities statement methods (one countries using general trade account system, the other - a specific one)
- due to FOB prices used in exports and CIF prices in imports (the CIF price can exceed the FOB value by 5 - 15 per cent)
- due to recalculation of the currency of one country into that of another country.

Significant differences are related with erroneous indication of origin of the country or consignee. The commodities are delivered to a country other than the one indicated in the declaration. Even in the case of export estimation by the consignor country there is no guarantee that all goods declared to Lithuania will arrive there. Very often the company deliveres one large cargo to Lithuania where it is being redistributed, leaving some part of it in Lithuania, while the rest of commodities are immediately exported to the neighbouring countries.

There are subjective reasons for an increase in these differences, i.e. mistakes in declarations, insufficient data control, smuggling.

Therefore, to provide as complete and reliable information as possible the (Lithuanian) Department of Statistics envisages the following means to improve the foreign trade statistics:
- to provide statistical information related to all aspects of foreign trade in compliance with methodological practices of Eurostat.
- to seek sustainable updating of foreign trade statistics methodology
- to strengthen data base control
- to maintain relations with other Baltic states, Estonian and Latvian Statistics services in particular, to agree on methodology issues, and to issue common publications as well
- to closely cooperate with the Lithuanian Customs Department, the customs and statistics institutions of other countries and Eurostat.

While speaking of smuggling, it should be stressed that the cross-border police has very poor equipment. The border posts are not computerised, so it is impossible to get information quickly, for example, on stolen cars. Making use of insufficient border protection, the cargo is delivered in a roundabout way in avoidance of border control posts and which lack technical capacities to control this.

***Source:*** *Comments of the Director of International Economic Relations Strategy Department, Lithuanian Ministry of Trade and Industry, A. Kantauskas.*

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